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

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**FORM 20-F**

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(Mark One)

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

☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2007

OR

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

OR

☐ SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report

For the transition period from to

Commission file number: 000-30666

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**NETEASE.COM, INC.**

(Exact name of Registrant as specified in its charter)

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N/A

(Translation of Registrant's name into English)

**Cayman Islands**

(Jurisdiction of incorporation or organization)

**26/F, SP Tower D****Tsinghua Science Park Building 8****No. 1 Zhongguancun East Road, Haidian District****Beijing 100084, People's Republic of China**

(Address of principal executive offices)

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**Onward Choi**

**26/F, SP Tower D****Tsinghua Science Park Building 8****No. 1 Zhongguancun East Road, Haidian District****Beijing 100084, People's Republic of China****Phone (86 10) 8255-8163****Facsimile (86 10) 8261-7072**

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

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

**NONE****Securities registered or to be registered pursuant to Section 12(g) of the Act.****Name of each exchange and Title of each class on which registered :****American Depositary Shares, each representing 25 ordinary shares, par value US\$0.0001 per share, NASDAQ Global****Select Market**

(Title of Class)

**Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.****NONE**

(Title of Class)

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Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:  
3,036,270,590 ordinary shares, par value US\$0.0001 per share.

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer ☒

Accelerated Filer ☐

Non-Accelerated Filer ☐

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

U.S. GAAP ☒

International Financial Reporting Standards as issued by the International Accounting Standards Board ☐

Other ☐

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

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

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## INTRODUCTION

This annual report on Form 20-F includes our audited consolidated financial statements as of December 31, 2006 and 2007, and for the years ended December 31, 2005, 2006 and 2007.

### Forward-Looking Information

This annual report on Form 20-F contains statements of a forward-looking nature. These statements are made under the “safe harbor” provisions of the U.S. Private Securities Litigation Reform Act of 1995. You can identify these forward-looking statements by terminology such as “will,” “expects,” “anticipates,” “future,” “intends,” “plans,” “believes,” “estimates” and similar statements. The accuracy of these statements may be impacted by a number of business risks and uncertainties that could cause actual results to differ materially from those projected or anticipated, including risks related to:

- the risk that the online game market will not continue to grow or that we will not be able to maintain our leading position in that market, which could occur if, for example, our new online games do not become as popular as management anticipates;
- the risk of changes in Chinese government regulation of the online game market that limit future growth of our revenue or causes revenue to decline;
- the risk that we may not be able to continuously develop new and creative online services or that we will not be able to set, or follow in a timely manner, trends in the market;
- the risk that the Internet advertising market in China will not continue to grow and will remain subject to intense competition;
- the risk that we will not be able to control our expenses in future periods;
- the impact of any future public health problem in China, including avian influenza or severe acute respiratory syndrome, or SARS;
- governmental uncertainties (including possible changes in the effective tax rates applicable to NetEase and its subsidiaries and affiliates), general competition and price pressures in the marketplace;
- the risk that fluctuations in the value of the Renminbi with respect to other currencies could adversely affect our business and financial results;
- the risk that current or future appointees to management are not effective in their respective positions; and
- other risks outlined in our filings with the Securities and Exchange Commission.

We do not undertake any obligation to update this forward-looking information, except as required under applicable law.

[Table of Contents](#)**PART I****Item 1. Identity of Directors, Senior Management and Advisers**

Not Applicable.

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

Not Applicable.

**Item 3. Key Information****A. Selected Financial Data**

The following table presents the selected consolidated financial information for our business. You should read the following information in conjunction with Item 5 “Operating and Financial Review and Prospects” below. The following data for the years ended December 31, 2005, 2006 and 2007 and as of December 31, 2006 and 2007 have been derived from our audited consolidated financial statements for those years, which were prepared in accordance with United States generally accepted accounting principles, or U.S. GAAP, and should be read in conjunction with those statements, which are included in this annual report beginning on page F-1. The following data for the years ended December 31, 2003 and 2004 and as of December 31, 2003, 2004 and 2005 has also been derived from our audited consolidated financial statements for those years, which were prepared in accordance with U.S. GAAP and are not included in this annual report.

|  | For the Year Ended December 31,              |               |               |               |               |               |
|--|--|---------------|---------------|---------------|---------------|---------------|
|  | 2003   | 2004          | 2005          | 2006          | 2007          | 2007          |
|  | RMB  | RMB           | RMB           | RMB           | RMB           | US\$ (Note 1) |
|  | (except per ordinary share and per ADS data) |               |               |               |               |               |
| <b>Statement of Operations Data:</b>                                     |  |               |               |               |               |               |
| Revenues (Note 2):   |  |               |               |               |               |               |
| Online game services   | 203,246,114                                  | 628,936,223   | 1,379,475,803 | 1,856,062,971 | 1,932,634,947 | 264,940,497   |
| Advertising services   | 86,183,733                                   | 171,054,305   | 241,200,444   | 285,772,653   | 305,057,556   | 41,819,641    |
| Wireless value-added services and others                                 | 279,659,170                                  | 158,310,317   | 73,742,136    | 75,406,121    | 68,018,461    | 9,324,495     |
| Total revenues   | 569,089,017                                  | 958,300,845   | 1,694,418,383 | 2,217,241,745 | 2,305,710,964 | 316,084,633   |
| Business tax (Note 2)  | (26,954,502)                                 | (54,703,018)  | (82,054,902)  | (52,882,275)  | (92,424,200)  | (12,670,222)  |
| Net revenues   | 542,134,515                                  | 903,597,827   | 1,612,363,481 | 2,164,359,470 | 2,213,286,764 | 303,414,411   |
| Cost of revenues (Note 2):   |  |               |               |               |               |               |
| Online game services   | (20,873,502)                                 | (74,629,515)  | (137,301,493) | (178,676,915) | (187,411,229) | (25,691,776)  |
| Advertising services   | (27,623,438)                                 | (54,056,435)  | (78,589,395)  | (125,183,293) | (143,676,057) | (19,696,221)  |
| Wireless value-added services and others                                 | (36,965,777)                                 | (55,117,445)  | (59,346,085)  | (77,437,973)  | (84,365,760)  | (11,565,509)  |
| Total cost of revenues   | (85,462,717)                                 | (183,803,395) | (275,236,973) | (381,298,181) | (415,453,046) | (56,953,506)  |
| Gross profit   | 456,671,798                                  | 719,794,432   | 1,337,126,508 | 1,783,061,289 | 1,797,833,718 | 246,460,905   |
| Operating expenses:  |  |               |               |               |               |               |
| Selling and marketing expenses   | (43,135,804)                                 | (152,842,334) | (152,192,422) | (170,142,691) | (235,318,304) | (32,259,247)  |
| General and administrative expenses                                      | (67,634,599)                                 | (101,631,070) | (117,942,605) | (179,879,602) | (176,178,740) | (24,151,940)  |
| Research and development expenses  | (19,120,827)                                 | (34,362,806)  | (90,170,092)  | (153,162,158) | (180,734,713) | (24,776,508)  |
| Insurance claims settlement for the now- settled class action litigation | —  | 16,553,200    | —             | —             | —             | —             |
| Total operating expenses   | (129,891,230)                                | (272,283,010) | (360,305,119) | (503,184,451) | (592,231,757) | (81,187,695)  |
| Operating profit   | 326,780,568                                  | 447,511,422   | 976,821,389   | 1,279,876,838 | 1,205,601,961 | 165,273,210   |
| Other income (expenses):   |  |               |               |               |               |               |
| Investment income  | 538,278                                      | 3,522,169     | 1,301,975     | 340,721       | 474,446       | 65,041        |
| Interest income  | 11,273,685                                   | 22,333,511    | 58,070,148    | 94,364,852    | 112,599,994   | 15,436,075    |
| Interest expenses  | —  | (3,877,129)   | (344,859)     | —             | —             | —             |
| Exchange loss  | —  | —             | (8,360,834)   | (958,435)     | (50,891,094)  | (6,976,543)   |

|  | For the Year Ended December 31,              |               |                 |                 |               |               |
|--|--|---------------|-----------------|-----------------|---------------|---------------|
|  | 2003   | 2004          | 2005            | 2006            | 2007          | 2007          |
|  | RMB  | RMB           | RMB             | RMB             | RMB           | US\$ (Note 1) |
|  | (except per ordinary share and per ADS data) |               |                 |                 |               |               |
| Other, net   | 5,410,171                                    | 507,428       | (540,628)       | 1,239,105       | (1,084,240)   | (148,636)     |
| Profit before tax  | 344,002,702                                  | 469,997,401   | 1,026,947,191   | 1,374,863,081   | 1,266,701,067 | 173,649,147   |
| Income tax benefit (expense)                                     | (21,129,978)                                 | (28,576,719)  | (94,957,022)    | (132,485,543)   | (2,689,309)   | (368,671)     |
| Profit after tax   | 322,872,724                                  | 441,420,682   | 931,990,169     | 1,242,377,538   | 1,264,011,758 | 173,280,476   |
| Minority interests   | —  | —             | —               | 400,046         | 74,364        | 10,194        |
| Net profit   | 322,872,724                                  | 441,420,682   | 931,990,169     | 1,242,777,584   | 1,264,086,122 | 173,290,670   |
| Unrealized gains on investments                                  | —  | —             | —               | —               | 1,332,300     | 182,642       |
| Comprehensive Income   | 322,872,724                                  | 441,420,682   | 931,990,169     | 1,242,777,584   | 1,265,418,422 | 173,473,312   |
| Net earnings per ordinary share, basic                           | 0.10   | 0.14          | 0.29            | 0.38            | 0.41          | 0.06          |
| Net earnings per ordinary share, diluted                         | 0.10   | 0.13          | 0.26            | 0.36            | 0.38          | 0.05          |
| Net earnings per ADS, basic (Note 3)                             | 2.59   | 3.49          | 7.22            | 9.61            | 10.24         | 1.40          |
| Net earnings per ADS, diluted (Note 3)                           | 2.43   | 3.24          | 6.59            | 8.91            | 9.55          | 1.31          |
| Weighted average number of shares Outstanding, basic             | 3,122,257,952                                | 3,157,841,781 | 3,225,684,510   | 3,231,832,008   | 3,086,451,412 | 3,086,451,412 |
| Weighted average number of ADSs Outstanding, basic<br>(Note 3)   | 124,890,318                                  | 126,313,671   | 129,027,380     | 129,273,280     | 123,458,056   | 123,458,056   |
| Weighted average number of shares Outstanding, diluted           | 3,353,659,329                                | 3,491,430,437 | 3,565,412,019   | 3,498,405,110   | 3,307,538,379 | 3,307,538,379 |
| Weighted average number of ADSs Outstanding, diluted<br>(Note 3) | 134,146,373                                  | 139,657,217   | 142,616,481     | 139,936,204     | 132,301,535   | 132,301,535   |
| Share compensation cost included in:                             |  |               |                 |                 |               |               |
| Cost of revenues   | —  | —             | —               | (16,614,309)    | (14,890,378)  | (2,041,288)   |
| Selling and marketing expenses                                   | —  | —             | —               | (21,147,343)    | (14,357,336)  | (1,968,214)   |
| General and administrative expenses                              | (151,166)                                    | (55,340)      | (13,835)        | (37,360,433)    | (33,887,323)  | (4,645,535)   |
| Research and development expenses                                | (88,236)                                     | —             | —               | (26,164,591)    | (32,293,138)  | (4,426,992)   |
|  | (239,402)                                    | (55,340)      | (13,835)        | (101,286,676)   | (95,428,175)  | (13,082,029)  |
| <b>Other Financial Data:</b>                                     |  |               |                 |                 |               |               |
| Capital expenditures   | (27,824,900)                                 | (60,142,252)  | (92,608,975)    | (142,513,502)   | (71,515,551)  | (9,803,903)   |
| Net cash provided by (used in):                                  |  |               |                 |                 |               |               |
| Operating activities   | 373,722,606                                  | 614,153,858   | 1,104,789,431   | 1,596,108,793   | 1,379,902,442 | 189,167,665   |
| Investing activities   | (360,283,078)                                | 105,834,484   | (1,618,749,356) | (1,218,242,458) | 952,298,424   | 130,548,408   |
| Financing activities   | 781,370,072                                  | 32,043,212    | 105,497,366     | (829,055,812)   | (960,409,501) | (131,660,338) |

| Balance Sheet Data:                   |               |               |               |               |               |             |
|---------------------------------------|---------------|---------------|---------------|---------------|---------------|-------------|
| Cash                                  | 1,356,069,544 | 2,123,891,537 | 1,685,744,081 | 1,206,476,526 | 2,482,820,821 | 340,364,218 |
| Property, equipment and software, net | 40,410,264    | 77,303,013    | 126,341,533   | 224,207,833   | 183,471,666   | 25,151,710  |
| Total assets                          | 1,786,692,092 | 2,450,140,398 | 3,624,985,519 | 4,373,707,830 | 4,685,659,381 | 642,346,309 |
| Total current liabilities             | 77,766,228    | 257,495,300   | 415,479,050   | 676,408,475   | 1,276,825,952 | 175,037,144 |
| Total long-term liabilities           | 827,901,449   | 839,399,578   | 818,413,108   | 791,631,174   | 10,200,000    | 1,398,295   |
| Working capital (Note 4)              | 1,654,998,363 | 2,108,955,067 | 3,081,823,774 | 3,452,777,455 | 3,159,467,168 | 433,124,116 |
| Total shareholders' equity            | 881,024,415   | 1,353,245,520 | 2,391,093,361 | 2,905,668,181 | 3,398,425,631 | 465,882,383 |

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- Note 2: We adopted the provisions of FIN 46 and consolidated our variable interest entities, or VIEs, Guangzhou NetEase Computer System Co., Ltd., or Guangzhou NetEase, Beijing Guangyitong Advertising Co. Ltd., or Guangyitong Advertising, and Guangzhou Ling Yi Electronics Technology Limited, or Ling Yi, on a prospective basis in our consolidated financial statements since January 1, 2004 in the case of Guangzhou NetEase and Guangyitong Advertising and since May 2004 in the case of Ling Yi until its dissolution in August 2007. Our company and our subsidiaries are effectively providing our services to the final customers via the VIEs in order to comply with the current Chinese regulatory requirements. Under the series of agreements entered with the VIEs, substantially all of the revenue of the VIEs, net of the applicable business tax payable by the VIEs, are passed to us and our subsidiaries in the form of technology and consulting service revenues. Prior to the consolidation of the VIEs in accordance with FIN 46, revenues in our company's financial statements represented revenues received by us and our subsidiaries from Guangzhou NetEase and Guangyitong Advertising, net of applicable business tax payable by these entities. The business tax presented in our financial statements represented business tax payable by us and our subsidiaries on our technology and consulting service revenues received from Guangzhou NetEase and Guangyitong Advertising. After the consolidation of the VIEs in accordance with FIN 46, revenues in our financial statements represent revenues generated from the final customers by the VIEs, before deducting any applicable business tax payable by the VIEs which is now presented under a separate line item after revenues. The business tax payable by us and our subsidiaries on intra-group revenues from the VIEs is recorded under cost of revenue as it is considered a cost in providing the services by the consolidated group.
- Note 3: Effective from March 27, 2006, the Company changed its ADS to ordinary share ratio from one ADS for every 100 ordinary shares to one ADS for every 25 ordinary shares. Therefore, the basic and diluted earnings per ADS as well as the basic and diluted weighted average number of ADS outstanding for the three years ended December 31, 2003, 2004 and 2005 have been retroactively restated.
- Note 4: Working capital represents total current assets less total current liabilities.

## **Exchange Rate Information**

We have published our financial statements in Renminbi, or RMB. Our business is currently conducted in and from China in Renminbi. In this annual report, all references to Renminbi and RMB are to the legal currency of China and all references to U.S. dollars, dollars, \$ and US\$ are to the legal currency of the United States. The conversion of Renminbi into U.S. dollars in this annual report is based on the noon buying rate in The City of New York for cable transfers of Renminbi as certified for customs purposes by the Federal Reserve Bank of New York. For your convenience, this annual report contains translations of some Renminbi or U.S. dollar amounts for 2007 at US\$1.00: RMB7.2946, which was the prevailing rate on December 31, 2007. The prevailing rate at June 19, 2008 was US\$1.00: RMB6.8770. We make no representation that any Renminbi or U.S. dollar amounts could have been, or could be, converted into U.S. dollars or Renminbi, as the case may be, at any particular rate, the rates stated below, or at all. The Chinese government imposes control over its foreign currency reserves in part through direct regulation of the conversion of Renminbi into foreign exchange and through restrictions on foreign trade.

The following table sets forth the average buying rate for Renminbi expressed as per one U.S. dollar for the years 2003, 2004, 2005, 2006 and 2007.

| <u>Year</u> | <u>Renminbi Average<sup>(1)</sup></u> |
|-------------|---------------------------------------|
| 2003        | 8.2771                                |
| 2004        | 8.2768                                |
| 2005        | 8.1826                                |
| 2006        | 7.9579                                |
| 2007        | 7.5806                                |

(1) Determined by averaging the rates on the last business day of each month during the relevant period.

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The following table sets forth the high and low exchange rates for Renminbi expressed as per one U.S. dollar during the past six months.

| <u>Month Ended</u> | <u>High</u> | <u>Low</u> |
|--------------------|-------------|------------|
| December 31, 2007  | 7.4120      | 7.2946     |
| January 31, 2008   | 7.2946      | 7.1818     |
| February 29, 2008  | 7.1973      | 7.1100     |
| March 31, 2008     | 7.1110      | 7.0105     |
| April 30, 2008     | 7.0185      | 6.9840     |
| May 31, 2008       | 7.0000      | 6.9377     |

**B. Capitalization and Indebtedness**

Not Applicable.

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

Not Applicable.

**D. Risk Factors****RISKS RELATED TO OUR COMPANY****Our business model continues to change and our prospects may be difficult to evaluate based on historical performance.**

Commencing with the launch of the NetEase websites in 1999 until 2001, the majority of our revenues came from online advertising. In 2001, we began focusing on wireless value-added services and, to a lesser extent other fee-based premium services, which grew to account for 69.4% of total revenues in 2002 but declined each year thereafter to 3.0% of total net revenues in 2007. More recently, we have devoted significant resources to our online games business, which, in turn, grew to account for 35.7% of our total revenues in 2003 and 65.8%, 81.9%, 84.6% and 84.4% of our total net revenues in 2004, 2005, 2006 and 2007, respectively. The evolution of our business focus over the past few years from solely operating the NetEase websites and selling online advertisements to providing wireless value-added and other fee-based premium services to developing and distributing online games could make it difficult for you to evaluate our future performance based on historical results. We cannot assure you that we will be able to increase or maintain our revenues from online games or any other services.

**Our business depends to a significant extent on two online games, which accounted for 81.9%, 84.6% and 81.4% of our total net revenues in 2005, 2006 and 2007, respectively. We may not be able to maintain the popularity of these games for a variety of reasons.**

Two of our in-house developed massively multi-player online role-playing games, known as MMORPGs, Westward Journey Online II (which was commercially launched in August 2002) and Fantasy Westward Journey (which was commercially launched in January 2004), contributed 81.9%, 84.6% and 81.4% of our total net revenues in 2005, 2006 and 2007, respectively. We expect that we will need to continually introduce new versions or substantive upgrades of these and our other online games on a frequent basis to maintain their popularity, although changes in users' tastes or in the overall market for online games in China could alter the anticipated life cycle of each version or upgrade or even cause our users to stop playing our games altogether. In September 2007, we commercially launched Westward Journey Online III, which is an enhanced version of Westward Journey Online II. Because of the limited history of the online games market in China, we cannot at this time estimate the total life cycle of any of our games. If we are unable to maintain the popularity of our existing online games or are unable to introduce new online games which are popular with online game users in China (as discussed in the next risk factor), our business and results of operations could be materially and adversely affected.



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### **If we fail to develop and introduce new online games timely and successfully, we will not be able to compete effectively and our ability to generate revenues will suffer.**

We operate in a highly competitive, quickly changing environment, and our future success depends not only on the popularity of our existing online games but also on our ability to develop and introduce new games that our customers and users choose to buy. If we are unsuccessful at developing and introducing new online games that are appealing to users with acceptable prices and terms, our business and operating results will be negatively impacted because we would not be able to compete effectively and our ability to generate revenues would suffer. The development of new games can be very difficult and requires high levels of innovation.

New technologies in online game programming or operations could render our current online titles or other online games that we develop in the future obsolete or unattractive to our subscribers, thereby limiting our ability to recover development costs and potentially adversely affecting our future revenues and profitability. In particular, the online game industry in China is transitioning from 2D to 3D games, with numerous new 3D game titles being launched in the market in recent years. In response to this trend, we have been devoting additional resources to developing or licensing 3D games and software components for such games, and we cannot assure you that such games will be successful. In particular, we have been devoting a significant portion of our research and development efforts to develop new games including fee-based and item-based games. Datang, our first 2.5D game, was commercially launched in July 2006, Westward Journey Online III, an enhanced version of our popular Westward Journey game series, was commercially launched in September 2007, and the open beta version of Tianxia II, our first item-based game, was launched in June 2008. We also have other new games currently in development such as Datang II. Both Tianxia II and Datang II have been in development for a significant period of time, in particular Tianxia II which was altered following unsatisfactory results from the initial beta testing in 2007. This development involves significant cost, and we are not able to predict if or when we will commercially launch any of our new games and whether such games will ultimately become popular.

In addition, we are required to devote significant resources to the ongoing operations of our online games, such as staff costs related to our “Games Masters” which supervise the activities within our games. If we fail to anticipate our users’ needs and technological trends accurately or are otherwise unable to complete the development of games in a timely fashion, we will be unable to introduce new games into the market to successfully compete.

The demand for new games is difficult to forecast, in part due to the relative immaturity of the market and relatively short life cycles of Internet-based technologies. As we introduce and support additional games and as competition in the market for our games intensifies, we expect that it will become more difficult to forecast demand. In particular, competition in the online game market is growing as more and more online games are introduced by existing and new market participants.

### **Substantially all of our online game revenues have been generated by games that use the pay-to-play revenue model, and we may be unable to effectively address ongoing or future market trends regarding new revenue models for online games in China.**

Except for our casual games which have contributed an insignificant amount of our revenue since their launch in 2005, substantially all of our online game revenues have been generated by games that use the pay-to-play revenue model whereby players purchase our prepaid point cards to pay for playing time. A number of our competitors have been transitioning to an item-based revenue model where end users are able to play the basic functions of the online games for free and may choose to purchase in-game value-added services, including certain in-game items and premium features, which enhance the game experience. Currently, we are developing games that use the item-based revenue model and the open beta testing version of our first item-based online game, Tianxia II, was launched in June 2008, but we cannot be certain that Tianxia II and our future item-based online games will be popular or generate the revenue our management expects. Moreover, it is possible that users of our existing pay-to-play games find that the item-based games offered by our competitors provide a more

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enjoyable gaming experience in which case the popularity of our existing games could be materially adversely affected. If there is an overall shift in the online game market in China to an item-based or another revenue model, we may be unable to launch new games or new versions of existing games which effectively use such model in a timely manner or at all, and we may be required to make significant research and development and selling and marketing expenditures to develop and promote such games.

### **Reports of violence and theft related to online games may result in bad publicity or governmental response that could have a material and adverse impact on our business.**

The media in China has reported incidents of violent crimes allegedly inspired by online games and theft of virtual items between users in online games. While we believe that such events were not related to our online games, it is possible that our reputation, as one of the leading online game providers in China, could be adversely affected by such behavior. In response to the media reports, in August 2005, the Chinese government enacted new regulations to prohibit all minors under the age of 18 from playing online games in which players are allowed to kill other players, an activity that has been termed Player Kills, or PK. The Chinese government has also taken steps to limit online game playing time for all minors under the age of 18. See below “—Risks Related to the Telecommunications and Internet Industries in China—The Chinese government has taken steps to limit online game playing time for all minors. These and any other new restrictions may materially and adversely impact our business and results of operations.” If the Chinese government should determine that online games have a negative impact on society, it may impose certain restrictions on the online game industry, which could in turn have a material and adverse effect on our business and results of operations.

### **Acts of cheating by users of online games could lessen the popularity of our online games, adversely affect our reputation and our results of operations.**

There have been a number of incidents where users, through a variety of methods, were able to modify the rules of our online games, particularly the online game we licensed from a third party. Although these users did not gain unauthorized access to our systems, they were able to modify the rules of our online games during game play in a manner that allowed them to cheat and disadvantage our other online game users which often has the effect of causing players to stop using the game and shortening the game's lifecycle. At one point, cheating by some of our online game users led to a decrease in the number of users of our licensed online game *PristonTale*, which we stopped charging for in August 2004 and stopped operating in May 2005. Although we have taken a number of steps to deter our users from engaging in cheating when playing our online games, we cannot assure you that we or the third parties from whom we license some of our online games will be successful or timely in taking corrective steps necessary to prevent users from modifying the terms of our online games.

### **Illegal game servers could harm our business and reputation and materially and adversely affect our results of operations.**

Several of our competitors have reported that some Internet cafés have installed illegal copies of such competitors' games on the cafés' servers and let their customers play such games on illegal servers without paying for the game playing time. While we already have in place numerous internal control measures to protect the source codes of our games from being stolen and to address illegal server usage and, to date, our games have not experienced such usage, our preventive measures may not be effective. The misappropriation of our game server installation software and installation of illegal game servers could harm our business and reputation and materially and adversely affect our results of operations.

### **Efforts to supervise the operation of our online games and portal may expose us to potential claims by our users.**

In our daily supervision of the operation of our online games and portal or during the investigation of users' complaints, we may take actions to regulate the behavior of our users. For example, if we suspect a player of installing cheating program on our online games, we may freeze his game account or even ban the player from

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logging on to our games and portal. Such regulatory activities are essential to maintain a fair playing environment for our users. However, if any of our regulatory activities are found to be wrongly implemented, our users may institute legal proceedings against us for damages or claims. Our operation, business and financial performance may be materially and adversely affected as a result.

**We depend upon multiple printing companies and distributors to produce and deliver our prepaid point cards to the various points of sale. If such parties mishandle our cards or the related passcodes, our reputation and results of operations could be materially and adversely affected.**

We appoint multiple printers and distributors throughout China to produce and deliver our prepaid point cards to the various points of sale. We generally have cards produced by individual printers in batches of thousands, or ten of thousands, of cards, with each card having an individual passcode which enables the purchaser to deposit the points on the card into their online user account to pay for game playing time or our other fee-based services. In addition, before the cards are purchased by users of the NetEase websites, we activate them on our internal systems.

In one instance in 2005, one of our printers created unauthorized duplicate batches of our cards with the same passcodes as the cards which we ordered. Because our internal system only allows a passcode for a particular card to be used once, a small number of customers were not able to use their cards because the passcode for the duplicate card had already been used. Although this incident had no material impact on our business or financial results, we have enhanced our efforts to ensure that our cards are produced and distributed in accordance with our instructions. In particular, we have focused our customer service team on quickly responding to customer complaints regarding our cards, both to maintain our reputation in the market and to identify any issues which may indicate a potential problem with a printer or distributor. We are also highly selective in our choice of such parties, and have begun activating our cards on our internal system as close as possible to the purchase of such cards by the end-user to prevent any duplicate cards. If, however, these efforts are unsuccessful and our printers or distributors mishandle our cards or the related passcodes, our reputation and results of operations could be materially and adversely affected.

**We expect that a portion of our future revenues will continue to come from our advertising services, which represented approximately 12.6% of our total net revenues for 2007, but we may not be able to compete effectively in this market because it is relatively new and intensely competitive, in which case our ability to generate and maintain advertising revenue in the future could be adversely affected.**

Although we anticipate that the revenues generated by our online games will continue to constitute the major portion of our future revenues, we believe that we will continue to rely on advertising revenues as one of our primary revenue sources for the foreseeable future. Online advertising in China is still relatively new and many of our current and potential advertisers have limited experience with the Internet as an advertising medium, have not traditionally devoted a significant portion of their advertising expenditures or other available funds to Web-based advertising, and may not find the Internet to be effective for promoting their products and services relative to traditional print and broadcast media. Our ability to generate and maintain significant advertising revenue will depend on a number of factors, many of which are beyond our control, including:

- the development of a large base of users possessing demographic characteristics attractive to advertisers;
- the development of software that blocks Internet advertisements before they appear on a user's screen;
- downward pressure on online advertising prices; and
- the effectiveness of our advertising delivery and tracking system.

Changes in government policy could also restrict or curtail our online advertising services. For example, as a result of the enactment of a series of regulations, administrative instructions and policies by the PRC government to restrict online medical advertising since July 2006, we stopped carrying advertisements from

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clients in this industry. Moreover, the acceptance of the Internet as a medium for advertising depends on the development of a measurement standard. No standards have been widely accepted for the measurement of the effectiveness of online advertising. Industry-wide standards may not develop sufficiently to support the Internet as an effective advertising medium. If these standards do not develop, advertisers may choose not to advertise on the Internet in general or through our portals or search engines.

In addition, the competition in the online advertising industry in China has intensified since Baidu.com, Inc., or Baidu, Tencent Inc., or Tencent, and Alibaba.com Limited, or Alibaba and other vertical Internet portals came into the market. The entry of additional, highly competitive Internet companies, whether domestic or international companies, into the Chinese market would further heighten competition for advertising spending in China.

If the Internet does not become more widely accepted as a medium for advertising, our ability to generate increased revenue will be negatively affected.

**Currently, we depend on the contractual relationships of Guangzhou NetEase Computer System Co., Ltd., or Guangzhou NetEase, with the two principal mobile phone companies in China at the national, provincial and local level for substantially all of our wireless value-added services revenues and the alteration or termination of these relationships could adversely impact our business.**

Our wireless value-added services are conducted in conjunction with the two principal mobile phone companies in China, China Mobile and China Unicom, which together service the major portion of China's mobile phone subscribers. We rely on the national, provincial and local affiliates of these two companies to deliver substantially all of our wireless value-added services. We also offer certain of these services through China Netcom's limited mobility regional mobile phone networks, but such services have contributed an insignificant amount of our wireless value-added services revenue to date. If our various contracts with either China Mobile or China Unicom are terminated or scaled-back, it may be difficult, if not impossible, to find appropriate replacement partners with the requisite licenses and permits, infrastructure and customer base to offer these services, which could adversely affect our business.

Our wireless value-added services are provided through a number of contracts with the provincial and local affiliates of China Mobile and with China Unicom, and each of these contracts is non-exclusive and of a limited term (generally six months to two years). These contracts may also be terminated in advance under certain circumstances. We cannot be certain that we will be able to renew these contracts as necessary or enter into new arrangements with these or other affiliates of China Mobile and China Unicom. We may also be compelled to amend or renew our arrangements with these mobile phone operators in ways which adversely affect our business.

In the event Guangzhou NetEase's relationships with either China Mobile or China Unicom are adversely altered or terminated, our revenue would likely be adversely affected and we may be unable to find alternatives that would replace such networks and revenue.

**We experienced a decline in the rate of growth of our online games which appears to be a result of the outbreak of severe acute respiratory syndrome, or SARS, in 2003 and any recurrence of SARS, an outbreak of the H5N1 strain of bird flu (avian influenza) or another widespread public health problem could further adversely affect our business and results of operations.**

During April and May 2003, we experienced a decline in the rate of growth of our online game services which we believe resulted from the closure of Internet cafés in Beijing and elsewhere to prevent the spread of SARS. Many users of our online game services can only access those services at Internet cafés. A renewed outbreak of SARS or another widespread public health problem in China where virtually all of our revenue is derived and in Beijing, Shanghai, Guangzhou and Hangzhou where most of our employees are located could have a negative effect on our operations.

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In addition, there has been confirmed human cases of avian influenza in PRC, Vietnam, Iraq, Thailand, Indonesia, Turkey, Cambodia and other countries which have proven fatal in some instances. If such an outbreak or any other similar epidemic were to spread in the PRC, where our operations are located, it may adversely affect our business and operating results.

Our operations may be impacted by a number of health-related factors, including, among other things:

- quarantines or closures of some of our offices which would severely disrupt our operations;
- the sickness or death of our key officers and employees;
- closure of Internet cafés and other public areas where people access the Internet; and
- a general slowdown in the Chinese economy.

Any of the foregoing events or other unforeseen consequences of public health problems could adversely affect our business and results of operations.

### **The success of our business is dependent on our ability to retain our existing key employees and to add and retain senior officers to our management.**

We depend on the services of our existing key employees. Our success will largely depend on our ability to retain these key employees and to attract and retain qualified senior and middle level managers to our management team. Future changes in management could cause material disruptions to our business. We also depend on our ability to attract and retain in the future highly skilled technical, editorial, marketing and customer service personnel, especially experienced online game software developers. We cannot assure you that we will be able to attract or retain such personnel or that any personnel we hire in the future will successfully integrate into our organization or ultimately contribute positively to our business. In particular, the market for experienced online game software programmers is intensely competitive in China. While we believe we offer compensation packages that are consistent with market practice, we cannot be certain that we will be able to hire and retain sufficient experienced programmers to support our online games business. We may also be unsuccessful in training and retaining less-experienced programmers on a cost-effective basis. The loss of any of our key employees would significantly harm our business. We do not maintain key person life insurance on any of our employees.

### **Our revenues fluctuate significantly and may adversely impact the trading price of our American Depositary Shares, or ADSs, or any other securities which become publicly traded.**

Our revenues and results of operations have varied significantly in the past and may continue to fluctuate in the future. Many of the factors that cause such fluctuation are outside our control. Steady revenues and results of operations will depend largely on our ability to:

- attract and retain users to the NetEase websites in the increasingly competitive Internet market in China;
- successfully implement our business strategies as planned; and
- update and develop our Internet applications, services, technologies and infrastructure.

Historically, advertising revenue has followed the same general seasonal trend throughout each year with the first quarter of the year being the weakest quarter due to the Chinese New Year holiday and the traditional close of advertisers' annual budgets and the third quarter as the strongest. Usage of our wireless value-added services and online games has generally increased around the Chinese New Year holiday and other Chinese holidays, in particular winter and summer school holidays during which school-aged users have more time to use such services and play games. Accordingly, you should not rely on quarter-to-quarter comparisons of our results of operations as an indication of our future performance. It is possible that future fluctuations may cause our results of operations to be below the expectations of market analysts and investors. This could cause the trading price of our ADSs or any other securities of ours which may become publicly traded to decline.

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### **Changes in accounting rules for share-based compensation may adversely affect our operating results, our stock price and our competitiveness in the employee marketplace.**

Our future success depends to a large degree on our continuing ability to identify, develop, motivate and retain highly skilled personnel for all areas of our organization. We have a history of using employee stock options to align employees' interest with the interests of our shareholders and encourage quality employees to join us and retain our quality employees by providing competitive compensation packages. On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, or SFAS 123(R), which requires the measurement and recognition of compensation expense for all share-based compensation to be based on estimated fair values. As a result, our operating results contain a charge for share-based compensation expense related to employee stock options. The recognition of share-based compensation in our statement of operations would have a negative effect on our reported results and earnings per share, which could in turn negatively affect our stock price. On the other hand, if we alter our employee share incentive plan to minimize the share-based compensation expenses, it may limit our ability to continue to use share-based awards as a tool to attract and retain our employees, and it may adversely affect our operations.

### **If we fail to establish and maintain relationships with content providers, we may not be able to attract traffic to the NetEase websites.**

We rely on a number of third party relationships to attract traffic and provide content in order to make the NetEase websites more attractive to users and advertisers. Most of our arrangements with content providers are short-term and may be terminated at the convenience of the other party. Some content providers have increased the fees they charge us for their content. This trend could increase our costs and operating expenses and could adversely affect our ability to obtain content at an economically acceptable cost. Moreover, our agreements with content providers are usually non-exclusive, although certain of our competitors have been entering into exclusive arrangements for certain content, particularly online video content. If we are not able to renew our agreements with content providers or our competitors obtain exclusive rights to content which we wish to offer on the NetEase websites, the attractiveness of our portal to users will be severely impaired. Also, if other Internet companies present the same or similar content in a superior manner, it would adversely affect our visitor traffic.

### **We expect that the increasing popularity of online video content among Internet users in China will increase our costs in future periods because it requires significant bandwidth to deliver and will likely necessitate investments by us in new video streaming technology.**

We believe that online video content is becoming increasingly popular among Internet users in China and that we will need to offer a wide range of video content on the NetEase websites to attract users. Although advances in video compression technology have allowed reductions in the bandwidth required to deliver video content, such content still requires significantly more bandwidth than the other forms of content we offer on the NetEase websites. If we are unable to pass on such increased costs to users, which we believe is unlikely for the foreseeable future, our costs will increase which could materially adversely affect our business and profitability. In addition, the technology for video content processing, transmission and high-speed data access systems is characterized by rapid developments and evolving industry standards. To enable users to access our video content quickly and reliably and remain competitive with other Internet portals in China and elsewhere, we anticipate that we will be required to invest in new video streaming technologies, including technologies developed by third parties, on a regular basis which will also increase our costs.

### **We do not own Guangzhou NetEase or Beijing Guangyitong Advertising Co., Ltd., or Guangyitong Advertising, and if they or their ultimate shareholders violate our contractual arrangements with them, our business could be disrupted, our reputation may be harmed and we may have to resort to litigation to enforce our rights which may be time consuming and expensive.**

Guangzhou NetEase and Guangyitong Advertising are owned by shareholders whose interests may differ from ours and those of our shareholders because they own a larger percentage of Guangzhou NetEase and



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Guangyitong Advertising than of our company. Specifically, the business and operations of Guangzhou NetEase, as the operator of the NetEase websites and a provider of online games and wireless value-added and other fee-based premium services, and Guangyitong Advertising, as an advertising firm, are subject to Chinese laws and regulations that differ from the laws and regulations that govern the business and operations of NetEase. For example, Chinese laws and regulations require us to verify the content of third party advertising content we place on the NetEase websites, and we are partly dependent upon the conduct of Guangyitong Advertising, which is not directly subject to those laws and regulations, in order to ensure that we remain compliant with those laws and regulations. Guangzhou NetEase, Guangyitong Advertising or their ultimate shareholders could violate our arrangements with them by, among other things, failing to operate and maintain the NetEase websites or their various businesses in an acceptable manner, failing to remit revenue to us on a timely basis or at all or diverting customers or business opportunities from our company. A violation of these agreements could disrupt our business and adversely affect our reputation in the market. If Guangzhou NetEase, Guangyitong Advertising or their ultimate shareholders violate our agreements with them, we may have to resort to litigation to enforce our rights. This litigation could result in the disruption of our business, diversion of our resource and the incurrence of substantial costs.

**Because our contractual arrangements with Guangzhou NetEase, Guangyitong Advertising and their ultimate shareholders do not detail the parties' rights and obligations, our remedies for a breach of these arrangements are limited.**

Our current relationship with Guangzhou NetEase, Guangyitong Advertising and their ultimate shareholders is based on a number of contracts. The terms of these agreements are often statements of general intent and do not detail the rights and obligations of the parties. Some of these contracts provide that the parties will enter into further agreements on the details of the services to be provided. Others contain price and payment terms that are subject to monthly adjustment. These provisions may be subject to differing interpretations, particularly on the details of the services to be provided and on price and payment terms. It may be difficult for us to obtain remedies or damages from Guangzhou NetEase, Guangyitong Advertising or their ultimate shareholders for breaching our agreements. Because we rely significantly on Guangzhou NetEase and Guangyitong Advertising for our business, the realization of any of these risks may disrupt our operations or cause degradation in the quality and service provided on, or a temporary or permanent shutdown of, the NetEase websites.

**A majority of the share capital of Guangzhou NetEase and Guangyitong Advertising is held by our major shareholder, who may cause these agreements to be amended in a manner that is adverse to us.**

Our major shareholder, William Lei Ding, holds the majority interest in Guangzhou NetEase and Guangyitong Advertising. As a result, Mr. Ding may be able to cause these agreements to be amended in a manner that will be adverse to our company, or may be able to cause these agreements not to be renewed, even if their renewal would be beneficial for us. Prior to our initial public offering of ADSs in 2000, a number of these agreements were amended. Although we have entered into an agreement that prevents the amendment of these agreements without the approval of the members of our Board other than Mr. Ding, we can provide no assurances that these agreements will not be amended in the future to contain terms that might differ from the terms that are currently in place. These differences may be adverse to our interests.

**We may not be able to conduct our operations without the services provided by Guangzhou NetEase and Guangyitong Advertising.**

Our operations are currently dependent upon our commercial relationships with Guangzhou NetEase and Guangyitong Advertising, and we derive most of our revenues from these companies. A portion of our revenues under our contracts with these companies is based upon preliminary and tentative amounts that have been agreed upon in advance and is subject to being trued-up at our company's discretion by the end of each quarter. If these companies are unwilling or unable to perform the agreements which we have entered into with them, we may not be able to conduct our operations in the manner in which we currently plan. In addition, Guangzhou NetEase and

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Guangyitong Advertising may seek to renew these agreements on terms that are disadvantageous to us. Although we have entered into a series of agreements that provide us with substantial ability to control these companies, we may not succeed in enforcing our rights under them. If we are unable to renew these agreements on favorable terms, or to enter into similar agreements with other parties, our business may not expand, and our operating expenses may increase.

### **One of our shareholders has significant influence over our company.**

Our founder, Chief Executive Officer and director, William Lei Ding, beneficially owned approximately 46.3% as of March 31, 2008 of our outstanding ordinary shares and is our largest shareholder. Accordingly, Mr. Ding has significant influence in determining the outcome of any corporate transaction or other matter submitted to the shareholders for approval, including mergers, consolidations, the sale of all or substantially all of our assets, election of directors and other significant corporate actions. He also has significant influence in preventing or causing a change in control. In addition, without the consent of this shareholder, we may be prevented from entering into transactions that could be beneficial to us. The interests of Mr. Ding may differ from the interests of our other shareholders.

### **Our arrangements with Guangzhou NetEase, Guangyitong Advertising and their respective shareholders may cause a transfer pricing adjustment and may be subject to scrutiny by the PRC tax authorities.**

We could face material and adverse tax consequences if the PRC tax authorities determine that our contracts with Guangzhou NetEase, Guangyitong Advertising and their respective shareholders were not entered into based on arm's length negotiations. Although our contractual arrangements are similar to other companies conducting similar operations in China, if the PRC tax authorities determine that these contracts were not entered into on an arm's length basis, they may adjust our income and expenses for PRC tax purposes in the form of a transfer pricing adjustment which may result in an increase in our taxes.

### **Our business benefits from certain PRC government incentives. Expiration of, or changes to, these incentives and PRC tax laws could have a material adverse effect on our operating results.**

Prior to January 1, 2008, foreign invested enterprises were generally subject to a national and local enterprise income tax, or EIT, at statutory rates of 30% and 3%, respectively. Our subsidiaries, NetEase Information Technology (Beijing) Co., Ltd., or NetEase Beijing, Guangzhou NetEase Interactive Entertainment Limited, or Guangzhou Interactive, Guangzhou Boguan Telecommunication Limited, or Boguan, NetEase (Hangzhou) Network Co., Ltd., or NetEase Hangzhou, and NetEase Yodao Information Technology (Beijing) Limited, or Yodao Information, and our VIE, Guangzhou NetEase, had been granted various preferential tax treatments because the local tax authorities had approved such companies as "High and New technology Enterprises" or "Software Enterprises" or similar designations under the then applicable tax rules and regulations.

Effective as of January 1, 2008, the Chinese government adopted a new income tax law which unified the EIT payable by domestic and foreign-invested enterprises at 25%. Preferential tax treatments continue to be granted to entities that are classified as "High and New Technology Enterprises Strongly Supported by the State" or conduct business in encouraged sectors, whether foreign invested enterprises or domestic companies, pursuant to which qualified enterprises can enjoy a reduced EIT rate of 15%. Under the new income tax law, enterprises that were established and already enjoyed preferential tax treatments before March 16, 2007, other than companies qualifying as "High and New Technology Enterprises," continue to enjoy such treatments (i) in the case of preferential tax rates, for a period of five years from January 1, 2008, or (ii) in the case of preferential tax exemption or reduction for a specified term, until the expiration of such term. The Chinese tax authorities are currently in the process of establishing a framework to receive and process applications from domestic and foreign-invested enterprises for the qualification of "High and New Technology Enterprises Strongly Supported by the State" and the granting of the High and New Technology Enterprises preferential tax status under the new income tax law. We will continue to assess the tax implications of the new income tax law.



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Accordingly, our foregoing subsidiaries and VIE that enjoyed preferential tax status as “Software Enterprises” or similar designations continue to be entitled to the preferential tax treatments currently enjoyed by them during the transition period so long as our foregoing subsidiaries and VIE is qualified as a “Software Enterprise.” However, the qualification as a “Software Enterprise” is subject to an annual assessment by the relevant government authorities in China. We cannot assure you that our foregoing subsidiaries and VIE will continue to meet the qualifications or that the relevant government authority will not revoke their “Software Enterprise” status. Besides, we cannot assure you, that each of these companies will be classified as a “High and New Technology Enterprise Strongly Supported by the State” and continue to be entitled to the preferential tax treatments after the transition period expires. Moreover, we are currently applying for the qualification of “High and New Technology Enterprises Strongly Supported by the State” for each of our foregoing subsidiaries and VIE that previously enjoyed preferential tax status of “High and New Technology Enterprises” but we cannot assure you that each of these companies will receive such qualification and continue to be entitled to the preferential tax treatments.

As of December 31, 2007, we are required under applicable accounting standards to report the deferred tax assets at the new statutory income tax rate of 25%, enacted on March 16, 2007, except for certain entities which are still under tax holiday. The application of increased statutory tax rate to 25% from the preferential tax rates applicable to our subsidiaries and VIE has resulted in the recording of an increase in our deferred tax assets and accordingly, a tax benefit of approximately RMB41.6 million (US\$5.7 million) for the year ended December 31, 2007. We expect that we will report a higher tax charge in future accounting periods if and when the High and New Technology Enterprises preferential tax treatments are granted by the Chinese tax authorities, as a result of a reduction to the deferred tax assets to reflect the lower preferred tax rates.

**We may be treated as a resident enterprise for PRC tax purposes following the effectiveness of the new income tax law on January 1, 2008, which may subject us to PRC income tax for our global income and withholding income tax for any dividends we pay to our non-PRC shareholders on profits earned after January 1, 2008.**

Under the new PRC income tax law, enterprises established outside of China whose “de facto management bodies” are located in China are considered “resident enterprises,” and will generally be subject to the uniform 25% enterprise income tax rate for their global income. Under the implementation rules of the new income tax law, “de facto management body” is defined as the body that has material and overall management and control over the business, personnel, accounts and properties of the enterprise. Substantially all of our management is currently located in the PRC. Accordingly, we may be considered a “resident enterprise” and may therefore be subject to the enterprise income tax of 25% of our global income and as a result, the amount of dividends we can pay to our shareholders could be reduced. We cannot confirm whether we will be considered a “resident enterprise” as the implementation rules are unclear at the moment.

Under the implementation rules of the new income tax law, dividends paid to “non-resident enterprises” by “resident enterprises” on profits earned after January 1, 2008 are regarded as income from “sources within the PRC” and therefore subject to a 10% withholding income tax, while dividends on profits earned before January 1, 2008 are not subject to the withholding income tax. A lower withholding income tax rate of 5% is applied if the “non-resident enterprises” are registered in Hong Kong or other jurisdictions that have a tax treaty arrangement with China. In view of this, we set up two Hong Kong subsidiaries, NetEase (Hong Kong) Limited, or NetEase Hong Kong, and Hong Kong NetEase Interactive Entertainment Limited, or Hong Kong NetEase Interactive, to reduce the withholding tax applicable to dividends from our subsidiaries in China to NetEase.com. In addition, because we may be treated as a “resident enterprise,” any dividends paid to the shareholders of NetEase.com which are considered “non-resident enterprises” may be subject to withholding income tax and the value of the investment in our shares or ADSs may be adversely and materially affected.

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**Table of Contents****While we believe that we currently have adequate internal control procedures in place, we are still exposed to potential risks from legislation requiring companies to evaluate controls under Section 404 of the Sarbanes-Oxley Act of 2002.**

While we believe that we currently have adequate internal control procedures in place, we are still exposed to potential risks from legislation requiring companies to evaluate controls under Section 404 of the Sarbanes-Oxley Act of 2002. Under the supervision and with the participation of our management, we have evaluated our internal controls systems in order to allow management to report on, and our registered independent public accounting firm to attest to, our internal controls, as required by Section 404 of the Sarbanes-Oxley Act. We have performed the system and process evaluation and testing required in an effort to comply with the management certification and auditor attestation requirements of Section 404. As a result, we have incurred additional expenses and a diversion of management's time. If we are not able to continue to meet the requirements of Section 404 in a timely manner or with adequate compliance, we might be subject to sanctions or investigation by regulatory authorities, such as the SEC or NASDAQ. Any such action could adversely affect our financial results and the market price of our ordinary shares.

**Unexpected network interruption caused by system failures may reduce visitor traffic and harm our reputation.**

Both the continual accessibility of the NetEase websites and the performance and reliability of our technical infrastructure are critical to our reputation and the ability of the NetEase websites to attract and retain users and advertisers. Any system failure or performance inadequacy that causes interruptions in the availability of our services or increases the response time of our services could reduce user satisfaction and traffic, which would reduce the NetEase websites' appeal to users and advertisers. As the number of NetEase Web pages and traffic increase, we cannot assure you that we will be able to scale our systems proportionately. In addition, any system failures and electrical outages could materially and adversely impact our business.

**Our operations are vulnerable to natural disasters and other events.**

We have limited backup systems and have experienced system failures and electrical outages from time to time in the past, which have disrupted our operations. Most of our servers and routers are currently located at several different locations in China. Our disaster recovery plan cannot fully ensure safety in the event of damage from fire, floods, typhoons, earthquakes, power loss, telecommunications failures, break-ins and similar events. If any of the foregoing occurs, we may experience a system shutdown. We do not carry any business interruption insurance. To improve the performance and to prevent disruption of our services, we may have to make substantial investments to deploy additional servers.

Although we carry property insurance with low coverage limits, our coverage may not be adequate to compensate us for all losses, particularly with respect to loss of business and reputation, that may occur.

In addition, fire, floods, droughts, typhoons, earthquakes and other natural disasters could result in material disruptions of our operations and adversely affect our revenues and profit. For example, a 8 magnitude earthquake struck the City of Wenchuan in Sichuan province on May 12, 2008, and the PRC government declared May 19, 2008 to May 21, 2008 as national mourning days for the earthquake. In connection with the period of mourning, we and the other major online game operators in China suspended our game operations during those three days.

**Computer viruses may cause delays or interruptions on our systems and may reduce visitor traffic and harm our reputation.**

Computer viruses may cause delays or other service interruptions on our systems. In addition, the inadvertent transmission of computer viruses could expose us to a material risk of loss or litigation and possible

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liability. We may be required to expend significant capital and other resources to protect the NetEase websites against the threat of such computer viruses and to alleviate any problems. Moreover, if a computer virus affecting our system is highly publicized, our reputation could be materially damaged and our visitor traffic may decrease.

**Computer hacking could damage our systems and reputation.**

Any compromise of security, such as computer hacking, could cause Internet usage to decline. "Hacking" involves efforts to gain unauthorized access to information or systems or to cause intentional malfunctions or loss or corruption of data, software, hardware or other computer equipment. Hackers, if successful, could misappropriate proprietary information or cause disruptions in our service. We may have to spend significant capital and human resources to rectify any damage to our system. In addition, we cannot assure you that any measures we take against computer hacking will be effective. A well publicized computer security breach could significantly damage our reputation and materially adversely affect our business. Although we have not experienced any hacking activity that allowed unauthorized access to any information stored on our network, caused any loss or corruption of data, software or other computer equipment, we have been subject to denial of service attacks that have caused portions of our network to be inaccessible for limited periods of time. In addition, we have had denial of service attacks and viruses or worms introduced into our network. Although we take a number of measures to ensure that our systems are secure and unaffected by security breaches, including ensuring that our servers are hosted at physically secure sites, limiting access to server ports, and using isolated intranets, passwords, and encryption technology, we cannot assure you that any measures we take against computer hacking will be effective.

**Some of our players make sales and purchases of our game accounts and virtual items through third-party auction websites, which may have a negative effect on our net revenues.**

Some of our players make sales and purchases of our game accounts and virtual items through third-party auction websites in exchange for real money. We do not generate any net revenues from these transactions. Accordingly, purchases and sales of our game accounts or virtual items on third-party websites could lead to decreased sales by us and also put downward pressure on the prices that we charge players for our virtual items and services, all of which could result in lower revenues generated for us by our games. New players may decide not to play our games as a result of any rule changes we might implement to restrict the players' ability to trade in game accounts or virtual items, which could materially adversely affect our business, results of operations and financial conditions.

**If our providers of bandwidth and server custody service fail to provide these services, our business could be materially curtailed.**

We rely on affiliates of China Netcom, China Telecom and CERNET to provide us with bandwidth and server custody service for Internet users to access the NetEase websites. If China Netcom, China Telecom, CERNET or their affiliates fail to provide such services or raise prices for their services, we may not be able to find a reliable and cost-effective substitute provider on a timely basis or at all. If this happens, our business could be materially curtailed.

**We may be held liable for information displayed on, retrieved from or linked to the NetEase websites.**

We may face liability for defamation, negligence, copyright, patent or trademark infringement and other claims based on the nature and content of the materials that are published on the NetEase websites. We are involved in several intellectual property infringement claims or actions and are occasionally subject to defamation claims. We believe that the amounts claimed in these actions, in the aggregate, are not material to our business. However, these amounts may be increased for a variety of reasons as the claims progress, and we and our affiliates could be subject to additional defamation or infringement claims which, singly or in the aggregate, could have a material adverse effect on our business and results of operations, if successful. We also could be

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subject to claims based upon content that is accessible on the NetEase websites such as content and materials posted by users on message boards, online communities, voting systems, e-mail or chat rooms that are offered on the NetEase websites. By providing technology for hypertext links to third-party websites, we may be held liable for copyright or trademark violations by those third party sites. Third parties could assert claims against us for losses incurred in reliance on any erroneous information distributed by us. Moreover, users of the NetEase Web-based e-mail services could seek damages from us for:

- unsolicited e-mails;
- lost or misplaced messages;
- illegal or fraudulent use of e-mail; or
- interruptions or delays in e-mail service.

We may incur significant costs in investigating and defending these claims, even if they do not result in liability.

### **Information displayed on, retrieved from or linked to the NetEase websites may subject us to claims of violating Chinese laws.**

Violations or perceived violations of Chinese laws arising from information displayed on, retrieved from or linked to the NetEase websites could result in significant penalties, including a temporary or complete cessation of our business. China has enacted regulations governing Internet access and the distribution of news and other information. Furthermore, the Propaganda Department of the Chinese Communist Party has been given the responsibility to censor news published in China to ensure, supervise and control a particular political ideology. In addition, the PRC Ministry of Industries and Information, or MII (prior to the PRC government restructuring in March 2008, its predecessor, the Ministry of Information Industry), has published implementing regulations that subject online information providers to potential liability for content included in their portals and the actions of subscribers and others using their systems, including liability for violation of PRC laws prohibiting the distribution of content deemed to be socially destabilizing. Furthermore, the MII may implement a requirement that users of blogs register under their real names. If such a regulation is implemented, our business may be negatively affected due to a decrease in the number of blog users.

In addition, the Ministry of Public Security has from time to time prohibited the distribution over the Internet of information which it believes to be socially destabilizing. The Ministry of Public Security also has the authority to require any local Internet service provider to block any website maintained outside China at its sole discretion.

The State Secrecy Bureau, which is directly responsible for the protection of state secrets of all PRC government and Chinese Communist Party organizations, is authorized to block any website it deems to be leaking state secrets or failing to meet the relevant regulations relating to the protection of state secrets in the distribution of online information. The term “state secrets” has been broadly interpreted by Chinese governmental authorities in the past. We may be liable under these pronouncements for content and materials posted or transmitted by users on message boards, virtual communities, chat rooms or e-mails. Furthermore, where the transmitted content clearly violates the laws of the PRC, we will be required to delete it. Moreover, if we consider transmitted content suspicious, we are required to report such content. We must also undergo computer security inspections, and if we fail to implement the relevant safeguards against security breaches, we may be shut down. In addition, under recently adopted regulations, Internet companies which provide bulletin board systems, chat rooms or similar services, such as our company, must apply for the approval of the State Secrecy Bureau. As the implementing rules of these new regulations have not been issued, we do not know how or when we will be expected to comply, or how our business will be affected by the application of these regulations.

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If the Chinese government takes any action to limit or eliminate the distribution of information through the NetEase websites, or to limit or regulate any current or future community functions available to users or otherwise block the NetEase websites, our business would be significantly harmed.

### **The information collected from our users may infringe on their privacy and may not be accurate.**

We collect demographic data, such as geographic location, income level and occupation, from our registered users in order to better understand users and their needs. We provide this data to online advertisers, on an anonymous aggregate basis, without disclosing personal details such as name and home address, to enable them to target specific demographic groups. If privacy concerns or regulatory restrictions prevent us from collecting this information or from selling demographically targeted advertising, the NetEase websites may be less attractive to advertisers.

In addition, if privacy concerns or regulatory restrictions prevent us from collecting or using this data, the analysis of our target market and the developing trend of the subject online game may not be accurate. Further, we rely solely on the data provided by our users and do not verify the authenticity of such data. If the information that we collect is materially inaccurate or false, this may also adversely affect our implementation of the online game developing strategy.

### **We may not be able to adequately protect our intellectual property, and we may be exposed to infringement claims by third parties.**

We rely on a combination of copyright, trademark and trade secrecy laws and contractual restrictions on disclosure to protect our intellectual property rights. Our efforts to protect our proprietary rights may not be effective to prevent unauthorized parties from copying or otherwise obtaining and using our technology. Monitoring unauthorized use of our services is difficult and costly, and we cannot be certain that the steps we take will effectively prevent misappropriation of our technology.

From time to time, we may have to resort to litigation to enforce our intellectual property rights, which could result in substantial costs and diversion of our resources. In addition, third parties have initiated litigation against us for alleged infringement of their proprietary rights, and additional claims may arise in the future. In the event of a successful claim of infringement and our failure or inability to develop non-infringing technology or content or license the infringed or similar technology or content on a timely basis, our business could suffer. Moreover, even if we are able to license the infringed or similar technology or content, license fees that we pay to licensors could be substantial or uneconomical. See Item 4.B. "Business Overview—Intellectual Property and Proprietary Rights."

### **We may be or become a passive foreign investment company, which could result in adverse U.S. federal income tax consequences to U.S. investors.**

We may be classified as a passive foreign investment company, or PFIC, by the U.S. Internal Revenue Service for U.S. federal income tax purposes. Such characterization could result in adverse U.S. federal income tax consequences to you if you are a U.S. investor. For example, U.S. investors who owned our ordinary shares or ADSs during any taxable year in which we were a PFIC generally are subject to increased U.S. tax liabilities and reporting requirements for that taxable year and all succeeding years, regardless of whether we actually continue to be a PFIC, although a shareholder election to terminate such deemed PFIC status may be available in certain circumstances. The same adverse U.S. federal income tax consequences will apply to U.S. investors who acquire our ordinary shares or ADSs during the current taxable year of 2008 or any subsequent taxable year if we are treated as a PFIC for that taxable year.

The determination of whether or not we are a PFIC is made on an annual basis and depends on the composition of our income and assets, including goodwill, from time to time. Specifically, we will be classified

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as a PFIC for U.S. tax purposes for a taxable year if either (a) 75% or more of our gross income for such taxable year is passive income, or (b) 50% or more of the average percentage of our assets during such taxable year either produce passive income or are held for the production of passive income. For such purposes, if we directly or indirectly own 25% or more of the shares of another corporation, we will be treated as if we (a) held directly a proportionate share of the other corporation's assets, and (b) received directly a proportionate share of the other corporation's income.

We do not believe that we are currently a PFIC. However, because the PFIC determination is highly fact intensive and made at the end of each taxable year, there can be no assurance that we will not be a PFIC for the current or any future taxable year or that the IRS will not challenge our determination concerning our PFIC status. For further discussion of the adverse U.S. federal income tax consequences of our possible classification as a PFIC, see Item 10.E. "Additional Information—Taxation."

### **If our subsidiaries are restricted from paying dividends to us, our primary internal source of funds would decrease.**

NetEase.com is a holding company with no significant assets other than cash on hand and its equity interests in its directly and indirectly-owned subsidiaries, NetEase Beijing, NetEase Hong Kong, NetEase Interactive Entertainment Ltd., or NetEase Interactive, Boguan, Hong Kong NetEase Interactive and Yodao Information, Guangzhou Interactive and NetEase Hangzhou. As a result, our primary internal source of funds is dividend payments from our subsidiaries. If these subsidiaries incur debt on their own behalf in the future, the instruments governing the debt may restrict their ability to pay dividends or make other distributions to us, which in turn would limit our ability to pay dividends on our ADSs or to make any required payments to holders of our convertible notes. PRC tax authorities may also require us to amend our contractual arrangements with Guangzhou NetEase, Guangyitong Advertising and their respective shareholders in a manner that would materially and adversely affect the ability of our subsidiaries to pay dividends and other distributions to us. In addition, Chinese legal restrictions permit payment of dividends only out of net income as determined in accordance with Chinese accounting standards and regulations. Under Chinese law, NetEase Beijing, Guangzhou Interactive, Boguan and NetEase Hangzhou are also required to set aside a portion of their net income each year to fund certain reserve funds. These reserves are not distributable as cash dividends. Also see "—We may be treated as a resident enterprise for PRC tax purposes following the effectiveness the new income tax law on January 1, 2008, which may subject us to PRC income tax for our global income and withholding income tax for any dividends we pay to our non-PRC shareholders on profits earned after January 1, 2008." above for further details.

## **RISKS RELATED TO DOING BUSINESS IN CHINA**

### **A slow-down in the Chinese economy may slow down our growth and profitability.**

The growth of the Chinese economy has been uneven across geographic regions and economic sectors. There can be no assurance that growth of the Chinese economy will be steady or that any slow down will not have a negative effect on our business. In recent years, the Chinese government announced its intention to use macroeconomic tools and regulations to slow the rate of growth of the Chinese economy, the results of which are difficult to predict. The Chinese economy overall affects our profitability as expenditures for advertisements and other services may decrease due to slowing domestic demand.

### **The uncertain legal environment in China could limit the legal protections available to you.**

The Chinese legal system is a civil law system based on written statutes. Unlike common law systems, it is a system in which decided legal cases have little precedential value. In the late 1970s, the Chinese government began to promulgate a comprehensive system of laws and regulations governing economic matters. The overall effect of legislation enacted over the past 20 years has significantly enhanced the protections afforded to foreign

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invested enterprises in China. However, these laws, regulations and legal requirements are relatively recent and are evolving rapidly, and their interpretation and enforcement involve uncertainties. These uncertainties could limit the legal protections available to foreign investors.

### **Changes in China's political and economic policies could harm our business.**

The economy of China has historically been a planned economy subject to governmental plans and quotas and has, in certain aspects, been transitioning to a more market-oriented economy. Although we believe that the economic reform and the macroeconomic measures adopted by the Chinese government have had a positive effect on the economic development of China, we cannot predict the future direction of these economic reforms or the effects these measures may have on our business, financial position or results of operations. In addition, the Chinese economy differs from the economies of most countries belonging to the Organization for Economic Co-operation and Development, or OECD. These differences include:

- economic structure;
- level of government involvement in the economy;
- level of development;
- level of capital reinvestment;
- control of foreign exchange;
- inflation rates;
- methods of allocating resources; and
- balance of payments position.

As a result of these differences, our business may not develop in the same way or at the same rate as might be expected if the Chinese economy were similar to those of the OECD member countries.

### **Fluctuation in Renminbi exchange rates could adversely affect the value of our ADSs and any cash dividend declared on them.**

The value of the Renminbi may fluctuate according to a number of factors. From 1994 to July 21, 2005, the conversion of Renminbi into foreign currencies, including US dollars, was based on exchange rates published by the People's Bank of China, which was set daily based on the previous day's interbank foreign exchange market rates in China and current exchange rates on the world financial markets. During that period, the official exchange rate for the conversion of Renminbi to US dollars was generally stable. However, on July 21, 2005, as a result of the Renminbi being re-pegged to a basket of currencies, the Renminbi was revalued and appreciated against the US dollar. There can be no assurance that such exchange rate will be stable in the future. Our revenues are primarily denominated in Renminbi, and any fluctuation in the exchange rate of Renminbi may affect the value of, and dividends, if any, payable on, our ADSs in foreign currency terms.

### **Restrictions on currency exchange may limit our ability to receive and use our revenues effectively.**

Because almost all of our future revenues may be in the form of Renminbi, any future restrictions on currency exchanges may limit our ability to use revenue generated in Renminbi to fund our business activities outside China or to make dividend payments in US dollars. Although the Chinese government introduced regulations in 1996 to allow greater convertibility of the Renminbi for current account transactions, significant restrictions still remain. Current account transactions include payments of dividends and trade and service-related foreign exchange transactions. As a result, our subsidiaries and affiliates in China may purchase foreign exchange for the payment of dividends to NetEase.com and of license and content fees to offshore software and content partners.



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In contrast, capital account transactions, which include foreign direct investment and loans, must be approved by the State Administration for Foreign Exchange, or SAFE. We cannot be certain that the Chinese regulatory authorities will not impose more stringent restrictions on the convertibility of the Renminbi, especially with respect to foreign exchange transactions.

**All participants in our existing equity compensation plans who are PRC citizens may be required to register with SAFE. We may also face regulatory uncertainties that could restrict our ability to adopt additional equity compensation plans for our directors, employees and other parties under PRC law.**

On April 6, 2007, the capital account department of SAFE issued the “Operating Procedures for Administration of Domestic Individuals Participating in the Employee Stock Option Plan or Stock Option Plan of An Overseas Listed Company, Hui Zong Fa [2007] No. 78),” or Circular 78. It is not clear at this time whether Circular 78 covers only equity compensation plans which provide for the grant of stock options or any type of equity compensation plan, such as a plan which authorizes the grant of restricted share awards. For any plans which are so covered and are adopted by a non-PRC listed company such as our company after April 6, 2007, Circular 78 requires all participants who are PRC citizens to register with and obtain approvals from SAFE prior to their participation in the plan. In addition, Circular 78 also requires PRC citizens to register with SAFE and make the necessary applications and filings by July 5, 2007 if they participated in an overseas listed company’s covered equity compensation plan prior to April 6, 2007. We believe that the registration and approval requirements contemplated in Circular 78 will be burdensome and time consuming.

Circular 78 has not yet been made publicly available nor formally promulgated by SAFE, but it is our understanding that SAFE has begun enforcing its provisions. Nonetheless, we cannot predict whether it will continue to enforce this circular or adopt additional or different requirements with respect to equity compensation plans. If it is determined that our equity compensation plans are subject to Circular 78, failure to comply with such provisions may subject us and the participants of our equity compensation plans who are PRC citizens to fines and legal sanctions and prevent us from being able to grant equity compensation to our personnel, which is currently a significant component of the compensation of many of our PRC employees. In that case, our business operations may be materially adversely affected.

**The Chinese government has strengthened the regulation of investments made by Chinese residents in offshore companies and reinvestments in China made by these offshore companies. Our business may be adversely affected by these new restrictions.**

The SAFE has adopted new regulations that require registration with, and approval from, Chinese government authorities in connection with direct or indirect offshore investment activities by Chinese residents. The SAFE regulations retroactively require registration of investments in non-Chinese companies previously made by Chinese residents. In particular, the SAFE regulations require Chinese residents to file with SAFE information about offshore companies in which they have directly or indirectly invested and to make follow-up filings in connection with certain material transactions involving such offshore companies, such as mergers, acquisitions, capital increases and decreases, external equity investments or equity transfers. In addition, Chinese residents must obtain approval from SAFE before they transfer domestic assets or equity interests in exchange for equity or other property rights in an offshore company. A newly established enterprise in China which receives foreign investments is also now required to provide detailed information about its controlling shareholders and to certify whether it is directly or indirectly controlled by a domestic entity or resident.

In the event that a Chinese shareholder with a direct or indirect stake in an offshore parent company fails to make the required SAFE registration, the Chinese subsidiaries of such offshore parent company may be prohibited from making distributions of profit to the offshore parent and from paying the offshore parent proceeds from any reduction in capital, share transfer or liquidation in respect of the Chinese subsidiaries. Further, failure to comply with the various SAFE registration requirements described above can result in liability under Chinese law for foreign exchange evasion.



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In accordance with the SAFE regulations, with the exception of companies listed on overseas stock markets, foreign exchange income received by overseas special purpose companies directly or indirectly controlled by Chinese residents for the purpose of raising funds for such Chinese residents' domestically controlled companies may not be retained by such offshore companies. Moreover, within thirty days of receiving any income, whether directly or indirectly through such overseas special purpose companies, a Chinese resident must remit all such income back to China.

These regulations may have a significant impact on our present and future structuring and investment. To comply with these regulations, our founder, Chief Executive Officer and director, William Lei Ding, has successfully filed with Guangdong Branch of SAFE information about NetEase.com and other offshore companies in which he has direct or indirect shareholding. We intend to take all necessary measures for ensuring that all required applications and filings will be duly made and all other requirements will be met. We further intend to structure and execute our future offshore acquisitions in a manner consistent with the new regulations and any other relevant legislation. However, because it is presently uncertain how the SAFE regulations, and any future legislation concerning offshore or cross-border transactions, will be interpreted and implemented by the relevant government authorities in connection with our future offshore financings or acquisitions, we cannot provide any assurances that we will be able to comply with, qualify under, or obtain any approvals required by the regulations or other legislation. Furthermore, we cannot assure you that any PRC shareholders of our company or any PRC company into which we invest will be able to comply with those requirements. The inability of our company or any PRC shareholder to secure required approvals or registrations in connection with our future offshore financings or acquisitions may subject us to legal sanctions, restrict our ability to pay dividends from our Chinese subsidiaries to our offshore holding company, and restrict our overseas or cross-border investment activities or affect our ownership structure.

## **RISKS RELATED TO THE TELECOMMUNICATIONS AND INTERNET INDUSTRIES IN CHINA**

### **Government regulation of the telecommunications and Internet industries may become more burdensome.**

Government regulation of the telecommunications and Internet industries is burdensome and may become more burdensome. New regulations could increase our costs of doing business and prevent us from efficiently delivering our services. These regulations may stop or slow down the expansion of our customer and user base and limit the access to the NetEase websites.

### **Increased government regulation of the telecommunications and Internet industries in China may result in the Chinese government requiring us to obtain additional licenses or other governmental approvals to conduct our business which, if unattainable, may restrict our operations.**

The telecommunications industry, including Internet content provider, or ICP, services and online games, is highly regulated by the Chinese government, the main relevant government authority being the MII. Prior to China's entry into the World Trade Organization, or WTO, the Chinese government generally prohibited foreign investors from taking any equity ownership in or operating any telecommunications business. ICP services are classified as telecommunications value-added services and therefore fell within the scope of this prohibition. This prohibition was partially lifted following China's entry into the WTO. Pursuant to the Administrative Rules for Foreign Investments in Telecommunications Enterprises promulgated by the State Council dated December 5, 2001, foreign investors are allowed to hold in the aggregate up to 50% of the total equity in any value-added telecommunications business in China. In addition, foreign and foreign invested enterprises are currently not able to apply for the required licenses for operating online games in China.

To operate the NetEase websites in compliance with all the relevant ICP-related Chinese regulations, Guangzhou NetEase successfully obtained ICP licenses issued by the Guangdong Provincial Telecommunications Bureau in 2000. The ICP license of Guangzhou NetEase issued by the Guangdong Provincial Telecommunications Bureau was replaced by the Value-Added Telecommunication Operating

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License issued by the MII in 2004. Guangzhou NetEase has also obtained the following licenses and registrations: a commercial website registration with the Beijing Municipal Administrative Bureau of Industry and Commerce, an audio-visual product operating license issued by Guangdong Culture Department to sell audio-visual products in Internet, an Internet publishing license issued by General Administration of Press and Publication, an Internet culture operating license for online game activities issued by the Ministry of Culture, a license for online dissemination of drug-related information issued by Guangdong Food and Drug Administration, and a permit for the Network Transmission of Audiovisual Programs issued by the State Administration of Radio, Film and Television. It has also received approvals for online dissemination of health information from the Department of Health of Guangdong Province and approvals for provision of online education-related information from the Department of Education of Guangdong Province. NetEase.com relies exclusively on contractual arrangements with Guangzhou NetEase and its approvals to operate as an Internet content provider.

However, we cannot be certain that we or our affiliates will be granted any other additional license, permit or clearance we may need in the future. Moreover, we cannot be certain that any local or national ICP or telecommunications license requirements will not conflict with one another or that any given license will be deemed sufficient by the relevant governmental authorities for the provision of our services. The PRC began several years ago to regulate its Internet sector by making pronouncements or enacting regulations regarding the legality of foreign investment in the PRC Internet sector and the existence and enforcement of content restrictions on the Internet. We believe that our current ownership structure complies with all existing PRC laws, rules and regulations. There are, however, substantial uncertainties regarding the interpretation of current PRC Internet laws and regulations. The PRC government may issue new interpretations of the regulations regarding supervision of the Information industry from time to time. In July 2006, the MII issued a notice to strengthen management of foreign investment in and operation of value-added telecommunication services. The notice emphasizes that foreign investors who wish to engage in value-added telecommunication services must strictly follow the relevant rules and regulations on foreign investment in telecommunication sectors. The notice also prohibits domestic telecommunication services providers from leasing, transferring or selling telecommunications business operating licenses to any foreign investor in any form, or providing any resources, sites or facilities to any foreign investor for their illegal operation of a telecommunications business in China. According to the notice, either the holder of a value-added telecommunication service license or its shareholders must directly own the domain names and trademarks used by such license holders in their provision of value-added telecommunication services. The notice further requires each license holder to have the necessary facilities, including servers, for its approved business operations and to maintain such facilities in the regions covered by its license. Value-added services license holders are required to evaluate the compliance with the requirements set forth in the notice. As a result of the foregoing, we plan to transfer several of our domain names and trademarks to Guangzhou NetEase if requested by the MII.

In addition, we are uncertain as to whether the Chinese government will reclassify our business as a media or retail company, due to our acceptance of fees for Internet advertising, online games and wireless value-added and other services as sources of revenues, or as a result of our current corporate structure. Such reclassification could subject us to penalties or fines or significant restrictions on our business. In addition, NetEase.com may have difficulties enforcing its rights under the agreements with Guangzhou NetEase and Guangyitong Advertising if any of these parties breaches any of the agreements with them because NetEase.com does not have approval from appropriate Chinese authorities to provide Internet content services, Internet advertising services or wireless value-added services. Future changes in Chinese government policies affecting the provision of information services, including the provision of online services, Internet access, e-commerce services and online advertising, may impose additional regulatory requirements on us or our service providers or otherwise harm our business.

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**The PRC government has intensified its regulation of Internet cafés, which are currently one of the primary venues for our users to access the NetEase websites and our services, especially online games. Intensified government regulation of Internet cafés could restrict our ability to maintain or increase our revenues and expand our customer base.**

In April 2001, the PRC government began tightening its regulation and supervision of Internet cafés, at which many of our users access the NetEase websites and our services, especially online games. In particular, a large number of unlicensed Internet cafés have been closed. In addition, the PRC government has imposed higher capital and facility requirements for the establishment of Internet cafés. Furthermore, the PRC government's policy, which encourages the development of a limited number of national and regional Internet cafe chains and discourages the establishment of independent Internet cafés, may slow down the growth of Internet cafés. In addition, the State Administration of Industry and Commerce, one of the government agencies in charge of Internet cafe licensing, and other government agencies jointly issued a notice suspending the issuance of new Internet cafe licenses for a period of six months. Although such six-month period has ended, we believe based on information available to us that, in practice, such suspension remains in effect. It is unclear when this suspension will be lifted, if at all. So long as Internet cafés are one of the primary venues for our users to access the NetEase websites and our services, any reduction in the number, or any slowdown in the growth, of Internet cafés in China could limit our ability to maintain or increase our revenues and expand our customer base, thereby reducing our profitability and growth prospects.

**The Chinese government has taken steps to limit online game playing time for all minors. These and any other new restrictions may materially and adversely impact our business and results of operations.**

As part of its anti-addiction online game policy, the Chinese government has taken several steps to discourage minors under the age of 18 from continuously playing online games once they exceed a set number of hours of continuous play. For example, in July 2005, the Ministry of Culture and the MII jointly issued an opinion which requires online game operators to develop systems and software for identity certification, to implement anti-addiction modifications to game rules and to restrict players under eighteen years of age from playing certain games. Subsequently, in August 2005, the General Administration of Press and Publications, or GAPP, proposed an online game anti-addiction system that would have reduced and eliminated experience points that a user can accumulate after three and five hours of consecutive playing, respectively. In March 2006, GAPP amended its proposal to require players to register with their real names and identity card numbers and to apply the anti-addiction system only to players under eighteen years of age. In April 2007, GAPP and several other government authorities jointly promulgated the *Notice Concerning the Protection of Minors' Physical and Mental Well-being and Implementation of Anti-addiction System on Online Games*, or the Notice, which confirmed the real-name verification proposal and requires online game operators to develop and test their anti-addiction systems from April 2007 to July 2007, after which no online games can be registered or operated without an anti-addiction system in accordance with the Notice. Accordingly, we have implemented our anti-addiction system to comply with the Notice. Since its implementation, we have not experienced a significant negative impact on our business as a result of the Notice.

However, it has been reported in the Chinese media that the Chinese government has concerns about the social impact of online games, and it may impose additional regulatory restrictions on us, our customers or otherwise take actions that harm our business.

**The Chinese government has not enacted any laws regarding virtual asset property rights and, accordingly, it is not clear what liabilities, if any, online game providers may have for virtual assets.**

One of the features of our MMORPGs which helps to build a large user base and maintain loyalty is that users can accumulate virtual tools, powers and rankings as they play the games. We believe that these virtual assets are highly valued by our users, particularly long-term users, and are traded among users. However, on occasion, such assets can be lost if, for example, a users' identity is stolen by another user or we experience a

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system error or crash. The Chinese government has not enacted any laws regarding virtual asset property rights. Accordingly, we have no basis to determine what are the legal rights, if any, associated with virtual assets and what liabilities we could be exposed to for the loss or destruction of virtual assets. We could therefore potentially be held liable for the way in which we handle and protect virtual assets.

### **We may be unable to compete successfully against new entrants and established industry competitors.**

The Chinese market for Internet content and services is intensely competitive and rapidly changing. Many companies offer competitive products or services including online games, Chinese language-based Web search, retrieval and navigation services, wireless value-added services and extensive Chinese language content, informational and community features and e-mail. In addition, as a consequence of China joining the WTO, the Chinese government has partially lifted restrictions on foreign-invested enterprises so that foreign investors may hold in the aggregate up to 50% of the total equity ownership in any value-added telecommunications business, including an Internet business, in China.

Currently, our competition comes from Chinese language-based Internet portal companies as well as US-based portal companies. Some of our current and potential competitors are much larger than we are, and currently offer, and could further develop or acquire, content and services that compete with the NetEase websites. We also face competition from online game developers and operators, Internet service providers, wireless value-added service providers, website operators and providers of Web browser software that incorporate search and retrieval features. With respect to online games, we believe that more competitors are entering this market in China and that our competitors are becoming more active in both licensing foreign-developed games and developing games in-house, which trends, if they continue, could adversely affect our online games revenues in the future. We believe that competition in the online advertising industry in China has intensified recently as new entrants have come into the market, such as Baidu, Tencent, Alibaba and other vertical Internet portals. Any of our present or future competitors may offer products and services that provide significant performance, price, creativity or other advantages over those offered by us and, therefore, achieve greater market acceptance than ours.

Because many of our existing competitors as well as a number of potential competitors have longer operating histories in the Internet market, greater name and brand recognition, better connections with the Chinese government, larger customer bases and databases and significantly greater financial, technical and marketing resources than we have, we cannot assure you that we will be able to compete successfully against our current or future competitors. Any increased competition could reduce page views, make it difficult for us to attract and retain users, reduce or eliminate our market share, lower our profit margins and reduce our revenues.

## **Item 4. Information on the Company**

### **A. History and Development of the Company**

Our business was founded in June 1997, and we began offering search services and free Web-based e-mail starting mid-1997 and early-1998, respectively. In mid-1998, we changed our business model from a software developer to an Internet technology company and commenced developing the NetEase websites. In mid-1999, we established our advertising sales force to sell advertisements on the NetEase websites and also began to offer e-commerce platforms and to provide online shopping mall and other e-commerce services in China through Guangzhou NetEase, a related party. In 2001, we also began focusing on fee-based premium services and online entertainment services, including online games, wireless value-added services, premium e-mail services and other subscription-type services. Our focus on these services continued from 2004 onwards.

In connection with the restructuring of our operations which is discussed below in Item 7.B. "Major Shareholders and Related Party Transactions—Related Party Transactions," NetEase.com, Inc. was incorporated in the Cayman Islands on July 6, 1999, and it operates under the Cayman Islands Companies Law (2004 Revision). Our principal executive offices are located at 26/F, SP Tower D, Tsinghua Science Park Building 8,

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No.1 Zhongguancun East Road, Haidian District, Beijing, People's Republic of China 100084. Our telephone number is (86-10) 8255-8163. Our agent for service of process in the United States is CT Corporation System, 111 Eighth Avenue, New York, New York 10011.

Our principal capital expenditures for 2007 consisted mainly of office renovations, furniture and fixtures, computer equipment and software costs for a total of approximately RMB71.5 million (US\$9.8 million). Our principal capital expenditures for 2005 and 2006 also consisted mainly of computer equipment as well as software for a total of RMB92.6 million and RMB142.5 million, respectively.

In June 2007, our subsidiary NetEase Hangzhou paid RMB27.0 million (US\$3.7 million) for the purchase of the right to use approximately 56,000 square meters of land in Hangzhou. We expect to spend approximately RMB301.0 million (US\$41.3 million) for the construction of buildings for a portion of our online game research and development team on such land during the remaining period of 2008 and the following two to three years. Contracts have not been signed for this expected spending. As of December 31, 2007, we spent RMB3.5 million (US\$0.4 million) for the initial design and preparation work for the construction of the buildings.

We made additional capital expenditures of approximately RMB15.4 million (US\$2.1 million) from January 1, 2008 to March 31, 2008, principally for purchases of additional servers and computer equipment in order to accommodate the expected increase in usage of our online games and free email services and, to a lesser extent, for increased traffic on the NetEase websites. Our capital expenditure plans for the period from April 1, 2008 to December 31, 2008 have not yet been fixed, but we expect to spend an additional approximately RMB90.6 million (US\$12.4 million), primarily for the same purposes. Contracts have not been signed for this expected spending. Our capital expenditures in 2008 have been, and are expected to continue to be, funded through operating cash flows and through our existing capital resources.

## **B. Business Overview**

### **OVERVIEW**

Through our subsidiaries and contracts with our affiliates Guangzhou NetEase and Guangyitong Advertising and their respective shareholders, we operate a leading interactive online community in China and are a major provider of Chinese language content and services through our online games, Internet portal and wireless value-added services businesses.

We generate revenues from fees we charge users of our online games and from selling advertisements on the NetEase websites, and to a much lesser extent, of wireless value-added and other fee-based premium services. Our basic service offerings on the NetEase websites are available without charge to our users.

Our ability to leverage our portal traffic to generate revenues in online gaming and advertising services is a key component of our growth strategy.

### **Online Games Services**

Our online games business focuses on offering massively multi-player online games, more specifically role-playing games, to the Chinese market. These MMORPGs, as they are commonly known, are played over the Internet in "virtual worlds" that exist on networked game servers to which thousands of players simultaneously connect and interact. We develop and operate MMORPGs that are targeted at or localized to the Chinese market, and we strive to provide the highest quality game playing experience to our users.

To pay for MMORPG playing time, players use our proprietary prepaid point system by purchasing physical point cards or virtual point cards online. We work with a wide range of distributors to distribute our point cards to gamers across China. Point card distribution channels include wholesalers, Internet cafés, software stores, supermarkets, bookstores and newspaper stands, as well as convenience stores mainly in Guangzhou Province,

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Shanghai and Beijing and in several second tier cities. In addition to this pay-to-play revenue model, the open beta version of our first item-based online game, Tianxia II, was launched in June 2008 and we plan to launch other new games using the item-based revenue model in the second half of 2008.

We have also developed an online casual game platform with various multi-player games.

### **Our Portal**

The NetEase websites provide Internet users with Chinese language online services centered around three core service categories—content, community and communication. Our wide range of content appeals to a broad audience group spanning all age groups. However, our services are particularly popular among younger audiences between the ages of 19 and 34. We are continually working to reinforce our leadership position through premium content and service development and innovation.

#### *Content*

The NetEase content channels provide news, information and online entertainment to the Chinese public. The websites consolidate and distribute content from more than one hundred international and domestic content providers. Content is distributed through various channels, including channels focusing on news, entertainment, sports, finance, information technology and automobiles.

#### *Community and Communication*

The NetEase websites provide a broad array of free and fee-based community and communication services, including e-mail, blogging, photos, instant messaging, matchmaking, alumni directories, clubs, e-cards, chat rooms and community forums.

#### *Other*

In addition to the services described above, the NetEase websites provide other services to our users, including a website directory and web pages search service. Additionally, we developed our own proprietary Internet search engine, Yodao, which was launched in December 2007 and is free of charge to users.

Among the various free and fee-based services that we are offering through our portal, we derived most of our revenue in 2007 from online games and advertising services.

### **Advertising Services**

Our large and growing user base attracts well-known advertisers to our web sites. The various content channels and wide range of online services offered through our Internet portal forms an effective medium for our clients to conduct integrated marketing campaigns to the millions of loyal NetEase users. Our online advertising offerings include banner advertising, channel sponsorships, direct e-mail, interactive media-rich sites, sponsored special events, games, contests and other activities.

### **Wireless Value-Added Services**

We offer a wide range of wireless value-added services, or WVAS, which allow users to receive news and other information, such as stock quotes and e-mails, download ringtones and logos for their mobile phones and participate in matchmaking communities and interactive games. Combining content from our Internet portal with mobile applications we have developed in-house, we can rapidly develop sophisticated WVAS.

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[Table of Contents](#)**OUR ORGANIZATIONAL STRUCTURE**

We conduct our business in China solely through our subsidiaries, NetEase Beijing, Yodao Information, Boguan, Guangzhou Interactive and NetEase Hangzhou.

Under current Chinese regulations, there are restrictions on the percentage interest foreign or foreign-invested companies may have in Chinese companies providing value-added telecommunications services in China, which include the provision of Internet content, online games and wireless value-added services. In addition, the operation by foreign or foreign-invested companies of advertising businesses in China is subject to government approval. In order to comply with these restrictions and other Chinese rules and regulations, NetEase.com and certain of its subsidiaries have entered into a series of contractual arrangements for the provision of such services with certain affiliated companies, namely Guangzhou NetEase and Guangyitong Advertising. We also had similar arrangements with Ling Yi, which generated an insignificant amount of revenue related to WVAS and was dissolved in August 2007. Under the contracts, we provide our Internet and wireless value-added applications, services and technologies and advertising services to Guangzhou NetEase and Guangyitong Advertising and they operate the NetEase websites and the online advertising business. For more information on these agreements, see Item 7.B. “Major Shareholders and Related Party Transactions—Related Party Transactions.”

Under our agreements with Guangzhou NetEase, we have agreed to pay its operating costs. Under our agreements with Guangyitong Advertising, we have agreed to provide performance guarantees and guarantee loans for working capital purposes to the extent required by Guangyitong Advertising for its operations. Guangzhou NetEase and Guangyitong Advertising are each prohibited from incurring any debt without our prior approval.

Guangzhou NetEase is 90% beneficially owned by our founder, Chief Executive Officer and major shareholder, William Lei Ding, and 10% owned by his brother, Bo Ding. Guangyitong Advertising is 80% owned by Guangzhou NetEase and 20% owned by Bo Ding. We do not have any direct ownership interest in Guangzhou NetEase or Guangyitong Advertising.

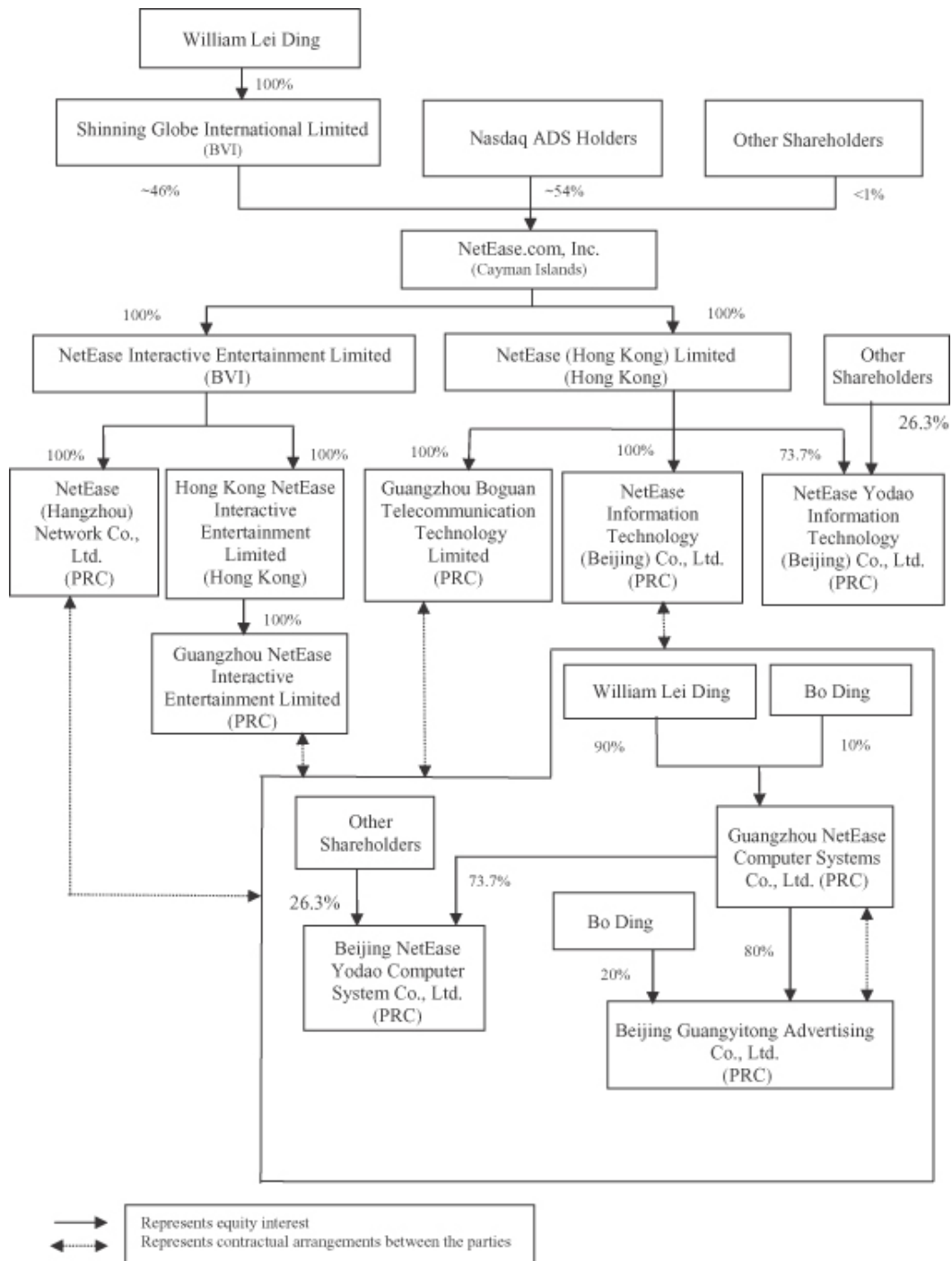
As a result of our contractual arrangements with these two companies, we bear the risks of, and enjoy the rewards associated with, and therefore are the primary beneficiary of our investments in Guangzhou NetEase and Guangyitong Advertising, and we have begun to consolidate their results of operations in our historical consolidated financial statements commencing in the fiscal year 2004. See also Item 5 “Operating and Financial Review and Prospects.”

Any violations by Guangzhou NetEase or Guangyitong Advertising of our agreements with them could disrupt our operations, degrade our services or shut down our services. See Item 3.D. “Risk Factors” for a detailed discussion of the risks to NetEase.com regarding its dependency on Guangzhou NetEase and Guangyitong Advertising.



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The following diagram shows the group structure of our subsidiaries and affiliated companies as of December 31, 2007:





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The affiliated variable interest entities shown in the box above are controlled by NetEase.com, Inc. through contractual arrangements between it and its subsidiaries, on the one hand, and the affiliated variable interest entities and their shareholders, on the other hand.

In 2007, we established two intermediate holding companies, NetEase Hong Kong and Hong Kong NetEase Interactive. NetEase Hangzhou became a subsidiary of Hong Kong NetEase Interactive in January 2008.

The 26.3% equity interests in Yodao Information and Yodao Computer are Chinese citizens who are employees of Yodao Information. Yodao Computer is in the process of applying for an ICP license in the PRC, but was inactive in 2007.

## **OUR SERVICES**

### **Online Games**

#### *Massively Multi-player Online Role-Playing Games*

We launched our first MMORPG, Westward Journey Online, in December 2001 and began charging users for playing time beginning in January 2002. Subsequently, we launched Westward Journey Online II and a MMORPG licensed from a Korean company, PristonTale, in August 2002. In January 2004, our second in-house developed MMORPG, Fantasy Westward Journey, was commercially launched. For the month of December 2007, peak concurrent users for this game reached over 1.5 million.

In addition, we licensed a Korean developed 3D MMORPG, named Fly For Fun, which we expect to commercially launch in the second half of 2008. We commercially launched our first 2.5D game, Datang, in July 2006, and Westward Journey Online III, an enhanced version of our popular Westward Journey game series, in September 2007. Tianxia II, our first item-based game, was launched in June 2008. We are also in the process of developing a new version of Datang and several item-based games, but we cannot predict if or when such new versions will be commercially launched.

For the month ended December 31, 2007, our online games in the aggregate had 757,830 average concurrent users, or ACU. The following table sets forth the average number of concurrent users for each of our MMORPG game titles for the periods indicated:

|                             | ACU for the month ended<br>December 31, |         |         |
|-----------------------------|---|---------|---------|
|                             | 2005                                    | 2006    | 2007    |
| Fantasy Westward Journey    | 383,912                                 | 453,295 | 546,135 |
| Westward Journey Online II  | 207,383                                 | 174,209 | 153,748 |
| Datang                      | —                                       | 13,326  | 8,349   |
| Westward Journey Online III | —                                       | —       | 49,598  |

Our MMORPG titles can be accessed from any location with an Internet connection by registered users of the NetEase websites. Users may enter our network with a password and a user-ID, after downloading our installation software or purchasing such software on a CD-ROM. Players of these games select a specific character to begin play. Over the course of play, these characters build up experience and enhanced game capabilities, wealth, weapons and other possessions, all of which may be carried over into subsequent gaming sessions. Players develop their characters according to choices they make within the construct of the game. Players also interact with computer operated characters as well as with other players that are playing on the same network server. Players are able to communicate with each other during the game through instant messaging or chatting features, allowing them to coordinate their activities with other players to form groups and achieve collective objectives.

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Game play is monitored by game masters, who appear as game characters within the game world and provide assistance and guidance to players, as well as policing behavior of players in the game world to maintain an atmosphere of fun and fair play.

Game content and game-play features are expanded through the development of expansion packs, which are released periodically for each game and which contribute to the ongoing popularity of the game.

### *Casual Games*

In 2005, we launched an online casual game platform which has various multi-player games such as billiards, card games and mahjong. Casual games are easier to play than MMORPGs and can be played to a conclusion within a short period of time. The basic versions of such games are available free-of-charge, and we sell virtual game enhancements, such as options for changing the appearance of the game-play or advanced tools, which players can use in the game, utilizing our prepaid point system. As of December 31, 2007, we had 29 casual games including 3 advanced casual games that offer a greater variety to users.

### *Customer Service*

We believe that providing strong, dependable customer support is a key component to success in the online games business. Our customer service center provides 24 hour-a-day customer service and technical support and can be contacted via telephone or e-mail. As of December 31, 2007, our company employed approximately 407 personnel in our call center as customer service specialists for our online games as well as for our other services.

### *User Fees*

Users of our MMORPG games pay fees according to the amount of time they play the games. Currently, we charge RMB0.40 (US\$0.05) per hour for all of our game titles, Westward Journey Online II, Fantasy Westward Journey, Datang and Westward Journey Online III.

In connection with the introduction of our online games, we developed a prepaid point card to facilitate payment of fees for our online game services and, to a lesser extent, our other fee-based value-added services. Users can buy prepaid point cards at a variety of locations in China, including Internet cafés, convenience stores, software stores, bookstores and newspaper stands. Electronic point cards can also be purchased through credit cards or online e-sales systems through which players can directly credit their accounts at Internet cafés or computer stores. Each prepaid card contains an account number and a password. The points represented by these cards can then be transferred into users' individual accounts on the NetEase websites and used to pay for our online services, primarily playing time for online games. We also utilize our point cards for the payment of virtual items as we launch item-based games for which playing time is free and players may purchase various virtual items to enhance their game-playing experience. We launched the open beta version of Tianxia II, our first item-based game, in June 2008.

Revenues from our online games accounted for 81.9%, 84.6% and 84.4% of total net revenues in 2005, 2006 and 2007, respectively.

### **Internet Portal**

Our Internet portal business, which is conducted through the NetEase websites, offers Chinese Internet users a network of Chinese language-based online content channels, community and communication services, including e-mail, instant messaging, and blogging. We also offer other Web-based applications and services, including a full text Chinese language search engine and a Web directory, to enhance their Internet experience. Our Internet services are all designed with user friendly interfaces and easy to understand instructions.

Our website content and services attract a large number of visitors who generate page views, which form the audience for us to provide advertising services for advertisers on our websites.

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### *Users*

The NetEase websites have registered and unregistered users. Any user may visit the NetEase websites without registering. Both registered and unregistered users generate page views when they visit our website. Only registered users can use our personalized services such as our free e-mail system and instant messaging, and our fee-based premium services such as our premium e-mail and dating services. Additionally, when registering an account, NetEase users are asked to provide us with demographic and preference information that better allow us to identify and target audiences with relevant online advertising.

### *Content*

The main homepage of the NetEase websites, [www.163.com](http://www.163.com), provides a destination for Chinese Internet users to identify and access resources, services, content and information on the Internet. The NetEase websites aggregate, organize and deliver information to meet the needs of Internet users in China. Our media channels provide users with an efficient and easy way to explore and utilize a wealth of information and content organized around a variety of topics.

The NetEase websites currently include various channels focusing on news, entertainment, sports, finance, information technology and automobiles.

Our content distribution platform enables the NetEase websites to offer in-depth local content as well as a variety of locally relevant regional and international content. We do not produce our own content for the NetEase websites, but rather obtain content from our content partners. Our content partners display their content on one or more of the NetEase websites and media channels free of charge or in exchange for a share of revenue, a licensing fee, online advertising, access to original content produced by the NetEase user community or a combination of these arrangements. We distribute this content through our content distribution system to Guangzhou NetEase, which determines the appropriate content to publish on the NetEase websites and to distribute to users of our wireless value-added services. Our content alliances are generally non-exclusive.

We believe that the breadth and relevance of our content offerings increases the number of visits our users make to the NetEase websites and the amount of time they spend on these sites. We adopt a significant amount of user-generated content from the community forums on the NetEase websites. We believe that this user-generated content is highly effective in maintaining user interest and ensuring repeat visits to the NetEase websites.

### *Community and Communication*

The NetEase websites have established a large online community member base as a result of our leading online community technology. We launched what we believe to be one of the first online communities in China in December 1998. Users can register with us online to interact with other registered community members. We believe that as users become more involved with our online community, they will return to the NetEase websites frequently.

NetEase users can interact through a variety of community services. They include:

*E-mail.* We provide registered users with free and fee-based premium Web-based e-mail services which support both the Chinese and English languages. Registered users can access and send e-mail through their Web browsers or through the POP3 and SMTP standards, which allow users to handle e-mails on their own e-mail applications without opening their browsers. The free Web-based e-mail service also includes free SPAM filters and anti-virus protection as well as the convenience of an address book to maintain user contact lists online. As of December 31, 2007, we had approximately 233 million registered free email users. We also offer value-added e-mail services for individuals, known as VIP, which provide fee-paying subscribers with the latest anti-virus and anti-SPAM filtering capabilities. The VIP e-mail service also includes enhanced security features as well as several convenient online and offline payment methods and 24-hour customer support. As of December 31, 2007, we had approximately 277,000 active VIP e-mail subscribers.

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*Online Community Forums.* We offer NetEase registered community members a variety of community forums where they can post messages and articles for viewing by other registered community members and other users. The NetEase online communities are hosted by volunteers, who are chosen by us based on their contributions to the communities. The NetEase community volunteers monitor our community forums and select appropriate articles for posting. In addition, these forums are also monitored by NetEase customer service personnel.

*Instant Messaging.* We offer NetEase registered users a communications platform to notify their online friends and other users with similar interests when they are online and to send and receive text messages seen by both parties nearly instantaneously, allowing NetEase registered users to participate in real-time dialogues. Users can access this service by downloading free software from the NetEase websites. During December 2007, we had approximately 129,000 peak concurrent users of our instant messaging service.

*Matchmaking and Others.* We offer a large number of other community services including online matchmaking services, a dedicated dating center, online greeting cards, chat rooms, alumni directories, photo album sharing, diary and blogging. Several of these services have significant subscriber bases. For example, our online matchmaking service had approximately 9.6 million accumulated registered accounts and approximately 55,000 subscribers as of December 31, 2007.

### *Other*

In addition to the services described above, the NetEase websites provide other services to our users including web search, blog search, image search, news search, online dictionary, desktop dictionary, toolbar and RSS reader, which automatically retrieves syndicated web contents and customized set of search results. Our web search service was powered by the Google search engine until July 2007. Subsequently, our web search service was powered by our own proprietary Internet search engine, Yodao, which was officially launched in December 2007.

### *Advertising Services on the Websites*

We provide advertising services for advertisers on our websites, utilizing many advertising formats and techniques. These include sponsorships of our channels, advertisements such as animated and interactive banners, floating buttons, text-links and other formats throughout our websites, advertising through targeted e-mail campaigns, interactive media-rich sites, and sponsored special events that integrate live events with online promotion and other media.

Furthermore, we perform analyses of our registered users' habits and preferences on a frequent basis and have used that information to tailor our advertising services. For example, we can deliver direct marketing advertisements via e-mail to users who fit within certain criteria based on their user profile. By developing user profiles and user behavior analyses, we intend to increase our ability to target specific user groups and thereby identify users who are attractive to online advertisers.

### *Fees and Revenues*

Revenue generated by our Internet portal business consists mainly of fees we receive from our fee-based premium services and revenue earned from the sale of advertising space on the NetEase websites.

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Generally, we price the services associated with our Internet portal as follows:

| <b>Service</b>  | <b>Pricing</b>   |
|---|--|
| Basic Services, including:<br>content services (such as news, local information, finance and weather);<br>chat rooms;<br>basic e-mail services;<br>basic personal ads;<br>basic matchmaking;<br>basic alumni clubs;<br>photo album;<br>diary;<br>blogging;<br>clubs;<br>dictionary;<br>electronic greeting cards;<br>instant messaging PC to PC;<br>web directories;<br>web searching; and<br>online shopping mall. | Free of charge   |
| Fee-Based Premium Services, including:<br>premium e-mail services;<br>premium matchmaking and dating services; and<br>premium alumni clubs.   | Monthly subscription basis (ranges from RMB3.00 (US\$0.41) to RMB60.00 (US\$8.23) per month) |
| Advertising Services, including:<br>channel sponsorship;<br>banner advertising;<br>direct e-mail; and<br>sponsored special events.  | Varies depending on service (see below).   |

Pricing for our advertising services has varied based on a number of factors including the duration for which advertisements appear on the NetEase websites, how often such Web pages are viewed by users and the number of users that perform a specific action, such as registering onto an advertisers website.

**Wireless Value-added Services**

Our primary wireless value-added offering is short messaging services, or SMS, which allows mobile phone users to, among other things, send and receive text messages from the Internet. We offer a wide variety of SMS services in the form of individual messages and subscription packages which allow users, for example, to receive news and information such as daily news and e-mails, download ringtones and logos for their mobile phones and participate in matchmaking communities and interactive games. In 2006, Internet-related services remained our most popular category of SMS services in terms of revenue, in particular e-mail-related services through which we notify subscribers via an SMS message that they have received an e-mail message in our premium VIP e-mail service. For an additional payment, we will also send subscribers the text of the e-mail message to their mobile phone via SMS.

In addition, we offer wireless application protocol, or WAP, services, which provide a browser-based platform to access and use sophisticated wireless value-added services, and multimedia messaging services, or MMS, which provide sophisticated, content-rich mobile messages. Both WAP and MMS services are available to

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mobile users with phones that are compatible with the advanced 2.5G mobile networks in China. We also offer interactive voice response services, or IVRS. IVRS allows users to access pre-recorded information from their mobile phones or interact with other users through voice chat simply by dialing specially designated IVRS phone numbers and responding to menu options. Our users can also order color ring-back tones, which enable users to customize the ringtone a caller hears. These ringtones can include voice recordings as well as pre-recorded music.

Revenues from wireless value-added services and others accounted for 4.4%, 3.4% and 3.0% of total net revenues in 2005, 2006 and 2007, respectively. Nonetheless, we intend to continue promoting SMS and non-SMS wireless services which have a strong tie-in with the NetEase websites, such as matchmaking community, photo album sharing and e-mail.

## **SALES AND MARKETING**

### **Sales**

#### *Online Games*

We sell game playing time to users of our MMORPGs largely in the form of prepaid point cards. We sell prepaid point cards to end users through over 1,700 distributors as of December 31, 2007. These distributors arrange for our cards to be offered at various retail points in China including, notably, Internet cafés where many of the users of our online games access our system, and to a much lesser extent, directly over the Internet. We typically sell prepaid point cards to distributors at a 13%-14% discount off of their face value.

Users can also purchase virtual prepaid cards online by debit cards or bank transfers, and receive the prepaid point information over the Internet.

#### *Advertising Services*

We believe the growing number of Internet users in China represents an attractive demographic target for advertisers because it represents an affluent, educated and technically sophisticated market. To capitalize on this advertising opportunity, we maintain a dedicated advertising services sales force, which had 107 sales professionals located in Beijing, Shanghai and Guangzhou as of December 31, 2007.

In addition, online advertising on the NetEase websites is also sold through online advertising sales networks and advertising agencies. We believe that our focus on providing widely-used services that are designed to appeal to a broad base of Internet users attracts a variety of blue chip advertisers, ranging from technology products to consumer brands (including increasingly Chinese companies). We intend to continue to attract online advertisers by promoting the NetEase brand name to potential advertisers. We also engage in providing cooperative promotional advertising solutions in which we act as the official sponsor or co-sponsor of special events or online content, such as websites that feature movies or television series, athletic events, music awards, charity concerts and industry exhibitions.

For a discussion of the seasonality of our revenue, see Item 5 “Operating and Financial Review and Prospects—Revenue—Seasonality of Revenues.”

### **Marketing**

We employ a variety of traditional and online marketing programs and promotional activities to build our brand as part of our overall marketing strategy. We focus on building brand awareness through proactive public relations and traditional and online advertising. In 2007, we invested in a series of marketing activities to further strengthen our brand image and continue to grow our user base. Our marketing campaigns consisted of corporate branding and announcements about our services through outdoor, print and online advertisements.

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We have entered into a number of revenue sharing agreements with third party promoters of our online game titles. Pursuant to these agreements, promoters market our game titles to potential customers in specific locations, principally Internet cafés and university campuses, in return for a share of revenues we receive from new users they recruit.

We plan to continue investing in various forms of marketing to further build awareness of our brand.

## **RESEARCH AND DEVELOPMENT**

We believe that the ability to develop and enhance our services is an integral part of our future success. Our product development efforts and strategies consist of incorporating new technologies from third parties as well as continuing to develop our own proprietary technology in order to produce user-friendly Internet and wireless applications, services and technologies for the Chinese market.

We have utilized and will continue to utilize the products and services of third parties to enhance our platform of technologies and services to provide competitive and diverse Internet and wireless services to our users. We also have utilized and will continue to utilize third-party advertisement serving technologies in conjunction with our own proprietary software. In addition, we plan to continue to expand our technologies, services and registered user base through diverse online services developed internally. We will seek to continually improve and enhance our existing services to respond to rapidly evolving competitive and technological conditions.

Our major area of focus is the development of our proprietary online games. Though we have obtained MMORPG titles in the past both through licensing arrangements and internal development, we believe internal development offers a number of advantages, including flexibility to release new versions and upgrades according to our own timetable, the ability to tailor new games to the Chinese audience and the ability to proactively monitor and counter hacking activities so as to ensure the integrity of the gaming environment. We will continue to focus on developing additional new games in the future. As of December 31, 2007, we had 671 programmers, network engineers and graphic designers dedicated to online game research and development.

In connection with our game development activities, we will occasionally license specific game technologies which we incorporate into our in-house developed games, such as a 3D game engine that we will be using in our newest MMORPGs.

## **INFRASTRUCTURE AND TECHNOLOGY**

Our infrastructure and technology have been designed for reliability, scalability and flexibility and are administered by our technical staff. The NetEase websites are made available primarily through network servers co-located in the facilities of China Netcom's Beijing affiliate and China Telecom's Beijing and Changzhou affiliates. As of December 31, 2007, there were approximately 10,000 of such co-located servers, operating with Web server software from Apache and Netscape. As of December 31, 2007, we had leased dedicated lines with a total of approximately 22.0 gigabits per second capacity from China Netcom's Beijing, Guangzhou and Changzhou affiliates, China Telecom's Beijing and Changzhou affiliates, and CERNET.

We license NetGravity's advertisement serving technology to provide internal advertising inventory management, and we have developed our own advertisement tracking system.

We use Oracle's database systems to manage our registered user database. NetEase has established a comprehensive user profile system, and we analyze user information on a weekly basis. We also deploy a single sign-on system that allows users to easily access our services within the NetEase websites. We intend to continue to use a combination of internally developed software products as well as third party products to enhance our Internet media services in the future.



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### **COMPETITION**

A number of companies offer competitive products or services in China, our main operating market. These include Perfect World Company Limited, or Perfect World, Giant Interactive Group Inc, or Giant, Shanda Interactive Entertainment Limited, or Shanda, The 9 Limited, or The9, Sina Corporation, or Sina, Sohu.com, Inc., or Sohu, Tom Online Inc., or Tom.com, 263.net, Linktone Ltd., or Linktone, Tencent, Chinadotcom Corporation, or Chinadotcom, Baidu and 21cn.com.

Specifically, we are encountering competition from companies offering MMORPGs and casual games that target the China market, such as Perfect World, Giant, Shanda, Softworld, Softstar Entertainment Inc., Actoz Soft Co., Ltd., NCsoft Corporation, The9, 9you, Kingsoft Corporation Limited, or Kingsoft, Waei International Digital Entertainment Co., Ltd. In addition, we face competition from other websites that offer online content and online community services, including Sina, Sohu, Tom.com, Tencent, 263.net, Baidu, 21cn.com and Alibaba. Some of our existing and potential competitors in these areas have significantly greater financial and marketing resources than we do. In addition, we believe that many of our competitors have become more active in both licensing foreign-developed games and developing games in-house.

Moreover, operators of Internet portals, such as Sina and Sohu, and dedicated service providers, such as Linktone, MTone Wireless Corporation and Newpalm Information Technology Co., Ltd. (a subsidiary of Chinadotcom), are major providers of wireless value-added services in the China market, and like our company, they also have partnership arrangements with both China Mobile and China Unicom, the two principal mobile phone operators in China. Overall, we have seen increasing competition in the wireless value-added services market.

We also believe that competition in the online advertising industry in China has intensified as new entrants have come into the market such as Baidu, Tencent and other vertical Internet portals. In addition, we face potential competition from US-based portals such as Yahoo!, Yahoo! Chinese and MSN which are currently increasing their Chinese language service offerings or have announced an intention to do so. We expect that China's entry into the WTO in 2001, and the resulting gradual opening of its telecommunications sector, may facilitate more foreign participation in the Chinese Internet market by companies such as Yahoo!, Google and Microsoft. Many of these Internet companies have longer operating histories in the Internet market, greater name and brand recognition, larger customer bases and databases and significantly greater financial, technical and marketing resources than we have. The entry of additional, highly competitive Internet companies into the Chinese market would further heighten competition. Finally, we face competition from websites that operate outside our market and offer content in the English language, which may be attractive to a portion of Chinese Internet users.

We also compete with traditional forms of media for advertising-related revenue. There can be no assurance that we will be able to compete successfully against our current or future competitors or that competition will not have a material adverse effect on our business, results of operations and financial condition.

### **GOVERNMENT REGULATIONS**

#### *Overview*

The Chinese government has enacted an extensive regulatory scheme governing the operation of Internet-related businesses, such as telecommunications, Internet information services, international connection to computer information networks, information security and censorship. In addition to MII, the various services of the PRC Internet industry are regulated by various governmental authorities, such as the State Administration for Industry and Commerce, or SAIC, the State Council Information Office, or SCIO, the General Administration for Press and Publication, or GAPP, the Ministry of Education, or MOE, the Ministry of Health, or MOH, the State Food and Drug Administration, or SFDA, the Ministry of Culture, or MOC, the State Administration of Radio, Film and Television, or SARFT, the Ministry of Commerce and the Ministry of Public Security.



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In September 2000, China's State Council promulgated the Telecommunications Regulations of the People's Republic of China, or the Telecom Regulations. The Telecom Regulations categorized all telecommunications businesses in China as either basic telecommunications businesses or value-added telecommunications businesses, with ICP services and e-mail services classified as value-added telecommunications businesses. According to the Telecom Regulations, the commercial operator of such services must obtain an operating license. The Telecom Regulations also set forth extensive guidelines with respect to different aspects of telecommunications operations in China.

In December 2001, in order to comply with China's commitments with respect to its entry into the WTO, the State Council promulgated the Regulation for the Administration of Foreign-invested Telecommunications Enterprises, or the FITE Regulations. The FITE Regulations set forth detailed requirements with respect to capitalization, investor qualifications and application procedures in connection with the establishment of a foreign invested telecom enterprise. Pursuant to the FITE Regulations, foreign investors may now hold an aggregate of no more than 50% of the total equity in any value-added telecommunications business in China.

The Circular of the Ministry of Information Industry on Intensifying the Administration of Foreign Investment in Value-Added Telecommunication Services, or the 2006 MII Circular, was promulgated by MII on July 13, 2006. The 2006 MII Circular provides that (i) any domain name used by a value-added telecom service provider must be legally owned by the service provider or its shareholder(s); (ii) any trademark used by a value-added telecom service provider must be legally owned by the service provider or its shareholder(s); (iii) the operation site and facilities of a value-added telecom service provider must be installed within the scope as prescribed by the operating licenses obtained by the service provider and must correspond to the value-added telecom services that the service provider has been approved to provide; and (iv) a value-added telecom service provider must establish or improve the measures of ensuring information security. Companies which have obtained operating licenses for value-added telecom services are required to conduct a self-examination and self-correction according to the foregoing requirements and report the results of such self-examination and self-correction to MII. To comply with these requirements, Guangzhou NetEase submitted its self-correction report to MII in 2007, and we intend to transfer certain of our trademarks and domain names to Guangzhou NetEase once we receive a response from MII regarding such report.

### *Classified Regulations*

#### *Internet Information Services*

The Measures for the Administration of Internet Information Services, or the ICP Measures, issued by the State Council went into effect on September 25, 2000. Under the ICP Measures, any entity that provides information to Internet users must obtain an operating license from MII or its local branch at the provincial level in accordance with the Telecom Regulations described above. To provide these services in compliance with all the relevant ICP-related Chinese regulations, Guangzhou NetEase successfully obtained an ICP license issued by the Guangdong Provincial Telecommunications Bureau. Subsequently, Guangzhou NetEase obtained a Value-Added Telecom Business Operating License from the Guangdong Provincial Telecommunications Bureau, which replaced its ICP license and authorizes Guangzhou NetEase to provide Internet content services. Guangzhou NetEase obtained an Inter-Provincial Value-Added Telecommunications Business Operating License from MII, which specifically authorizes it to provide Internet content services on a national basis.

The Regulations for the Administration of Internet Bulletin Board Services, which was issued by MII on October 8, 2000, provide that any ICP operator engaged in providing online bulletin board services is subject to a special approval and filing process with the relevant government telecommunications authorities. Guangzhou NetEase has obtained a permit to operate its bulletin board services.

The Provisional Regulations for the Administration of Website Operation of News Publications, which were jointly issued by SCIO and MII on November 6, 2000, stipulate that non-news organizations may not publish news items produced by themselves and require the websites of non-news organizations to be approved by SCIO

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after securing permission from SICO at the provincial level. On September 25, 2005, the Regulations for the Administration of Internet News Information Services were promulgated jointly by SCIO and MII. The regulations require that any ICP operator that is a non-news organization but engaged in Internet news information services must obtain approval for those services from SCIO. Guangzhou NetEase has obtained an Internet News Information Service License from SCIO.

On June 27, 2002, MII and GAPP jointly promulgated the Provisional Measures for the Administration of Internet Publishing, which require Internet publishers to secure approval from GAPP. The term "Internet publishing" is defined as an act of online dissemination whereby Internet information service providers select, edit and process works created by themselves or others (including content from books, newspapers, periodicals, audio and video products, electronic publications, etc. that have already been formally published or works that have been made public in other media) and subsequently post the same on the Internet or transmit the same to users via the Internet for browsing, use or downloading by the public. Guangzhou NetEase has obtained a license from GAPP to engage in Internet publishing.

On July 8, 2004, SFDA issued the Measures for the Administration of Internet Drug Information Services, which stipulate that websites publishing drug-related information must obtain a license from local food and drug administrations. Guangzhou NetEase has obtained a license for publishing drug-related information from the Guangdong Food and Drug Administration.

According to the Measures for the Administration of Internet Medical and Health Information Services, which were issued by MOH on January 8, 2001, websites publishing medical and health information must gain approval from local health administrations. In compliance with the above regulation, Guangzhou NetEase has secured an approval for publishing medical and health information through a formal reply issued by the Guangdong Health Administration.

The Provisional Measures for the Administration of Educational Websites and Online Education School were released by MOE on July 5, 2000. This regulation requires that educational websites, which include websites publishing education-related information, must obtain an approval from the relevant administrative department regulating education. In a formal reply issued by the Guangdong Education Administration, Guangzhou NetEase has been approved to operate educational websites.

Pursuant to the Measures for the Administration of Internet E-mail Services, or the Internet E-mail Measures, which were issued by MII on February 20, 2006, e-mail service providers must obtain value-added telecommunications business operating licenses or file for recordation as nonprofit Internet service providers. In addition, each e-mail service provider must keep a record of the timing, sender's or recipient's e-mail address and IP address of each e-mail transmitted through its servers for 60 days. The Internet E-mail Measures also state that an Internet e-mail service provider is obligated to keep confidential the users' personal registered information and Internet e-mail addresses. An Internet e-mail service provider and its employees may not illegally use any user's personal registered information or Internet e-mail address and may not, without consent of the user, divulge the user's personal registered information or Internet e-mail address, unless otherwise prescribed by another law or administrative regulation. Guangzhou NetEase has obtained an Inter-Provincial Value-Added Telecommunications Business Operating License.

SARFT and MII jointly issued the Regulations for the Administration of Internet Audiovisual Program Services, or the Audiovisual Regulations, on December 20, 2007, which require that online audio and video service providers must obtain a permit from SARFT in accordance with the Audiovisual Regulations. Guangzhou NetEase has obtained the Permit for the Network Transmission of Audiovisual Programs issued by SARFT.

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### *Information Security and Censorship*

Regulations governing information security and censorship include:

- *The Law of the People's Republic of China on the Preservation of State Secrets (1988) and its Implementation Rules (1990).*
- *The Law of the People's Republic of China on the Preservation of State Security (1993) and its Implementation Rules (1994).*
- *The Rules of the People's Republic of China for Protecting the Security of Computer Information Systems (1994).*
- *The Administrative Regulations for the Protection of Secrecy on Computer Information System Connected to International Networks (1997).*
- *The Regulations for the Protection of State Secrets for Computer Information Systems on the Internet (2000).*
- *The Notice issued by the Ministry of Public Security of the People's Republic of China Regarding Issues Relating to the Implementation of the Administrative Measure for the Security Protection of International Connections to Computer Information Networks (2000).*
- *The Detailed Implementation Rules for the Administration of Commercial Website Filings for the Record (2000).*
- *The Decision of the Standing Committee of the National People's Congress Regarding the Safeguarding of Internet Security (2002).*
- *The Provisions on the Technical Measures for the Protection of the Security of the Internet (2005).*
- *The Administrative Regulations for the Classified Protection of Information Security (2007).*

Under the Administrative Regulations for the Protection of Secrecy on Computer Information System Connected to International Networks and various other laws and regulations, ICP operators and Internet publishers are prohibited from posting or displaying any content that:

- opposes the fundamental principles set forth in China's Constitution;
- compromises state security, divulges state secrets, subverts state power or damages national unity;
- harms the dignity or interests of the state;
- incites ethnic hatred or racial discrimination or damages inter-ethnic unity;
- sabotages China's religious policy or propagates heretical teachings or feudal superstitions;
- disseminates rumors, disturbs social order or disrupts social stability;
- propagates obscenity, pornography, gambling, violence, murder or fear or incites the commission of crimes;
- insults or slanders a third party or infringes upon the lawful rights and interests of a third party; or
- includes other content prohibited by laws or administrative regulations.

Failure to comply with these content censorship requirements may result in the revocation of licenses and the closing down of the concerned websites. To ensure compliance with these regulatory requirements, Guangzhou NetEase has taken all reasonable steps to avoid displaying any of the prohibited contents on the NetEase websites. In addition, it is mandatory for Internet companies in the PRC to complete security-filing procedures and regularly update information security and censorship systems for their websites with the local public security bureau. Guangzhou NetEase has obtained a Filing and Registration Certificate for Computer Information System Connected to International Networks issued by Guangzhou Public Security Bureau.

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According to the Detailed Implementation Rules for the Administration of Commercial Website Filings for the Record, websites should register their names with the Beijing Municipal Administration of Industry and Commerce, or BAIC, and obtain electronic registration marks, which should be placed at their homepages. Guangzhou NetEase has registered the NetEase websites with BAIC and subsequently placed the electronic registration mark on its homepage.

On June 23, 2007, the Ministry of Public Security, the State Secrecy Bureau, the State Cryptography Administration Bureau and the State Council Informatization Office jointly issued the Administrative Regulations for the Classified Protection of Information Security, according to which websites should determine the protection classification of their information systems pursuant to a classification guideline and file such classification with the Ministry of Public Security and its bureaus at provincial level. Guangzhou NetEase has followed the requirements and filed its classification with the Guangzhou Public Security Bureau.

### *Online Games*

The Measures for the Administration of Software Products, which were issued by MII on October 27, 2000, classify online games products as software products, and a software registration certificate issued by the MII is required for the operation and sales of each online game. In compliance with this regulation, all of our online games, including Westward Journey Online II, Fantasy Westward Journey, Datang, Tianxia II, Fly For Fun and Westward Journey Online III, have been registered with MII and its offices at the provincial level.

Pursuant to the Provisional Regulations for the Administration of Online Culture promulgated by MOC in May 2003, online game operators are required to obtain an Internet Culture Operating License from MOC, which Guangzhou NetEase has received. In 2004, MOC promulgated the Notice Regarding the Strengthening of Network Games Censorship, which provides that imported online games must be reviewed and approved by MOC before they can be put into public testing or operation. In November 2005, MOC issued Guangzhou NetEase a certificate of public testing for Fly for Fun.

In addition, for imported online games, the relevant license agreements for such games are regarded as technology import contracts and, accordingly, must be registered with the Ministry of Commerce. Guangzhou NetEase has registered the license agreement for Fly for Fun with the local office of the Ministry of Commerce. Such license agreements also need to be registered with the State Copyright Bureau, otherwise the licensee cannot remit licensing fees out of China to the foreign game licensor. Guangzhou NetEase has registered the license contract for Fly for Fun with the State Copyright Bureau.

The publication of online games also requires approval from GAPP in accordance with the Provisional Rules for the Administration of Internet Publishing jointly promulgated by GAPP and MII on June 27, 2002. Guangzhou NetEase has received such approval. In addition, in April 2007, GAPP and several other government authorities jointly promulgated the *Notice Concerning the Protection of Minors' Physical and Mental Well-being and Implementation of Anti-addiction System on Online Games* (the "Notice"), which confirms the real-name verification scheme and anti-addiction system standard made by GAPP in previous years and requires online game operators to develop and test their anti-addiction systems from April 2007 to July 2007, after which no online games can be registered or operated without an anti-addiction system in accordance with the Notice. Accordingly, we have implemented our anti-addiction system to comply with the Notice in July 2007. Since its implementation, we have not experienced a significant negative impact of the Notice on our business.

On February 18, 1994, the State Council promulgated the Rules of the People's Republic of China for Protecting the Security of Computer Information Systems, which define Security Products for Computer Information Systems as software and hardware products designed for the protection of computer information security and stipulate that a license must be obtained before selling Security Products for Computer Information Systems. The Ministry of Public Security issued the Measures for the Administration of Security Products for Computer Information Systems Examination and Sales License on June 28, 1997 confirming that a license for the

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sale of security products for computer information systems must be obtained as a precondition for sales of such products. Guangzhou NetEase has developed a technology which is designed to protect the passwords of online game players and falls into the scope of security products for computer information systems which is subject to this license requirement. Guangzhou NetEase has obtained the above-mentioned license from the Guangdong Public Security Bureau.

According to the Guidelines for the Filing for Recordation of Domestic Online Games issued by MOC in 2005, domestic online games operating in China must be filed for recordation with MOC before they can be put into operation. Our in-house developed online games, including Westward Journey Online II, Fantasy Westward Journey, Datang, Tianxia II and Westward Journey III have been filed with MOC for recordation. Westward Journey Online II, Fantasy Westward Journey and Datang have successfully finished the recordation process while Tianxia II and Westward Journey III are still in the review process.

The Regulations for the Administration of Audio and Video Products, which was released by the State Council on December 25, 2001, require that the publication, production, duplication, importation, wholesale, retail and renting of the audio and video products are subject to a license issued by competent authorities. Guangzhou NetEase has obtained such license from Guangdong Culture Administration.

### *Wireless Value-Added Services*

The Measures for the Administration of Telecommunications Business Operating Licenses issued by MII on December 26, 2001 differentiated telecom licenses into two types: license for basic telecom services and license for value-added telecom services. Geographically, a telecom license can be granted for intra-provincial or inter-provincial activities.

In April 2004, MII issued the Notice on Certain Issues Regarding the Regulation of Short Message Services, or the SMS Notice, which required all SMS providers to obtain a relevant operating license within 30 days after the issuance of the notice, otherwise, the mobile operators in China will immediately cease to provide connection services to such provider. Guangzhou NetEase has obtained an Inter-Provincial Value-Added Telecommunications Business Operating License from MII, and has completed the requisite registrations with the local offices of MII in 31 provinces.

### *Online Advertising*

The Regulations for the Administration of Advertising and its Detailed Implementation Rules were both promulgated by the State Council and SAIC, which took effect on December 1, 1987 and January 1, 2005, respectively. According to these regulations, websites engaged in advertising must apply for a business license to conduct such business. In compliance with such regulations, Guangyitong Advertising, which operates our online advertising business through a series of agreements with Guangzhou NetEase, and Guangzhou NetEase have obtained a business license to carry out the design, production, agency and release of advertisements.

## **INTELLECTUAL PROPERTY AND PROPRIETARY RIGHTS**

We rely on a combination of copyright, trademark and trade secrecy laws and contractual restrictions on disclosure to protect our intellectual property rights. We require our employees to enter into agreements requiring them to keep confidential all information relating to our customers, methods, business and trade secrets during and after their employment with us. Our employees are required to acknowledge and recognize that all inventions, trade secrets, works of authorship, developments and other processes, whether or not patentable or copyrightable, made by them during their employment are our property. They also sign all necessary documents to substantiate our sole and exclusive right to those works and to transfer any ownership that they may claim in those works to us.

We have full legal rights over and have registered a number of domain names, including:

- [www.netease.com](http://www.netease.com);

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- [www.163.com](http://www.163.com);
- [www.yeah.net](http://www.yeah.net);
- [www.126.com](http://www.126.com); and
- [www.netease.net](http://www.netease.net)

Guangzhou NetEase and NetEase Beijing have successfully registered numerous trademarks with China's Trademark Office, including marks incorporating the words "NetEase" and "Yeah" in English and for marks for "NetEase" as written in Chinese in traditional and simplified Chinese characters. In addition, they have registered trademarks involving Chinese characters and phrases that have meanings relating to our Web pages, products and services, including our dating and friends matching services, chat services, online gaming and our search engine. We have also registered a number of trademarks in Hong Kong incorporating the words "NetEase" in English and the marks for "NetEase" as written in Chinese in traditional and simplified Chinese characters. In addition, we have also filed and registered the marks for "NetEase" in English in the United States. As described above under "—Government Regulations," we intend to transfer certain of our trademarks and domain names to Guangzhou NetEase to comply with the 2006 MII Circular.

In addition, we have registered our Westward Journey Online II, Fantasy Westward Journey, Tianxia II, Datang and Westward Journey III games with the State Copyright Bureau of China. Moreover, we have filed some patent applications with the State Intellectual Property Office of China and have obtained Certificate of Design Patent for the Password Protection Device from the State Intellectual Property Office.

While we actively take steps to protect our proprietary rights, such steps may not be adequate to prevent the infringement or misappropriation of our intellectual property. Infringement or misappropriation of our intellectual property could materially harm our business. We own the intellectual property (other than the content) relating to the NetEase websites and the technology that enables on-line community, personalization and e-commerce services on those sites. We license content from various freelance providers and other content providers.

Many parties are actively developing community, online game, e-commerce, search and related Web technologies. We expect these parties to continue to take steps to protect these technologies, including seeking patent protection. There may be patents issued or pending that are held by others and that cover significant parts of our technology, business methods or services. For example, we are aware that a number of patents have been issued in areas of e-commerce, Web-based information indexing and retrieval and online direct marketing. Disputes over rights to these technologies are likely to arise in the future. We cannot be certain that our products do not or will not infringe valid patents, copyrights or other intellectual property rights held by third parties. We may be subject to legal proceedings and claims from time to time relating to the intellectual property of others.

### **C. Organizational Structure**

Our organizational structure is set forth above under "—Our Organizational Structure."

### **D. Property, Plants and Equipment**

Our principal executive offices are currently located at 26/F, SP Tower D, Tsinghua Science Park Building 8, No.1 Zhongguancun East Road, Haidian District, Beijing, People's Republic of China 100084. We lease our current principal executive offices at an effective annual rent of approximately RMB6.0 million (US\$0.8 million), including management fees, for 4,354 square meters under a lease that expires in May 2009. We also occupy 1,663 square meters under a lease in Beijing that expires in July 2009. In Hangzhou, we occupy 3,186 square meters under leases that expire in October 2008, May 2009 and June 2010 and have also purchased land use rights for approximately 56,000 square meters of land as described in "—History and Development of the Company" above. In Guangzhou, we occupy 3,253 square meters under leases that expire in March 2011. We



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also occupy a building in Guangzhou with total floor area of 20,000 square meters. We currently do not have a lease for such property but have accrued imputed rent for it. For more information on this property, see Item 5 “Operating and Financial Review and Prospects” and Item 7.B. “Major Shareholder and Related Party Transactions—Related Party Transactions.” We believe that we will be able to obtain adequate facilities, principally through the leasing and acquisition of appropriate properties, to accommodate our future expansion plans.

As of December 31, 2007, we leased dedicated lines with a total capacity of approximately 22,000 megabits per second from various affiliates of China Netcom and China Telecom and from CERNET. We lease such capacity pursuant to short term contracts. Our bandwidth fees were approximately RMB65.0 million (US\$8.9 million) for the year ended December 31, 2007.

### **Item 4A. Unresolved Staff Comments**

Not Applicable.

### **Item 5. Operating and Financial Review and Prospects**

*The following discussion of our financial condition and results of operations is based upon and should be read in conjunction with our consolidated financial statements and their related notes included in this annual report. This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, including, without limitation, statements regarding our expectations, beliefs, intentions or future strategies that are signified by the words “expect,” “anticipate,” “intend,” “believe,” or similar language. All forward-looking statements included in this annual report are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. In evaluating our business, you should carefully consider the information provided under Item 3.D. “Risk Factors.”. Actual results could differ materially from those projected in the forward-looking statements. We caution you that our businesses and financial performance are subject to substantial risks and uncertainties.*

#### **A. OPERATING RESULTS**

##### **Overview**

NetEase is a leading Internet technology company in China. Our innovative online games, communities and personalized premium services, which allow registered users to interact with other community members, have established a large and stable user base for the NetEase websites which are operated by our affiliate. As of December 31, 2007, we had registered an accumulated total of approximately 809 million accounts.

For the year ended December 31, 2007, we continued to develop our online games and advertising business. We also provide wireless value-added and other fee-based premium services, but we expect that revenue from such services will remain a relatively small part of our total revenue for the foreseeable future.

We achieved a net profit of RMB1,264.1 million (US\$173.3 million) for 2007 and generated positive operating cash flows of RMB1,379.9 million (US\$189.2 million) during the year. We recorded retained earnings of RMB1,123.2 million, RMB2,338.1 million and RMB3,225.8 million (US\$442.2 million) as of December 31, 2005, 2006 and 2007, respectively.

##### **Our Corporate Structure**

NetEase.com, Inc. was incorporated in the Cayman Islands on July 6, 1999 as an Internet technology company in China. In 2007, we established two intermediate holding companies, namely NetEase Hong Kong and Hong Kong NetEase Interactive. Guangzhou Interactive and NetEase Hangzhou became wholly owned subsidiaries of Hong Kong NetEase Interactive in December 2007 and January 2008, respectively. NetEase Beijing, Boguan and Yodao Information became subsidiaries of NetEase Hong Kong in December 2007.



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NetEase Beijing, Guangzhou Interactive, Boguan, Yodao Information and NetEase Hangzhou were established in China on August 30, 1999, October 15, 2002, December 8, 2003, March 21, 2006 and June 2, 2006, respectively.

NetEase.com, Inc. conducts its business in China through its subsidiaries. Under current Chinese regulations, there are restrictions on the percentage interest foreign or foreign-invested companies may have in Chinese companies providing value-added telecommunications services in China, which include the provision of Internet content, online games and wireless value-added services such as SMS. In addition, the operation by foreign or foreign-invested companies of advertising businesses in China is subject to government approval. In order to comply with these restrictions and other Chinese rules and regulations, NetEase.com, Inc. and certain of its subsidiaries have entered into a series of contractual arrangements for the provision of such services with certain affiliated companies, namely Guangzhou NetEase, Guangyitong Advertising and Ling Yi (until it was dissolved in August 2007). These affiliated companies are considered “variable interest entities” for accounting purposes (see “—Basis of Presentation” below), and are referred to collectively in this section as “VIEs.” The revenue earned by the VIEs largely flows through to NetEase.com, Inc. and its subsidiaries pursuant to such contractual arrangements. Based on these agreements, NetEase Beijing, NetEase Hangzhou, Guangzhou Interactive and Boguan provide technical consulting and related services to the VIEs.

Guangzhou NetEase is a limited liability company organized under the laws of China and is 90% owned by our major shareholder, William Lei Ding. Guangzhou NetEase has been approved by the Chinese authorities to operate as an Internet content provider and operates the NetEase websites. Guangzhou NetEase’s 80% owned subsidiary, Guangyitong Advertising, is licensed by the Chinese authorities to operate an advertising business and engages in Internet-related advertising design, production and dissemination. Ling Yi, which was formed in October 2003 and dissolved in August 2007, was also a limited liability company organized under the laws of China and was 90% owned by our major shareholder. Ling Yi was approved to operate as an Internet content provider. For the years ended December 31, 2005, 2006 and 2007 until its dissolution in August 2007, Ling Yi earned revenue relating to WAP services and MMS, which represented a small portion of our wireless value-added services revenue.

In September 2007, Guangzhou NetEase and three Chinese citizens incorporated a domestic enterprise, Yodao Computer, for the purpose of applying for an ICP license under the applicable Chinese telecommunication laws to operate our own proprietary internet search engine, Yodao.

We believe that our present operations are structured to comply with the relevant Chinese laws. However, many Chinese regulations are subject to extensive interpretive powers of governmental agencies and commissions. We cannot be certain that the Chinese government will not take action to prohibit or restrict our business activities. Future changes in Chinese government policies affecting the provision of information services, including the provision of online services, Internet access, e-commerce services and online advertising, may impose additional regulatory requirements on us or our service providers or otherwise harm our business.

### **Basis of Presentation**

On January 17, 2003, the Financial Accounting Standards Board issued FASB Interpretation No. 46: Consolidation of Variable Interest Entities, an interpretation of ARB 51, or FIN 46, which was subsequently amended by a revised interpretation, or FIN 46-R. These interpretations address financial reporting for entities over which control is achieved through a means other than voting rights. According to the requirements of FIN 46 and FIN 46-R, we have evaluated our relationships with the previously unconsolidated affiliated companies, Guangzhou NetEase and Guangyitong Advertising, as well as Ling Yi (which was dissolved in August 2007). We have concluded that Guangzhou NetEase, Guangyitong Advertising and Ling Yi are VIEs, and NetEase.com, Inc. is the primary beneficiary of these affiliated companies. Accordingly, we adopted the provisions of FIN 46 and consolidated Guangzhou NetEase and Guangyitong Advertising on a prospective basis from January 1, 2004 and Ling Yi from May 17, 2004 until its dissolution in August 2007.

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### **Revenue**

We generate our revenues from the provision of online games services, advertising services and wireless value-added services and others. Through our predecessor company, in mid-1998, we changed our business model from a software developer to an Internet technology company. In July 1999, we began to offer e-commerce platforms and to provide online auction services in China through Guangzhou NetEase. In 2001, we also began focusing on fee-based premium services and online entertainment services, including online games, wireless value-added services, premium e-mail services and other subscription-type services.

No customer individually accounted for greater than 10% of our total revenues for the years ended December 31, 2005, 2006 and 2007.

#### *Online Games Services*

We derive all our online game services revenues from customers through the sale of prepaid point cards. Customers can purchase physical prepaid point cards in different locations in China, including Internet caf  s, software stores, convenience stores and bookstores, or can purchase prepaid points from vendors who register the points in our system. Customers can also purchase virtual prepaid cards online by debit cards or bank transfers, and receive the prepaid point information over the Internet. Customers can use the points to play our online games and use our other fee-based services. We recognize revenues from the sale of prepaid points as the points are used by customers.

We develop our own proprietary online games, as well as license games from third party developers. We expect that we will face increasing competition as online game providers in China and abroad expand their presence in the Chinese market or enter it for the first time.

#### *Advertising Services*

We derive most of our advertising services revenue from fees we earn from advertisements placed on the NetEase websites. Approximately 90.0%, 92.6% and 97.7% of our total advertising revenue was derived from brand advertising for the years ended December 31, 2005, 2006 and 2007, respectively, with the remainder generated by our paid search engine business.

We expect that the online advertising market in China will continue to grow as Internet usage in China increases and as more companies, in particular China-based companies in a variety of industries, accept the Internet as an effective advertising medium. Moreover, we expect that as the e-commerce industry further develops in China, there will be more small- to medium-size online businesses using paid search services to advertise or market their businesses and products. Accordingly, we believe that the growth rate for paid search-related advertising in the China market may increase at a faster rate than online brand advertising, although search-related advertising is still at its initial stage in China and developing from a much smaller base.

#### *Wireless Value-Added Services and Others*

We derive a portion of our wireless value-added services and others revenues from providing to our customers value-added services through SMS.

Our online fee-based premium services, supplied to registered users of the NetEase websites, include premium e-mail, premium matchmaking and dating services and premium alumni clubs.

#### *Seasonality of revenues*

Historically, advertising revenues have followed the same general seasonal trend throughout each year with the first quarter of the year being the weakest quarter due to the Chinese New Year holiday and the traditional close of advertisers' annual budgets and the third quarter as the strongest. Usage of our online games and wireless value-added services has generally increased around the Chinese New Year holiday and other Chinese holidays, in particular winter and summer school holidays.

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### **Cost of Revenues**

#### *Online Games Services*

Cost of revenues for our online games services consist primarily of business tax payable on intra-group revenues, staff costs (in particular remuneration to employees known as the “Game Masters” who are responsible for the daily co-ordination and regulation of the activities inside our games’ virtual worlds), revenue sharing expenses paid to Internet data centers, or IDC, for the rental of servers, and printing costs for our prepaid point cards.

In addition, cost of revenues for our online games services include that portion of bandwidth and server custody fees and depreciation and amortization of computers and software which are attributable to our online games business. Our subsidiaries and VIEs have network servers co-located in facilities owned by China Telecom’s and China Netcom’s affiliates, for which we pay custody fees to China Telecom and China Netcom.

#### *Advertising Services*

Cost of revenues related to our advertising services consists primarily of business tax payable on intra-group revenues, staff costs for editors of the various content channels for the NetEase websites and content fees paid to content providers for the NetEase websites as well as that portion of bandwidth and server custody fees, depreciation and amortization of computers and software which are attributable to the provision of advertising services and fees payable to a vendor for the use of search results generated by its search engine.

#### *Wireless Value-Added Services and Others*

Cost of revenues related to our wireless value-added services and others consists primarily of staff costs (principally compensation expenses for editorial professionals) and content fees, as well as that portion of bandwidth and server custody fees, depreciation and amortization of computers and software which are attributable to the provision of wireless value-added and other services. It also includes business tax payable on intra-group revenues. We pay content fees to third party partners for the right to use proprietary content developed by them, such as ringtones and logos. We also pay content fees to newspaper and magazine publishers for the right to use their proprietary content, such as headline news and articles.

### **Operating Expenses**

Operating expenses include selling and marketing expenses, general and administrative expenses and research and development expenses.

#### *Selling and Marketing Expenses*

Selling and marketing expenses consist primarily of salary and welfare expenses and compensation costs for our sales and marketing staff, as well as marketing and advertising expenses payable to third party vendors.

#### *General and Administrative Expenses*

General and administrative expenses consist primarily of salary and welfare expenses and compensation costs for our general administrative and management staff, as well as certain mandatory welfare expenses payable to staff in other departments of our company; office rental; legal, professional and consultancy fees; bad debt expenses; recruiting expenses; travel expenses and depreciation charges. In 2007, general and administrative expenses also included imputed rent for a building in Guangzhou occupied by us. We and William Lei Ding, our Chief Executive Officer, director and major shareholder, have been in ongoing negotiations with the third party developer regarding its possible purchase by one of our subsidiaries in the PRC. During this time, with the developer’s permission, we have been occupying the property without a lease or the payment of any rent. We recorded an imputed rental expense on our financial statements which was calculated based on the estimated rental value of the property and totalling RMB9.4 million (US\$1.3 million) in 2007. For additional information on this property, see Item 7.B. “Related Party Transactions—Lease of Property in Guangzhou.”

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**Table of Contents***Research and Development Expenses*

Research and development expenses consist principally of salary and welfare expenses and compensation costs for our research and development professionals. For the years ended December 31, 2005, 2006 and 2007, such expenses also included licensing and training fees paid to a third party developer of a 3D game engine to be used in our future online games.

**Share-Based Compensation Cost**

In December 1999, we adopted a stock incentive plan, called the 1999 Stock Option Plan, for our employees, senior management and advisory board. In 2000, we replaced the 1999 Stock Option Plan with a new stock option plan, called the 2000 Stock Option Plan. The 2000 Stock Option Plan was subsequently amended and restated in May 2001. Since the 2000 Stock Option Plan was adopted, we granted options to our employees, directors, consultants, a member of our advisory board and certain members of our senior management under that plan. The vesting periods for these options generally range from two years to four years. In addition, certain of the options granted were cancelled as a result of the resignation of these personnel.

For the years ended December 31, 2005, 2006 and 2007, we recorded share-based compensation cost of approximately RMB13,835, RMB101.3 million and RMB95.4 million (US\$13.1 million), respectively. This cost has been allocated to (i) cost of revenues, (ii) selling and marketing expenses, (iii) general and administrative expenses and (iv) research and development expenses, depending on the functions for which these personnel and employees are responsible. The significant increase in share-based compensation cost in 2006 was mainly due to our adoption of SFAS 123R effective January 1, 2006.

As of December 31, 2005, 2006 and 2007, we recorded no deferred compensation cost relating to share option grants. We may incur additional share-based compensation cost in the future as a result of the possible recruitment of additional management personnel and the granting of new share options or other share-based compensation to these personnel and other members of our staff under SFAS 123R.

**Income Taxes***Cayman Islands*

Under the current laws of the Cayman Islands, we are not subject to tax on income or capital gain. Additionally, upon payments of dividends to our shareholders, no Cayman Islands withholding tax will be imposed.

*British Virgin Islands ("BVI")*

NetEase Interactive is exempted from income tax on its foreign-derived income in the BVI. There are no withholding taxes in the BVI.

*Hong Kong*

Hong Kong NetEase Interactive and NetEase Hong Kong have no taxable income in Hong Kong, and are therefore not subject to Hong Kong profits tax.

*China*

Prior to January 1, 2008, foreign invested enterprises were generally subject to a national and local enterprise income tax, at statutory rates of 30% and 3%, respectively.

NetEase Beijing, being a foreign invested enterprise and located in the New Technology Industrial Development Experimental Zone in Beijing, has been recognized as a "High and New Technology Enterprise."

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According to an approval granted by the Haidian State Tax Bureau in November 2000, NetEase Beijing was entitled to a reduced EIT rate of 15% commencing from 2000. In addition, the approval also granted NetEase Beijing with a full exemption from EIT from 2000 to 2002, a 50% reduction in EIT from 2003 to 2005, and a full exemption from the local income tax from 2000 onwards. Consequently, NetEase Beijing was exempted from EIT and local income tax from 2000 to 2002, and enjoyed a 50% reduction in EIT for 2003, 2004 and 2005. According to the approval granted by the Haidian State Tax Bureau on April 14, 2006, NetEase Beijing was recognized as an “Advanced Technology Enterprise” and entitled to a reduced EIT rate of 10% for 2006 and 2007 and a full exemption from the local income tax for 2006 and 2007.

Guangzhou Interactive was recognized as a “Newly Established High and New Technology Enterprise” in April 2003. According to an approval granted by the Guangzhou Tian He State Tax Bureau, Guangzhou Interactive was entitled to a full exemption from EIT from 2003 to 2004. Subsequently, in June and December 2004, Guangzhou Interactive was recognized as a “Software Enterprise” and a “New and High Technology Enterprise,” respectively, and was subject to a reduced EIT rate of 7.5% from 2005 to 2007. In 2006, Guangzhou Interactive received an exemption from the local tax rate of 3% from 2005 to 2007.

Boguan was recognized as “Software Enterprise” on September 2005. It was exempted from EIT on its profits for 2006 and 2007, and is subject to a 50% reduction in EIT from 2008 to 2010. Boguan was subject to a 3% local income tax rate for 2006, and it was exempted from the 3% local income tax for 2007.

NetEase Hangzhou was recognized as a “Software Enterprise” and a “High and New Technology Enterprise” in April and September 2007, respectively, and, as a result, is entitled to a full exemption from EIT in 2007 and 2008 and a 50% reduction in EIT from 2009 to 2011. NetEase Hangzhou was subject to a 3% local income tax rate for 2007.

Yodao Information was subject to EIT at the rate of 30% with no local income tax being imposed by the local tax authority in 2006. Yodao Information was recognized as a newly established “High and New Technology Enterprise” in May 2007. According to an approval granted by the Haidian State Tax Bureau in August 2007, Yodao Information is entitled to a full exemption from EIT in 2007 and 2008 and a 50% reduction in EIT from 2009 to 2011.

Guangyitong Advertising, Ling Yi (dissolved in August 2007) and Yodao Computer were subject to EIT at an overall income tax rate of 33% in 2007. Guangzhou NetEase was recognized as a “High and New Technology Enterprise” in December 2004. Hence, Guangzhou NetEase was subject to a reduced income tax rate of 15% from 2004 to 2007.

Effective as of January 1, 2008, the Chinese government adopted a new income tax law which unified the EIT payable by domestic and foreign-invested enterprises at 25%. For a discussion of the effects of the new EIT law, please see the discussion under Item 3.B. “Risk Factors—Our business benefits from certain PRC government incentives. Expiration of, or changes to, these incentives and PRC tax laws could have a material adverse effect on our operating results.”

On January 1, 2007, we adopted Financial Interpretation No. 48 “Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109,” or FIN 48, issued by the FASB in June 2006 which clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements. In connection with such adoption, we did not have any adjustment to the opening balance of retained earnings as of January 1, 2007, and as of December 31, 2007, we did not have any significant unrecognized uncertain tax positions. For the year ended December 31, 2007, we did not have any interest and penalties associated with our tax positions.

**Business Taxes**

In China, business taxes are imposed by the government on the revenues reported by the selling entities for the provision of taxable services in China, transfer of intangible assets and the sale of immovable properties in

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China. The business tax rate varies depending on the nature of the revenues. The applicable business tax rate for our revenues generally ranges from 3% to 5%. We are also subject to cultural development fee on the provision of advertising services in China. The applicable tax rate is 3% of the advertising services revenue.

In December 2007, Guangzhou NetEase received an approval from the Guangzhou local tax authority allowing it to deduct the service fees paid to its cooperative partners from its gross wireless value-added services revenue in deriving the amount of business tax payable in accordance with the relevant rules, implemented with retroactive effect from January 1, 2003. As a result, Guangzhou NetEase received a business tax refund in June 2008 of approximately RMB147 million (US\$20.2 million) for the excess amount paid in previous years. Guangzhou NetEase will calculate its business taxes on this basis in future periods, subject to any change of policy by local tax authority.

### **Critical Accounting Policies and Estimates**

The preparation of financial statements often requires the selection of specific accounting methods and policies from several acceptable alternatives. Further, significant estimates and judgments may be required in selecting and applying those methods and policies in the recognition of the assets and liabilities in our consolidated balance sheet, the revenues and expenses in our consolidated statement of operations and the information that is contained in our significant accounting policies and notes to the consolidated financial statements. Management bases its estimates and judgments on historical experience and various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates and judgments under different assumptions or conditions.

We believe that the following are some of the more critical judgment areas in the application of our accounting policies that affect our financial condition and results of operation.

### ***Critical Accounting Policies and Estimates Regarding Revenue Recognition***

#### *Online Games Services*

We provide online games services through Guangzhou NetEase. Regarding the revenue recognition for our online games, we sell prepaid point cards to the end users who may use the points on such cards for online game services provided by us. We recognize the related revenue when the registered points are consumed for our online game services. We effectively charge players according to their playtime of our online game services.

#### *Advertising Services*

We derive advertising fees principally from short-term advertising contracts. With respect to the advertising contracts that do not include a fixed delivery pattern for the advertising services, revenues are generally deferred until completion of the contracts. For the advertising contracts with a fixed delivery pattern, revenues are recognized ratably over the period in which the advertisement is displayed and only if collection of the resulting receivables is probable.

Our obligations may include guarantees of a minimum number of impressions or times that an advertisement appears in pages viewed by users. To the extent that minimum guaranteed impressions are not met within the contractual time period, we defer recognition of the corresponding revenues until the remaining guaranteed impression levels are achieved. In addition, we occasionally enter into “cost per action,” or CPA, advertising contracts whereby revenue is received by us when an online user performs a specific action such as purchasing a product from or registering with the advertiser. Revenue for CPA contracts is recognized when the specific action is completed.

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### ***Other Critical Accounting Policies and Estimates***

#### *Research and Development Costs*

We recognize costs to develop our online game products in accordance with SFAS No. 86, "Accounting for Costs of Computer Software to be Sold, Leased or Otherwise Marketed." Costs incurred for the development of online game products prior to the establishment of technological feasibility are expensed when incurred. Once an online game has reached technological feasibility with a proven ability to operate in the Chinese market, all subsequent online game development costs are capitalized until that game is marketed. Technical feasibility is evaluated on a product-by-product basis, but typically encompasses both technical design and game design documentation. For the years ended December 31, 2005, 2006 and 2007, the cost incurred for development of on-line game products was not capitalized because of the uncertainty in technological feasibility.

We recognize website and internally used software development costs in accordance with Statement of Position No. 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." Accordingly, we expense all costs that are incurred in connection with the planning and implementation phases of development and costs that are associated with repair or maintenance of the existing websites and software. Direct costs incurred to develop the software during the application development stage and to obtain computer software from third parties that can provide future benefits are capitalized.

#### *Depreciation*

We depreciate our computer equipment, software and other assets (other than leasehold improvements) on a straight-line basis over their estimated useful lives, which range from two years to fifteen years. We depreciate leasehold improvements, which are included in our operating expenses, on a straight-line basis over the lesser of the relevant lease term or their estimated useful lives.

#### *Allowances for Doubtful Accounts*

We maintain allowances for doubtful accounts receivable based on various information, including aging analysis of accounts receivable balances, historical bad debt rates, repayment patterns and credit worthiness of customers and industry trend analysis. We also make specific provisions for bad debts if there is strong evidence showing that the debts are likely to be irrecoverable. We have adopted a general provisioning policy for doubtful debts for our trade receivable balances. We provide for 80%, in the case of direct customers, and 50% in the case of advertising agents, of the outstanding trade receivable balances overdue for more than six months. We provide for 100% in the case of all parties for outstanding trade receivable balances overdue for more than one year. In addition to the general provisions for trade receivables, we also make specific bad debt provisions for problem account receivable balances.

#### *Stock-Based Compensation Expense*

We adopted the provisions of, and have accounted for stock-based compensation in accordance with, Statement of Financial Accounting Standards, or SFAS, No. 123 (revised 2004), "Share-Based Payment," or SFAS 123R since January 1, 2006. We elected the modified-prospective method, under which prior periods are not revised for comparative purposes. Under the fair value recognition provisions of SFAS 123R, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as an expense on a straight-line basis, net of estimated forfeitures, over the requisite service period, which is generally the vesting period. We use the Black-Scholes option pricing model to determine the fair value of stock options. The determination of the fair value of stock-based compensation awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of complex and subjective variables, including our expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rate and expected dividends. Furthermore, we are required to estimate forfeitures at the time of grant and record stock-based compensation expense only for



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those awards that are expected to vest. If actual forfeitures differ from those estimates, we may need to revise those estimates used in subsequent periods. If factors change and we employ different assumptions for estimating stock-based compensation expense in future periods or if we decide to use a different valuation model, the future periods may differ significantly from what we have recorded in the current period and could materially affect our operating income, net income and net income per share. The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable, characteristics not present in our option grants. Existing valuation models, including the Black-Scholes and lattice binomial models, may not provide reliable measures of the fair values of our stock-based compensation. Consequently, there is a risk that our estimates of the fair values of our stock-based compensation awards on the grant dates may bear little resemblance to the actual values realized upon the exercise, expiration, early termination or forfeiture of those stock-based payments in the future. Certain stock-based compensation awards, such as employee stock options, may expire worthless or otherwise result in zero intrinsic value as compared to the fair values originally estimated on the grant date and reported in our financial statements. Alternatively, value may be realized from these instruments that are significantly higher than the fair values originally estimated on the grant date and reported in our financial statements. Currently, there is no market-based mechanism or other practical application to verify the reliability and accuracy of the estimates stemming from these valuation models, nor is there a means to compare and adjust the estimates to actual values. The guidance provided in SFAS 123R and Staff accounting Bulletin No. 107 is relatively new. The application of these principles may be subject to further interpretation and refinement over time. There are significant differences among valuation models, and there is a possibility that we will adopt different valuation models in the future. This may result in a lack of consistency in future periods and materially affect the fair value estimates of stock-based compensation awards. It may also result in a lack of comparability with other companies that use different models, methods and assumptions.

### **Repurchase of Shares**

On May 18, 2006, our board of directors approved a share repurchase program for up to US\$50 million worth of our issued and outstanding ADSs for approximately one month. Pursuant to this program, approximately 2.4 million of our issued and outstanding ADSs were repurchased for an aggregate purchase consideration of US\$50.1 million (including transaction costs) in open-market transactions. The share repurchase program ended on June 17, 2006.

On August 28, 2006, our board of directors approved a share repurchase program for up to US\$100 million worth of our issued and outstanding ADSs for a period not to exceed six months. Pursuant to this program, approximately 3.6 million of our issued and outstanding ADSs were repurchased for an aggregate purchase consideration of US\$60.1 million (including transaction costs) in open-market transactions when the share repurchase program ended on February 27, 2007.

On March 13, 2007, our board of directors approved a share repurchase program for up to US\$100 million worth of our issued and outstanding ADSs for a period not to exceed three months. Pursuant to this program, approximately 5.3 million of our issued and outstanding ADSs were repurchased for an aggregate purchase consideration of US\$95.7 million (including transaction costs) in open-market transactions. The share repurchase program ended on June 12, 2007.

On July 2, 2007, our board of directors approved a share repurchase program of up to US\$120 million worth of our issued and outstanding ADSs for a period not to exceed 12 months. As of December 31, 2007, approximately 2.2 million of our issued and outstanding ADSs were purchased for an aggregate purchase consideration of approximately US\$35.7 million (including transaction costs). The share repurchase program will end on July 1, 2008.

For details of the ADS repurchases conducted in 2007, see the share repurchase table in Item 16.E. "Purchase of Equity Securities by the Issuer and Affiliated Purchasers."

We funded all of the foregoing repurchases from available working capital.

[Table of Contents](#)**Consolidated Results of Operations**

The following table sets forth a summary of our audited consolidated statements of operations for the periods indicated both in Renminbi and as a percentage of total revenues:

|  | For the Year Ended December 31, |        |               |        |               |        |
|--|---------------------------------|--------|---------------|--------|---------------|--------|
|  | 2005<br>RMB                     | %      | 2006<br>RMB   | %      | 2007<br>RMB   | %      |
| <b>Statement of Operations Data:</b>     |                                 |        |               |        |               |        |
| Revenues:                                |                                 |        |               |        |               |        |
| Online game services                     | 1,379,475,803                   | 81.4   | 1,856,062,971 | 83.7   | 1,932,634,947 | 83.8   |
| Advertising services                     | 241,200,444                     | 14.2   | 285,772,653   | 12.9   | 305,057,556   | 13.2   |
| Wireless value-added services and others | 73,742,136                      | 4.4    | 75,406,121    | 3.4    | 68,018,461    | 3.0    |
| Total revenues                           | 1,694,418,383                   | 100.0  | 2,217,241,745 | 100.0  | 2,305,710,964 | 100.0  |
| Business tax                             | (82,054,902)                    | (4.8)  | (52,882,275)  | (2.4)  | (92,424,200)  | (4.0)  |
| Net revenues                             | 1,612,363,481                   | 95.2   | 2,164,359,470 | 97.6   | 2,213,286,764 | 96.0   |
| Cost of revenues:                        |                                 |        |               |        |               |        |
| Online game services                     | (137,301,493)                   | (8.1)  | (178,676,915) | (8.1)  | (187,411,229) | (8.1)  |
| Advertising services                     | (78,589,395)                    | (4.6)  | (125,183,293) | (5.6)  | (143,676,057) | (6.2)  |
| Wireless value-added services and others | (59,346,085)                    | (3.5)  | (77,437,973)  | (3.5)  | (84,365,760)  | (3.7)  |
| Total cost of revenues                   | (275,236,973)                   | (16.2) | (381,298,181) | (17.2) | (415,453,046) | (18.0) |
| Gross profit                             | 1,337,126,508                   | 78.9   | 1,783,061,289 | 80.4   | 1,797,833,718 | 78.0   |
| Operating expenses:                      |                                 |        |               |        |               |        |
| Selling and marketing expenses           | (152,192,422)                   | (9.0)  | (170,142,691) | (7.7)  | (235,318,304) | (10.2) |
| General and administrative expenses      | (117,942,605)                   | (7.0)  | (179,879,602) | (8.1)  | (176,178,740) | (7.6)  |
| Research and development expenses        | (90,170,092)                    | (5.3)  | (153,162,158) | (6.9)  | (180,734,713) | (7.8)  |
| Total operating expenses                 | (360,305,119)                   | (21.3) | (503,184,451) | (22.7) | (592,231,757) | (25.6) |
| Operating profit                         | 976,821,389                     | 57.6   | 1,279,876,838 | 57.7   | 1,205,601,961 | 52.4   |
| Other income (expenses):                 |                                 |        |               |        |               |        |
| Investment income                        | 1,301,975                       | 0.1    | 340,721       | 0.0    | 474,446       | 0.0    |
| Interest income                          | 58,070,148                      | 3.4    | 94,364,852    | 4.3    | 112,599,994   | 4.8    |
| Interest expenses                        | (344,859)                       | (0.0)  | —             | —      | —             | —      |
| Exchange losses                          | (8,360,834)                     | (0.5)  | (958,435)     | (0.0)  | (50,891,094)  | (2.2)  |
| Other, net                               | (540,628)                       | (0.0)  | 1,239,105     | 0.1    | (1,084,240)   | (0.1)  |
| Profit before tax                        | 1,026,947,191                   | 60.6   | 1,374,863,081 | 62.0   | 1,266,701,067 | 54.9   |
| Income tax expense                       | (94,957,022)                    | (5.6)  | (132,485,543) | (6.0)  | (2,689,309)   | (0.1)  |
| Profit after tax                         | 931,990,169                     | 55.0   | 1,242,377,538 | 56.0   | 1,264,011,758 | 54.8   |
| Minority interests                       | —                               | —      | 400,046       | (0.0)  | 74,364        | (0.0)  |
| Net profit                               | 931,990,169                     | 55.0   | 1,242,777,584 | 56.0   | 1,264,086,122 | 54.8   |
| Unrealized gains on investments          | —                               | —      | —             | —      | 1,332,300     | 0.1    |
| Comprehensive Income                     | 931,990,169                     | 55.0   | 1,242,777,584 | 56.0   | 1,265,418,422 | 54.9   |
| Share compensation cost included in:     |                                 |        |               |        |               |        |
| Cost of revenues                         | —                               | —      | (16,614,309)  | (0.7)  | (14,890,378)  | (0.6)  |
| Selling and marketing expenses           | —                               | —      | (21,147,343)  | (1.0)  | (14,357,336)  | (0.6)  |
| General and administrative expenses      | (13,835)                        | (0.0)  | (37,360,433)  | (1.7)  | (33,887,323)  | (1.5)  |
| Research and development expenses        | —                               | —      | (26,164,591)  | (1.2)  | (32,293,138)  | (1.4)  |

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**Table of Contents****Year Ended December 31, 2007 Compared to Year Ended December 31, 2006****Revenues**

Total net revenues increased by 2.3% to RMB2,213.3 million (US\$303.4 million) in 2007 from RMB2,164.4 million in 2006. Net revenues from online games services, advertising services, and wireless value-added services and others constituted 84.4%, 12.6% and 3.0%, respectively, of our total net revenues in 2007. This compares with 84.6%, 12.1% and 3.3%, respectively, in 2006.

*Online Games Services*

Net revenues from online games services increased by 2.1% to RMB1,868.9 million (US\$256.2 million) in 2007 from RMB1,830.3 million in 2006. The number of peak concurrent players for Fantasy Westward Journey increased to approximately 1,519,000 in December 2007 from 1,335,000 in December 2006, and the number of average concurrent users for Fantasy Westward Journey increased to approximately 546,000 in December 2007 from approximately 453,000 in December 2006. The continued growth in popularity of Fantasy Westward Journey throughout 2007 was mainly attributable to the successful launching of new expansion packs for the game in the year. In addition, the number of peak concurrent players for Westward Journey Online III reached approximately 117,000 in December 2007, and the number of average concurrent users for Westward Journey Online III achieved approximately 49,000 in December 2007. This increase was offset in part by reduced revenues from our other principal online game, Westward Journey Online II. The number of peak concurrent players for Westward Journey Online II decreased to approximately 367,000 in December 2007 from approximately 440,000 in December 2006, and the number of average concurrent players for Westward Journey Online II decreased to approximately 153,000 in December 2007 from approximately 174,000 in December 2006.

*Advertising Services*

Net revenues from advertising services increased by 6.7% to RMB279.1 million (US\$38.3 million) in 2007 from RMB261.5 million in 2006, primarily due to the overall expansion of China's online advertising market.

Average net revenue per traditional advertiser (i.e., customers which do not advertise through our search services) increased to approximately RMB623,000 (US\$85,000) in 2007 from RMB590,000 in 2006. The number of traditional advertisers using the NetEase websites increased to 438 in 2007 from 410 in 2006, with revenues from our top ten advertisers comprising 27.9% of our total advertising services revenues in 2007 as compared to 37.3% in 2006.

*Wireless Value-Added Services and Others*

Net revenues from wireless value-added services and others decreased by 10.1% to RMB65.3 million (US\$9.0 million) in 2007 from RMB72.6 million in 2006. This decrease was primarily due to reduced revenues from SMS services resulting from our reduced marketing promotion of our SMS business and under-performing SMS products. The decrease was offset in part by increased revenues from our other value-added services as a result of our continuing enhancements to such services and integration of other value-added services and products.

**Cost of Revenues**

Our cost of revenues increased by 9.0% to RMB415.5 million (US\$57.0 million) in 2007 from RMB381.3 million in 2006. The year-over-year increase was mainly due to an increase in depreciation cost, staff-related cost, business tax on intra-group revenue, cost of third party content and technology cost. In 2007, costs relating to online games services, advertising services and wireless value-added services and others represented 45.1%, 34.6% and 20.3% of total cost of revenues, respectively, as compared with 46.9%, 32.8% and 20.3% of the cost of revenues, respectively, in 2006.

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### *Online Games Services*

Cost of revenues from our online games services increased by 4.9% to RMB187.4 million (US\$25.7 million) in 2007 from RMB178.7 million in 2006. This increase in cost of revenues in 2007 was primarily due to a combination of the following factors:

- Staff-related costs increased by RMB9.9 million to RMB31.2 million (US\$4.3 million) in 2007 from RMB21.3 million in 2006, mainly as a result of an increase in the level of salaries and bonuses as well as an increase in the number of employees. The number of full time employees in our online games department increased to 1,208 as of December 31, 2007 from 1,052 as of December 31, 2006.
- Business tax payable on intra-group revenues related to online games from our VIEs increased by RMB3.6 million to RMB9.4 million (US\$12.8 million) in 2007 from RMB8.8 million in 2006 due to continued growth in the popularity of Fantasy Westward Journey and the commercial launch of Westward Journey Online III in September 2007.
- Depreciation and amortization costs of computers and software increased by RMB0.5 million to RMB8.9 million (US\$1.2 million) in 2007 from RMB8.4 million in 2006.

These increases were partially offset by the following factors:

- Bandwidth and server custody fees decreased by RMB2.3 million to RMB19.3 million (US\$2.6 million) in 2007 from RMB21.6 million in 2006 due to the fact that reductions in fee rates charged by the service providers more than offset an increase in bandwidth usage caused by the rising volume of online game services.
- Printing cost for prepaid point cards decreased by RMB1.7 million to RMB9.4 million (US\$1.3 million) in 2007 from RMB11.1 million in 2006, as a result of the reduced consumption of physical point cards in 2007 compared to 2006.
- Revenue sharing expenses decreased by RMB1.5 million to RMB15.1 million (US\$2.1 million) in 2007 from RMB16.6 million in 2006 due to reduced business cooperation with the internet data centers in 2007.

### *Advertising Services*

Cost of revenues from our advertising services increased by 14.8% to RMB143.7 million (US\$19.7 million) in 2007 from RMB125.2 million in 2006. The increase in cost of revenues in 2007 was primarily due to a combination of the following factors:

- Cost of third party content for the NetEase websites increased by RMB7.5 million to RMB18.9 million (US\$2.6 million) in 2007 from RMB11.4 million in 2006, as a result of our efforts to improve the range and quality of the content we offer on those sites.
- Depreciation and amortization costs of computers and software increased by RMB4.7 million to RMB20.0 million (US\$2.7 million) in 2007 from RMB15.3 million in 2006, mainly due to additional servers purchased during the year to satisfy our ongoing business capacity requirements and to provide capacity for our newly launched search engine service, Yodao, in 2007.
- Staff-related costs increased by RMB3.9 million to RMB56.8 million (US\$7.8 million) in 2007 from RMB52.9 million in 2006, mainly as a result of an increase in salaries and other compensation payments, such as bonuses and welfare benefits, and also due to an expansion of the number of editors of the various content channels for the NetEase websites to 386 as of December 31, 2007 from 293 as of December 31, 2006.
- Bandwidth and server custody fees increased by RMB1.9 million to RMB25.1 million (US\$3.4 million) in 2007 from RMB23.2 million in 2006, as a result of an increase in bandwidth usage for supporting the continuous growth of traffic on the NetEase websites.

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- Business tax payable by us on intra-group revenues related to advertising services from our VIEs increased by RMB0.8 million to RMB13.4 million (US\$1.8 million) in 2007 from RMB12.6 million in 2006, primarily due to increased demand for advertising spaces on the NetEase websites.

### *Wireless Value-Added Services and Others*

Cost of revenues from our wireless value-added services and others increased 9.0% to RMB84.4 million (US\$11.6 million) in 2007 from RMB77.4 million in 2006. This increase in cost of revenues in 2007 was primarily due to a combination of the following factors:

- Depreciation and amortization costs of computers and software increased by RMB7.7 million to RMB42.9 million (US\$5.9 million) in 2007 from RMB35.2 million in 2006, mainly due to additional servers purchased during the year to meet the increase in demand for our various free services such as e-mail and album.
- Bandwidth and server custody fees increased by RMB3.5 million to RMB27.2 million (US\$3.7 million) in 2007 from RMB23.7 million in 2006, as a result of an increase in bandwidth usage.

These increases were partially offset by the fact that staff-related costs decreased by RMB4.9 million to RMB9.5 million (US\$1.3 million) in 2007 from RMB14.4 million in 2006, as a result of decreased headcount due to the reorganization of our SMS business in 2007.

### **Gross Profit**

Our gross profit increased by 0.8% to RMB1,797.8 million (US\$246.5 million) in 2007 from RMB1,783.1 million in 2006.

The following table sets forth the audited consolidated gross profits and gross profit margins of our business activities for the periods indicated. The gross profit margins in 2006 and 2007 were calculated by dividing our gross profits over our net revenues for the corresponding type of services. The net revenues are before netting-off the business taxes payable by us on intra-group revenues from our VIEs, which are recorded under cost of revenues.

|  | For the Year Ended December 31, |               |             |
|--|---------------------------------|---------------|-------------|
|  | 2006                            | 2007          | 2007        |
|  | RMB                             | RMB           | US\$        |
| <b>Gross profit (loss):</b>              |                                 |               |             |
| Online game services                     | 1,651,616,697                   | 1,681,446,765 | 230,505,685 |
| Advertising services                     | 136,298,684                     | 135,451,607   | 18,568,751  |
| Wireless value-added services and others | (4,854,092)                     | (19,064,654)  | (2,613,531) |
| Total gross profit                       | 1,783,061,289                   | 1,797,833,718 | 246,460,905 |
| <b>Gross profit (loss) margin:</b>       |                                 |               |             |
| Online game services                     | 90.2%                           | 90.0%         | 90.0%       |
| Advertising services                     | 52.1%                           | 48.5%         | 48.5%       |
| Wireless value-added services and others | (6.7)%                          | (29.2)%       | (29.2)%     |
| Total gross profit margin                | 82.4%                           | 81.2%         | 81.2%       |

The slight decrease in gross profit margin for online game services in 2007 was mainly due to the increased cost of revenues which outpaced the increase in net revenues. Higher cost of revenues was mainly the result of increased headcount and higher level of salaries and bonuses paid to the employees in our online game business in 2007.

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The decrease in gross profit margin for advertising services was mainly due to the increase in salaries and other benefits paid to content editors and the increased costs associated with our online advertising business, such as cost of third party content, server depreciation charges and bandwidth and server custody fees for the purpose of maintaining and increasing the traffic of the NetEase websites.

The gross loss margin for wireless value-added services and others increased significantly in 2007 compared to 2006 as a result of an increase in the cost of revenues, including server depreciation costs and bandwidth and server custody fees, associated with our various free e-mail and photo album services. The increase in cost of revenue was offset in part by reduced salaries and revenue sharing expenses as a result of the reorganization of our SMS business in 2007.

### **Operating Expenses**

Total operating expenses increased by 17.7% to RMB592.2 million (US\$81.2 million) in 2007 from RMB503.2 million in 2006. Operating expenses as a percentage of total net revenue increased from 23.2% in 2006 to 26.8% in 2007. The increase was driven primarily by the increase in both selling and marketing expenses and research and development expenses.

Selling and marketing expenses increased by 38.3% to RMB235.3 million (US\$32.3 million) in 2007 from RMB170.1 million in 2006, primarily due to a combination of the following factors:

- An increase in marketing costs of approximately RMB47.2 million (US\$6.5 million) for advertising and marketing promotion of Westward Journey Online III, Fantasy Westward Journey and Tianxia II in 2007.
- An increase in labor cost of approximately RMB11.2 million (US\$1.5 million) associated with the expansion of regional game promotion activities in China during 2007.
- An increase in transportation costs by approximately RMB2.1 million (US\$0.3 million) due to the increased level of promotional activities and events in 2007.
- An increase in staff-related costs of our online game and advertising sales team of approximately RMB5.1 million (US\$0.7 million) in 2007. This increase was partially offset by the decrease in staff costs of approximately RMB3.8 million (US\$0.5 million) resulting from the reduction of the marketing team in the wireless department in 2007.

General and administrative expenses decreased by 2.1% to RMB176.2 million (US\$24.2 million) in 2007 from RMB179.9 million in 2006, primarily due to a combination of the following factors:

- A decrease in professional fees of approximately RMB10.6 million (US\$1.5 million) associated with reduced expenses incurred for outside consultants by approximately RMB6.3 million (US\$0.9 million) in 2007, and the fact that the remaining cost of our zero coupon convertible subordinated notes of approximately RMB4.3 million (US\$0.6 million) was fully amortized in July 2006.
- A decrease in allowance for bad and doubtful debts of approximately RMB12.8 million (US\$1.8 million) in 2007.

These decreases were substantially offset by the following factors:

- An increase in staff-related costs by approximately RMB8.5 million (US\$1.2 million) in 2007, mainly as a result of an increase in the level of salaries and other compensation payments.
- An increase in depreciation expense of approximately RMB11.9 million (US\$1.6 million), mainly as a result of the purchase of computers and servers during 2007, and the full year depreciation expense in 2007 related to the decoration, improvements and the equipment installation expenditure for our offices in Guangzhou compared to the approximately six months of such depreciation expense in 2006.

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Research and development expenses increased by 18.0% to RMB180.7 million (US\$24.8 million) in 2007 from RMB153.2 million in 2006, primarily due to an increase in staff-related costs by approximately RMB38.6 million (US\$5.3 million) in 2007, mainly as a result of increased headcount of program developers in our online games department and higher salaries and other benefits paid to our research and development team during 2007. The increase was partially offset by a decrease in research and development expense of approximately RMB11.6 million (US\$1.6 million) in 2007, resulting from a one-time write-off in software cost for our licensed online 3D game, Fly for Fun, in 2006.

**Allowances for Doubtful Accounts**

As of December 31, 2007, the gross accounts receivable balance before any allowance for bad and doubtful accounts was RMB179.3 million (US\$24.6 million). After providing for doubtful accounts in the amount of RMB12.6 million (US\$1.7 million), the net balance of accounts receivable was RMB166.7 million (US\$22.9 million) as of December 31, 2007. The allowance for doubtful accounts consisted of general provisions of RMB4.9 million (US\$0.7 million) and specific provisions of RMB7.7 million (US\$1.1 million).

We periodically review our general provisioning policy for doubtful accounts. In assessing the adequacy and reasonableness of the policy, we consider the aging analysis of accounts receivable balances, historical bad debt rates, repayment patterns and credit worthiness of customers and industry trend analysis.

As of December 31, 2007, we had one customer with a receivable balance exceeding 10% of the total accounts receivable balance. The approximate total outstanding accounts receivable balance then outstanding (and percentage thereon) was RMB18.6 million (US\$2.5 million) or 10.4%.

**Other Income (Expenses)**

Other income in 2007 mainly consisted of interest income. Interest income increased to RMB112.6 million (US\$15.4 million) in 2007 from RMB94.4 million in 2006, mainly due to an increase in short-term bank deposits in China and abroad. The cash for such deposits was generated largely from our operations as well as from the proceeds of our US\$100 million zero coupon convertible subordinated notes issued in July 2003. We did not incur interest expense in 2007 and 2006. In 2007, we recognized an exchange loss of RMB50.9 million (US\$7.0 million) upon translating foreign-currency monetary assets and liabilities, primarily due to the rising value of the Renminbi against the US dollar in 2007. In 2006, we recognized an exchange loss of RMB1.0 million.

**Income Tax**

Income tax decreased significantly to RMB2.7 million (US\$0.4 million) in 2007 from RMB132.5 million in 2006. Our effective tax rate in 2007 was 0.2% as compared with 9.6% in 2006. This significant reduction in income tax was mainly due to the receipt of an investment incentive tax refund and the tax benefit resulted from the increased deferred tax assets which were booked under applicable accounting standards at the new statutory income tax rate.

**Net Profit**

As a result of the foregoing, net profit increased by 1.7% to RMB1,264.1 million (US\$173.3 million) in 2007 from RMB1,242.8 million in 2006.

**Year Ended December 31, 2006 Compared to Year Ended December 31, 2005****Revenues**

Total net revenues increased by 34.2% to RMB2,164.4 million in 2006 from RMB1,612.4 million in 2005. Net revenues from online games services, advertising services, and wireless value-added services and others constituted 84.6%, 12.1% and 3.3%, respectively, of our total net revenues in 2006, as compared with 81.9%, 13.7% and 4.4%, respectively, in 2005.



**Table of Contents***Online Games Services*

Net revenues from online games services increased by 38.6% to RMB1,830.3 million in 2006 from RMB1,320.6 million in 2005. This increase was mainly due to the continued growth in the number of users and average playing time per user of our in-house developed MMORPG, Fantasy Westward Journey. The number of peak concurrent players for Fantasy Westward Journey increased to approximately 1,335,000 in December 2006 from 1,043,000 in December 2005, and the number of average concurrent users for Fantasy Westward Journey increased to approximately 453,000 in December 2006 from approximately 384,000 in December 2005. The continued growth in popularity of Fantasy Westward Journey throughout 2006 was mainly attributable to the successful launching of new expansion packs for the game in the year. This increase was offset in part by reduced revenues from our other principal online game, Westward Journey Online II. The number of peak concurrent players for Westward Journey Online II decreased to approximately 440,000 in December 2006 from approximately 535,000 in December 2005, and the number of average concurrent players for Westward Journey Online II decreased to approximately 174,000 in December 2006 from approximately 207,000 in December 2005.

*Advertising Services*

Net revenues from advertising services increased by 18.5% to RMB261.5 million in 2006 from RMB220.7 million in 2005, primarily due to the overall expansion of China's robust online advertising market.

Average net revenue per traditional advertiser (i.e., customers which do not advertise through our search services) increased to approximately RMB590,000 in 2006 from RMB508,000 in 2005. The number of traditional advertisers using the NetEase websites increased to 410 in 2006 from 387 in 2005, with revenues from our top ten advertisers comprising 37.3% of our total advertising services revenues in 2006 as compared to 46.6% in 2005.

*Wireless Value-Added Services and Others*

Net revenues from wireless value-added services and others increased by 2.2% to RMB72.6 million from RMB71.0 million in 2005. This increase was primarily due to an increase in the number of paying customers for our other fee-based premium services and the sales of accessory products related to our online games.

**Cost of Revenues**

Our cost of revenues increased by 38.5% to RMB381.3 million in 2006 from RMB275.2 million in 2005. The year over year increase was primarily driven by our 30.9% revenue growth and the higher cost of advertising services. In 2006, costs relating to online games services, advertising services and wireless value-added services and others represented 46.9%, 32.8% and 20.3% of total cost of revenues, respectively. This compares with 49.9%, 28.5% and 21.6% of the cost of revenues, respectively, in 2005.

*Online Games Services*

Cost of revenues from our online games services increased by 30.1% to RMB178.7 million in 2006 from RMB137.3 million in 2005. This increase in cost of revenues in 2006 was primarily due to a combination of the following factors:

- Business tax payable by us on intra-group revenues related to online games from our VIEs increased by RMB23.8 million to RMB89.8 million in 2006 from RMB66.0 million in 2005 due to continued growth in the popularity of our Fantasy Westward Journey game.
- Staff-related costs increased by RMB10.3 million to RMB21.3 million in 2006 from RMB10.9 million in 2005, mainly as a result of an increase in salary levels and other compensation payments (including

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share-based compensation costs of RMB5.1 million following our adoption of SFAS 123R for the fiscal year beginning January 1, 2006) and also due to an increase in the number of staff. The number of staff in our online games department increased from 606 as of December 31, 2005 to 1,052 as of December 31, 2006.

- Bandwidth and server custody fees increased by RMB7.7 million to RMB21.1 million in 2006 from RMB13.4 million in 2005, as a result of the increase in bandwidth usage.
- Commission charges paid to service companies increased by RMB6.3 million to RMB7.4 million in 2006 from RMB1.0 million 2005, mainly as a result of the increase in sales of prepaid point cards.
- Depreciation and amortization costs of computers and software increased by RMB4.2 million to RMB8.4 million in 2006 from RMB4.2 million in 2005.

These increases were partially offset by the fact that payments to the celebrities acting as our spokespersons for our online games Westward Journey Online II and Fantasy Westward Journey decreased to zero in 2006 compared to RMB15.2 million in 2005. Our contracts with these spokespersons expired in November 2005 and were not renewed.

### *Advertising Services*

Cost of revenues from our advertising services increased 59.3% to RMB125.2 million in 2006 from RMB78.6 million in 2005. The increase in cost of revenues in 2006 was primarily due to a combination of the following factors:

- Staff-related costs increased by RMB25.5 million to RMB53.4 million in 2006 from RMB27.9 million in 2005, mainly as a result of an increase in salaries and other compensation payments such as bonuses and welfare benefits (including share-based compensation costs of RMB8.3 million following our adoption of SFAS 123R for the fiscal year beginning January 1, 2006) and also due to an expansion of the number of editors of the various content channels for the NetEase websites from 250 as of December 31, 2005 to 293 as of December 31, 2006.
- Depreciation and amortization costs of computers and software increased by RMB8.3 million to RMB16.2 million in 2006 from RMB7.9 million in 2005, mainly due to additional servers purchased during the year to enhance our on-going business capacity requirements.
- Bandwidth and server custody fees increased by RMB7.9 million to RMB20.2 million in 2006 from RMB12.3 million in 2005, as a result of an increase in bandwidth usage.
- Cost of third party content for the NetEase websites increased by RMB1.9 million to RMB11.4 million in 2006 from RMB9.5 million in 2005, as a result of our efforts to improve the range and quality of the content we offer on those sites.
- Business tax payable by us on intra-group revenues related to advertising services from our VIEs increased by RMB1.7 million to RMB12.6 million in 2006 from RMB10.9 million in 2005, due to the improvement in sales driven by the continued increase in demand for advertising space on the NetEase websites.

### *Wireless Value-Added Services and Others*

Cost of revenues from our wireless value-added services and others increased 30.5% to RMB77.4 million in 2006 from RMB59.3 million in 2005. This increase in cost of revenues in 2006 was primarily due to a combination of the following factors:

- Depreciation and amortization costs of computers and software increased by RMB15.3 million to RMB34.4 million in 2006 from RMB19.1 million in 2005, mainly due to additional servers purchased during the year to handle the increase in demand for our free services such as our free e-mail services.

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- Bandwidth and server custody fees increased by RMB6.7 million to RMB19.8 million in 2006 from RMB13.1 million in 2005, as a result of an increase in bandwidth usage.
- Staff-related costs increased by RMB5.0 million to RMB13.8 million in 2006 from RMB8.8 million in 2005, as a result of the increase in share-based compensation costs (which amounted to RMB3.2 million following our adoption of SFAS 123R for the fiscal year beginning January 1, 2006) and also due to redundancy costs paid to staff in rationalizing the wireless value-added services business.

These increases were partially offset by the following factors:

- SMS network transmission fees decreased by RMB5.6 million to RMB0.8 million in 2006 from RMB6.4 million in 2005 due to a decrease in the number of SMS messages being sent through our instant messaging service, POPO, which we provided free of charge to our customers.
- Reversal of provision of business tax payable increased by RMB2.4 million to RMB8.2 million in 2006 from RMB5.8 million in 2005.

## **Gross Profit**

As a result of the strong revenue growth in 2006, our gross profit increased by 33.4% to RMB1,783.1 million in 2006 from RMB1,337.1 million in 2005.

The following table sets forth the audited consolidated gross profits and gross profit margins of our business activities for the periods indicated. The gross profit margins in 2005 and 2006 were calculated by dividing our gross profits over our net revenues for the corresponding type of services. The net revenues are before netting-off the business taxes payable by us on intra-group revenues from our VIEs, which are recorded under cost of revenues.

|  | <b>For the Year Ended December 31,</b> |                      |
|--|--|----------------------|
|  | <b>2005</b>                            | <b>2006</b>          |
|  | <b>RMB</b>                             | <b>RMB</b>           |
| <b>Gross profit (loss):</b>              |  |                      |
| Online game services                     | 1,183,322,871                          | 1,651,616,697        |
| Advertising services                     | 142,109,011                            | 136,298,684          |
| Wireless value-added services and others | 11,694,626                             | (4,854,092)          |
| Total gross profit                       | <u>1,337,126,508</u>                   | <u>1,783,061,289</u> |
| <b>Gross profit (loss) margin:</b>       |  |                      |
| Online game services                     | 89.6%                                  | 90.2%                |
| Advertising services                     | 64.4%                                  | 52.1%                |
| Wireless value-added services and others | 16.5%                                  | (6.7)%               |
| Total gross profit margin                | <u>82.9%</u>                           | <u>82.4%</u>         |

The decrease in total gross profit margin was primarily due to the fact that the decrease in gross profit margin for advertising services and wireless value-added services and others outweighed the increase in gross profit margin for online game services.

The increase in gross profit margin for online game services in 2006 was mainly due to increased revenue resulting from the continued increase in popularity of Fantasy Westward Journey in 2006, which outpaced the increase in cost of revenues. The cost of revenues for online games services are mainly fixed or incremental in nature such that the increase in revenues do not necessarily lead to a corresponding increase in cost of revenues. Such scalability and operational leverage of online game services led to the improvement in gross profit margins.

The decrease in gross profit margin for advertising services was mainly due to the increase in salaries and other benefits paid to content editors and the increased costs associated with our online advertising business so as to enhance the content and attractiveness of the NetEase websites.

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The gross profit margin for wireless value-added services and others decreased significantly in 2006 compared to 2005, which was mainly due to an increase in the cost of revenues from these services, as we continued to offer various free services such as e-mail. This resulted in higher costs associated with these services, in particular higher server depreciation costs.

### **Operating Expenses**

Total operating expenses increased by 39.7% to RMB503.2 million in 2006 from RMB360.3 million in 2005. Operating expenses as a percentage of total net revenue increased from 22.3% in 2005 to 23.2% in 2006. The increase was driven primarily by an increase in all categories of operating expenses, particularly general and administrative expenses and research and development expenses.

Selling and marketing expenses increased by 11.8% to RMB170.1 million in 2006 from RMB152.2 million in 2005, primarily due to the increase in staff-related costs of approximately RMB34.0 million as a result of an increase in salaries (including share-based compensation costs of RMB21.1 million following our adoption of SFAS 123R for the fiscal year beginning January 1, 2006) and commissions paid to our advertising sales team and online game team. This increase was substantially offset by the overall reduction in the number of company-sponsored marketing events which reduced selling and marketing expenses by approximately RMB13.9 million in 2006.

General and administrative expenses increased by 52.5% to RMB179.9 million in 2006 from RMB117.9 million in 2005 primarily due to the following reasons:

- An increase in staff-related costs by approximately RMB26.2 million, mainly as a result of an increase in salaries and other compensation payments such as bonuses and welfare benefits (including share-based compensation costs of RMB37.4 million following our adoption of SFAS 123R for the fiscal year beginning January 1, 2006).
- An increase in professional fees of approximately RMB14.8 million mainly due to additional costs incurred for engaging consultants to assist in compliance with the U.S. Sarbanes-Oxley Act.
- An increase in office rentals (including imputed rental expense for the property we occupy in Guangzhou), decoration and office charges for our offices in Beijing and Guangzhou of approximately RMB12.6 million.
- An increase in allowance for bad and doubtful debts of approximately RMB3.9 million.

Research and development expenses increased 69.9% to RMB153.2 million in 2006 from RMB90.2 million in 2005, primarily due to the following reasons:

- An increase in staff-related costs by approximately RMB71.6 million, mainly as a result of an increase in salaries and other compensation benefits such as bonuses and welfare benefits (including share-based compensation costs of RMB26.2 million following our adoption of SFAS 123R for the fiscal year beginning January 1, 2006), for the enhancement of existing products and for the development of new products.
- The research and development expense of approximately RMB20.7 million resulting from the upfront fee we paid for licensing a 3D game technology in 2005 did not recur in 2006.
- A one-time write-off of RMB11.6 million in software cost for our licensed online 3D game, Fly for Fun, in 2006.

### **Allowances for Doubtful Accounts**

As of December 31, 2006, the gross accounts receivable balance before any allowance for bad and doubtful accounts was RMB155.8 million. After providing for doubtful accounts in the amount of RMB24.1 million, the net balance of accounts receivable was RMB131.7 million as of December 31, 2006. The allowance for doubtful accounts consisted of general provisions of RMB11.8 million and specific provisions for certain debtors of RMB12.3 million.

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We periodically review our general provisioning policy for doubtful accounts. In assessing the adequacy and reasonableness of the policy, we consider the aging analysis of accounts receivable balances, historical bad debt rates, repayment patterns and credit worthiness of customers and industry trend analysis.

As of December 31, 2006, we had three customers with a receivable balance exceeding 10% of the total accounts receivable balance. Details of the approximate total outstanding accounts receivable balance then outstanding (and percentage thereon) are set out below:

Customer A: RMB19.3 million or 12.4%

Customer B: RMB19.6 million or 12.6%

Customer C: RMB15.8 million or 10.2%

With respect to the accounts receivable balances of the above-mentioned customers, we established an allowance for doubtful accounts totaling RMB5.6 million at December 31, 2006. We had no such allowance for those customers at December 31, 2005.

**Other Income (Expenses)**

Other income in 2006 mainly consisted of interest income. Interest income increased to RMB94.4 million in 2006 from RMB58.1 million in 2005, mainly due to the increase in short-term bank deposits in China and abroad. The cash for such deposits was generated largely from our operations as well as from the proceeds of our US\$100 million zero coupon convertible subordinated notes issued in July 2003. Investment income decreased to RMB0.3 million in 2006 from RMB1.3 million in 2005, mainly due to less interest income generated from investments in US treasury notes and bonds as these notes and bonds matured during 2005. Interest expense decreased to zero in 2006 from RMB0.3 million in 2005, as the accrual of interest payable to the holders of our convertible notes from January 10, 2004 which became due ceased on January 26, 2005. In 2006, we recognized an exchange loss of RMB1.0 million upon translating monetary assets and liabilities which are denominated in currencies other than Renminbi into Renminbi, due to the appreciation in the value of Renminbi. In 2005, we recognized an exchange loss of RMB8.4 million.

**Income Tax**

Income tax increased significantly to RMB132.5 million in 2006 from RMB95.0 million in 2005. The increase was mainly due to an increase in revenues and taxable income in 2006 and the end of a tax holiday in January 2005 for one of our subsidiary companies in Guangzhou. Our effective tax rate in 2006 was 9.6% as compared with 9.2% in 2005.

**Net Profit**

As a result of the foregoing, net profit increased by 33.3% to RMB1,242.8 million in 2006 from RMB932.0 million in 2005.

[Table of Contents](#)**Quarterly Results of Operations Data**

The following table sets forth selected unaudited quarterly consolidated statements of operations data for each of the four fiscal quarters for the year ended December 31, 2007 in Renminbi. Our management believes this data has been prepared substantially on the same basis as the consolidated audited financial statements, including all necessary adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of such data. Operating results for any quarter are not necessarily indicative of results for any future quarter. You should read the quarterly data for the four quarters set forth below in conjunction with our consolidated financial statements and the related notes included elsewhere in this annual report.

|  | Quarter Ended      |                    |                       |                      |
|--|--------------------|--------------------|-----------------------|----------------------|
|  | March 31,<br>2007  | June 30,<br>2007   | September 30,<br>2007 | December 31,<br>2007 |
|  | (Unaudited)<br>RMB | (Unaudited)<br>RMB | (Unaudited)<br>RMB    | (Unaudited)<br>RMB   |
| Revenues:                                |                    |                    |                       |                      |
| Online game services                     | 481,865,952        | 475,149,731        | 468,651,024           | 506,968,240          |
| Advertising services                     | 56,195,605         | 65,328,019         | 85,478,302            | 98,055,630           |
| Wireless value-added services and others | 16,550,555         | 17,494,877         | 16,946,709            | 17,026,320           |
| Total revenues                           | 554,612,112        | 557,972,627        | 571,076,035           | 622,050,190          |
| Business tax                             | (21,316,231)       | (21,926,013)       | (23,420,856)          | (25,761,100)         |
| Net revenues                             | 533,295,881        | 536,046,614        | 547,655,179           | 596,289,090          |
| Cost of revenues:                        |                    |                    |                       |                      |
| Online game services                     | (48,506,860)       | (45,151,473)       | (48,094,598)          | (45,658,298)         |
| Advertising services                     | (33,039,634)       | (31,585,837)       | (35,946,007)          | (43,104,579)         |
| Wireless value-added services and others | (21,658,024)       | (21,529,809)       | (21,670,109)          | (19,507,818)         |
| Total cost of revenues                   | (103,204,518)      | (98,267,119)       | (105,710,714)         | (108,270,695)        |
| Gross profit                             | 430,091,363        | 437,779,495        | 441,944,465           | 488,018,395          |
| Operating expenses:                      |                    |                    |                       |                      |
| Selling and marketing expenses           | (43,089,175)       | (49,272,271)       | (83,189,695)          | (59,767,163)         |
| General and administrative expenses      | (35,181,129)       | (48,380,093)       | (48,276,202)          | (44,341,316)         |
| Research and development expenses        | (39,384,969)       | (45,110,176)       | (47,515,112)          | (48,724,456)         |
| Total operating expenses                 | (117,655,273)      | (142,762,540)      | (178,981,009)         | (152,832,935)        |
| Operating profit                         | 312,436,090        | 295,016,955        | 262,963,456           | 335,185,460          |
| Other income (expenses):                 |                    |                    |                       |                      |
| Investment income                        | 126,279            | 117,317            | 116,843               | 114,007              |
| Interest income                          | 23,262,363         | 28,409,895         | 29,194,435            | 31,733,301           |
| Exchange losses                          | (531,592)          | (8,866,713)        | (11,262,630)          | (30,230,159)         |
| Other, net                               | (200,630)          | (67,475)           | (902,185)             | 86,050               |
| Profit before tax                        | 335,092,510        | 314,609,979        | 280,109,919           | 336,888,659          |
| Income tax (expenses) benefit            | (33,597,844)       | (2,013,483)        | (19,946,757)          | 52,868,775           |
| Profit after tax                         | 301,494,666        | 312,596,496        | 260,163,162           | 389,757,434          |
| Minority interests                       | —                  | —                  | —                     | 74,364               |
| Net profit                               | 301,494,666        | 312,596,496        | 260,163,162           | 389,831,798          |
| Unrealized gains on investments          | —                  | —                  | —                     | 1,332,300            |
| Comprehensive Income                     | 301,494,666        | 312,596,496        | 260,163,162           | 391,164,098          |

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**Table of Contents****B. LIQUIDITY AND CAPITAL RESOURCES**

Our capital requirements relate primarily to financing:

- our working capital requirements, such as bandwidth and server custody fees, staff costs, sales and marketing expenses and research and development, and
- costs associated with the expansion of our business, such as the purchase of servers.

*Operating Activities*

Cash provided by operating activities was RMB1,379.9 million (US\$189.2 million), RMB1,596.1 million and RMB1,104.8 million for the years ended December 31, 2007, 2006 and 2005, respectively. For the year ended December 31, 2007, cash provided by operating activities consisted primarily of our operating profit of RMB1,264.1 million (US\$173.3 million), adjusted for, principally:

- a decrease in accounts payable and other liabilities totaling RMB25.9 million (US\$3.6 million),
- depreciation and amortization charges of RMB99.1 million (US\$13.6 million),
- unrealized exchange losses of RMB50.9 million (US\$7.0 million),
- an increase in accounts receivable of RMB29.8 million (US\$4.1 million),
- a decrease in allowance for doubtful accounts of RMB5.3 million (US\$0.7 million),
- an increase in prepayments and other current assets of RMB16.5 million (US\$2.3 million), and
- an increase in deferred tax assets of RMB53.7 million (US\$7.4 million).

For the year ended December 31, 2006, cash provided by operating activities consisted primarily of our operating profit of RMB1,242.8 million adjusted for, principally:

- an increase in accounts payable and other liabilities totaling RMB242.8 million,
- depreciation and amortization charges of RMB82.7 million,
- an increase in accounts receivable of RMB69.6 million,
- an increase in allowance for doubtful accounts of RMB7.5 million,
- an increase in prepayments and other current assets of RMB13.9 million, and
- an increase in deferred tax assets of RMB11.2 million.

For the year ended December 31, 2005, cash provided by operating activities consisted primarily of our operating profit of RMB932.0 million, adjusted for, principally:

- an increase in accounts payable and other liabilities totaling RMB163.7 million,
- depreciation and amortization charges of RMB48.7 million,
- an increase in deferred tax assets of RMB19.9 million,
- an increase in accounts receivable of RMB16.9 million,
- an increase in prepayments and other current assets of RMB13.1 million, and
- an increase in exchange losses of RMB8.4 million.

*Investing Activities*

Cash provided by investing activities was RMB952.3 million (US\$130.5 million) for the year ended December 31, 2007, cash used in investing activities was RMB1,218.2 million for the year ended December 31,



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2006, and cash used in investing activities was RMB1,618.7 million for the year ended December 31, 2005. For the year ended December 31, 2007, cash provided by investing activities mainly consisted of matured time deposits of RMB1,530.8 million (US\$209.9 million), partially offset by an increase in time deposits of RMB476.3 million (US\$65.3 million), the purchase of fixed assets of RMB71.5 million (US\$9.8 million), and the prepayment for land use right of RMB27.0 million (US\$3.7 million).

For the year ended December 31, 2006, cash used in investing activities mainly consisted of an increase in investments in time deposits of RMB2,164.9 million and the purchase of fixed assets of RMB142.5 million, partially offset by matured time deposits of RMB1,125.1 million.

For the year ended December 31, 2005, cash used in investing activities mainly consisted of an increase in investments in time deposits of RMB1,692.5 million and the purchase of fixed assets of RMB92.6 million, partially offset by a decrease in held-to-maturity investments of RMB165.5 million.

### *Financing Activities*

Cash used in financing activities was RMB960.4 million (US\$131.7 million) and RMB829.1 million for the years ended December 31, 2007 and 2006, respectively. Cash provided by financing activities was RMB105.5 million for the year ended December 31, 2005.

For the year ended December 31, 2007, cash used in financing activities mainly consisted of company share repurchases of RMB1,003.7 million (US\$137.6 million), partially offset by proceeds from the issuance of shares on the exercise of employee stock options of RMB43.2 million (US\$5.9 million).

For the year ended December 31, 2006, cash used in financing activities mainly consisted of company share repurchases of RMB873.4 million, partially offset by proceeds from the issuance of shares on the exercise of employee stock options of RMB44.1 million.

For the year ended December 31, 2005, cash provided by financing activities mainly consisted of proceeds from the issuance of ordinary shares upon the exercise of employee share options of RMB105.7 million.

We believe that our current levels of cash and cash equivalents and cash flows from operations will be sufficient to meet our anticipated cash needs for at least the next 12 months, including for the planned redemption of our zero coupon convertible subordinated notes as described below. However, we may need additional cash resources if we experience changed business conditions or other developments. We may also need additional cash resources if we find and wish to pursue opportunities for investment, acquisition, strategic cooperation or other similar action. If we determine that our cash requirements exceed our amounts of cash and cash equivalents on hand, we may seek to issue debt or equity securities or obtain a credit facility. Any issuance of equity securities could cause dilution for our shareholders. Any incurrence of indebtedness could increase our debt service obligations and cause us to be subject to restrictive operating and finance covenants. It is possible that, when we need additional cash resources, financing will only be available to us in amounts or on terms that would not be acceptable to us or financing will not be available at all.

### *Indebtedness*

As of December 31, 2007, we had US\$88.0 million aggregate principal amount of zero coupon convertible subordinated notes due July 15, 2023 outstanding. We announced on June 13, 2008 that we will redeem all of our outstanding zero coupon convertible subordinated notes on July 15, 2008.

On May 17, 2007, we entered into a revolving loan facility with the Hong Kong office of a commercial bank, which was available, upon our request, for the refinancing of our convertible notes upon redemption requests by noteholders. The facility was a committed facility in the amount of US\$100 million expiring on

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July 31, 2008 with an interest rate of 0.10% per annum over the London Inter Bank Offering Rate upon drawdown. A commitment fee of 0.05% per annum on the undrawn balance of the facility amount was payable annually in arrears from the start of the availability period to the maturity date. Under the committed facility, the lender created a general lien and reserved the right to combine and consolidate all or any of the accounts we maintained with the bank in an amount of US\$100 million. In light of the committed facility, as of December 2006, we classified the callable obligations of the convertible notes as long-term payable in accordance with SFAS No. 6, "Classification of Short-Term Obligations Expected to Be Refinanced." This classification is consistent with ARB No. 43 and SFAS No. 78, "Classification of Obligations that are Callable by the Creditor." In December 2007, we cancelled such facility with the bank prior to its expiration. We have classified the callable obligations of the convertible notes as short term payable as of December 31, 2007.

### **C. RESEARCH AND DEVELOPMENT**

We believe that an integral part of our future success will depend on our ability to develop and enhance our services. Our product development efforts and strategies consist of incorporating new technologies from third parties as well as continuing to develop our own proprietary technology.

We have utilized and will continue to utilize the products and services of third parties to enhance our platform of technologies and services to provide competitive and diverse Internet and wireless services to our users. In addition, we plan to continue to expand our technologies, products and services and registered user base through diverse online community products and services developed internally, particularly with respect to our online game services. We will seek to continually improve and enhance our existing services to respond to rapidly evolving competitive and technological conditions. For the years 2005, 2006 and 2007, we spent RMB90.2 million, RMB153.2 million and 180.7 million (US\$24.8 million), respectively, on research and development activities.

### **D. TREND INFORMATION**

Based on our observations, we believe that the following trends are likely to have a material effect on our business in the near term:

- We believe that there has been increasing demand by online game users for new and unique online games and increasing competition in this area. We believe that these trends will force us to devote additional resources to developing and launching additional games, updating existing games at a faster rate than we have in the past and licensing games from third parties. In particular, the online game industry in China is transitioning from 2D to 3D games, with numerous new 3D game titles being launched in the market in recent years. In response to this trend, we have been devoting additional resources to developing or licensing 3D games. Nonetheless, we also believe that the market for 2D online games will continue to grow in popularity for the foreseeable future.
- Our online games business may be adversely affected if, as is predicted by some industry commentators, the Chinese government takes additional steps to slow the growth in this market. We may not be able to adequately respond to any such regulatory changes in the online games market.
- Substantially all of our online game revenues have been generated by games that use the pay-to-play revenue model whereby players purchase our prepaid point cards to pay for playing time. A number of our competitors, including Giant, Perfect World, Shanda and Kingsoft use primarily or entirely an item-based revenue model where end users are able to play the basic functions of the online games for free and may choose to purchase in-game value-added services, including certain in-game items and premium features, which enhance the game experience. Currently, we are developing games that use the item-based revenue model and launched our first item-based online game, Tianxia II, in June 2008, but we cannot be certain that Tianxia II and our future item-based online games will be popular or generate the revenue our management expects. Moreover, it is possible that users of our existing pay-to-play games find that the item-based games offered by our competitors provide a more enjoyable

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gaming experience in which case the popularity of our existing games could be materially adversely affected. If there is an overall shift in the online game market in China to an item-based or another revenue model, we may be unable to launch new games or new versions of existing games which effectively use such model, and we may be required to make significant research and development and selling and marketing expenditures to develop and promote such games.

- Online video content is becoming increasingly popular among Internet users in China. Many providers of video content prefer to enter into exclusive distribution agreements with Internet portals. Accordingly, we believe that the sources for such content are more limited in comparison to other types of content.
- A general increase in competition for online services has elevated the importance of brand building and brand awareness. We believe that this trend may require us to increase our marketing and advertising efforts and budgets in order to keep our brand names and the NetEase websites visible and prominent.
- We expect that for at least the next several quarters, our fixed costs in connection with our Internet portal business will increase, without a corresponding increase in revenue, due to the ongoing increase in the number of users for our free e-mail service and increasing bandwidth fees resulting from increased usage of the NetEase websites. In addition, we expect that the increasing popularity of online video content will increase our cost because it requires significant bandwidth to deliver and requires us to invest in new video streaming technology.

## **E. OFF-BALANCE SHEET ARRANGEMENTS**

We do 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.

## **F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS**

We have entered into leasing arrangements relating to our office premises. We also have contractual obligations in respect of server custody fees and capital expenditures related to the construction of the research and development center in Hangzhou. In addition, we announced on June 13, 2008 that we will redeem all of our outstanding zero coupon convertible subordinated notes on July 15, 2008. The following sets forth our contractual obligations for long-term payables, operating leases, server custody fees, zero coupon convertible subordinates notes and capital expenditures as of December 31, 2007 (in U.S. dollars):

|      | <b>Rental<br/>commitments</b> | <b>Server custody<br/>fee<br/>commitments</b> | <b>Zero coupon<br/>convertible<br/>subordinated notes</b> | <b>Long-term<br/>payables</b> | <b>Capital<br/>commitments</b> | <b>Total</b>       |
|------|-------------------------------|---|---|-------------------------------|--------------------------------|--------------------|
| 2008 | 1,688,594                     | 6,844,238                                     | 87,980,000  | —                             | 3,195,646                      | 99,708,478         |
| 2009 | 572,820                       | 873,053                                       | —   | —                             | 292,134                        | 1,738,007          |
| 2010 | 56,591                        | —   | —   | —                             | —                              | 56,591             |
| 2011 | —                             | —   | —   | —                             | —                              | —                  |
| 2012 | —                             | —   | —   | 1,398,295                     | —                              | 1,398,295          |
|      | <u>2,318,005</u>              | <u>7,717,291</u>                              | <u>87,980,000</u>   | <u>1,398,295</u>              | <u>3,487,780</u>               | <u>102,901,371</u> |

Other than the obligations set forth above, we do not have any long-term commitments.

## **Quantitative and Qualitative Disclosures About Market Risk**

### *Interest Rate Risk*

Our exposure to market rate risk for changes in interest rates relates primarily to the interest income generated by excess cash invested in short term money market accounts and certificates of deposit. We have not

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used derivative financial instruments in our investment portfolio. Interest earning instruments carry a degree of interest rate risk. We have not been exposed nor do we anticipate being exposed to material risks due to changes in interest rates. However, our future interest income may fall short of expectations due to changes in interest rates.

### *Foreign Currency Risk*

Substantially all our revenues and expenses are denominated in Renminbi, but as noted above, a substantial portion of our cash is kept in U.S. dollars. Although we believe that, in general, our exposure to foreign exchange risks should be limited, the value of our ADSs will be affected by the foreign exchange rate between U.S. dollars and Renminbi. For example, to the extent that we need to convert U.S. dollars into Renminbi for our operational needs and the Renminbi appreciates against the U.S. dollars at that time, our financial position and the price of our ADSs may be adversely affected. Conversely, if we decide to convert our Renminbi into U.S. dollars for the purpose of declaring dividends on our ADSs or otherwise and the U.S. dollar appreciates against the Renminbi, the U.S. dollar equivalent of our earnings from our subsidiaries and controlled entities in China would be reduced.

In July 2005, the Chinese government announced that it is pegging the exchange rate of the Chinese Renminbi against a number of currencies, rather than just the US dollar. This change in policy has resulted in an appreciation in the value of the Renminbi against the US dollar. Although we generate substantially all of our revenues in Renminbi which has become more valuable in US dollar terms, we translate our monetary assets and liabilities which are denominated in currencies other than Renminbi into Renminbi as of each accounting period end, in accordance with applicable accounting standards. As a result of this foreign currency translation, we reported a RMB50.9 million (US\$7.0 million) exchange loss in 2007. We have not engaged in any hedging activities, and we may experience additional economic loss as a result of any foreign currency exchange rate fluctuations. In addition, we cannot predict at this time what will be the long-term effect of the Chinese government's decision to tie the Renminbi to a basket of currencies, rather than just to the U.S. dollar.

### **Recent Accounting Pronouncements**

In December 2007, the SEC issued Staff Accounting Bulletin No. 110 or SAB 110, codified as SAB Topic 14, "Share-based payment." SAB 110 states that the SEC staff will continue to accept, under certain circumstances, the use of the simplified method in developing an estimate of expected term of "plain vanilla" share options in accordance with SFAS No. 123 (revised 2004 and SAB No. 107 beyond December 31, 2007). The adoption of SAB 110 did not require any adjustments to our consolidated financial statements for the year ended December 31, 2007.

In September 2006, the Financial Accounting Standards Board, or FASB issued SFAS No. 157, "Fair Value Measurements," or SFAS 157. SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. We adopted SFAS 157 at the beginning of our fiscal year 2008, and we do not expect the adoption of SFAS 157 will have a material impact to our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115", or SFAS 159. This standard permits an entity to choose to measure financial instruments and certain other items at fair value. Most of the provisions in SFAS 159 are elective, however, the amendment to FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities," applies to all entities with available-for-sale and trading securities. Under SFAS 159, all entities are allowed to choose to measure eligible items at fair value at specified election dates. A business entity will report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option (a) may be applied instrument by instrument, with a few exceptions, such as investments otherwise accounted for by the equity

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method, (b) is irrevocable (unless a new election date occurs), and (c) is applied only to the entire arrangement and not to a portion of an instrument. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. We adopted SFAS 159 at the beginning of 2008 and did not make any elections for fair value accounting. Therefore, we did not record a cumulative-effect adjustment to our opening retained earnings balance.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), "Business Combinations," or SFAS 141R. This statement establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statement to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for fiscal years beginning after December 15, 2008. Adoption is prospective and early adoption is not permitted. Accordingly, any business combinations we engage in will be recorded and disclosed following existing US GAAP until January 1, 2009. Adoption of SFAS 141R will not impact our accounting for business combinations closed prior to its adoption, but given the nature of the changes noted above, we are currently assessing the potential impact that the adoption of SFAS 141R will have on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51," or SFAS 160. This Statement amends Accounting Research Bulletin No. 51, Consolidated Financial Statements, to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. It requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. This statement establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation. SFAS 160 is effective for fiscal years beginning after December 15, 2008. We are currently evaluating the impact of SFAS 160 on our consolidated financial position, results of operations and cash flows.

In May 2008, the FASB issued FASB Staff Position No. APB 14-1, or FSP, which clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants. Additionally, FSP specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. FSP applies to convertible debt instruments that, by their stated terms, may be settled in cash, including partial cash settlement, unless the embedded conversion option is required to be separately accounted for as a derivative under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. We are currently evaluating the impact of FSP on our consolidated financial statements.

[Table of Contents](#)**Item 6. Directors, Senior Management and Employees****A. Directors and Senior Management**

The names of our directors and executive officers, their ages as of June 1, 2008 and the principal positions with NetEase held by them are as follows:

| <u>Name</u>       | <u>Age</u> | <u>Position</u>                         |
|-------------------|------------|---|
| William Lei Ding  | 36         | Director and Chief Executive Officer    |
| Onward Choi       | 37         | Acting Chief Financial Officer          |
| Michael Tong      | 37         | Director and Co-Chief Operating Officer |
| Zhonghui Zhan     | 36         | Co-Chief Operating Officer              |
| Alice Cheng (1)   | 47         | Director                                |
| Lun Feng          | 48         | Director                                |
| Denny Lee         | 40         | Director                                |
| Michael Leung (1) | 54         | Director                                |
| Joseph Tong (1)   | 45         | Director                                |

(1) Member of the audit, compensation and nominating committees.

**Biographical Information**

*William Lei Ding*, our founder, has served as a director since July 1999 and as our Chief Executive Officer since November 2005. From March 2001 until November 2005, Mr. Ding served as our Chief Architect, and, from June 2001 until September 2001, he served as our Acting Chief Executive Officer and Acting Chief Operating Officer. Mr. Ding also stepped down as Chairman of the board of directors in September 2001 (the company currently has no permanently appointed Chairman). From July 1999 until March 2001, Mr. Ding served as Co-Chief Technology Officer, and from July 1999 until April 2000, he also served as our interim Chief Executive Officer. Mr. Ding established Guangzhou NetEase, our affiliate, in May 1997. Mr. Ding holds a Bachelor of Science degree in Communication Technology from the University of Electronic Science and Technology of China.

*Onward Choi* has served as our Acting Chief Financial Officer when Denny Lee stepped down from such position on June 30, 2007. Mr. Choi was our Financial Controller and Corporate Finance Director for the periods from January 2005 to June 2007 and November 2003 to December 2004, respectively. Prior to that, Mr. Choi worked at Ernst & Young Beijing, including as a senior manager of the assurance and advisory business services department. Mr. Choi also worked at KPMG (assurance) and the Hong Kong Trade Development Council (finance and accounting). Mr. Choi is a member of the Institute of Chartered Accountants in England and Wales, a member of the Association of Chartered Certified Accountants, a member of the Hong Kong Institute of Certified Public Accountants and a registered practising Certified Public Accountant in Hong Kong. Mr. Choi holds a Bachelor of Arts degree in accountancy with honors from the Hong Kong Polytechnic University.

*Michael Tong* became an Executive Director of our company in June 2003 and our Chief Operating Officer in July 2004. He has also served as one of our directors since December 1999. Previously, he was an Executive Director with techpacific.com Venture Capital Limited. In that capacity, he was primarily responsible for portfolio management of the funds managed by techpacific.com and its subsidiaries. Prior to joining techpacific.com in December 2000, Mr. Tong worked at Softbank China Venture Investments Limited in Hong Kong, where he was responsible for the evaluation, financial modeling, due diligence review and structuring of Softbank's investments. He also worked at Nomura China Venture Investments Limited, Jardine Fleming Securities Limited and Ernst & Young, all in Hong Kong. Mr. Tong graduated with a Bachelor of Business Administration from the University of Wisconsin, Madison with a major in Accounting and an extra concentration in Computer Science in 1993. He is a member of the American Institute of Certified Public Accountants and the CFA Institute and is a Chartered Financial Analyst.



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*Zhonghui Zhan* joined our company in October 1999 and has since served in various positions. Mr. Zhan was appointed as our Co-Chief Operating Officer in May 2006. Mr. Zhan has extensive experience in software and product development and management, and has had a leading role in many projects since joining us, including the development of our EaseBar browser toolbar and our proprietary content delivery system. Mr. Zhan received his Bachelor of Science and Master's Degree in Automation from the South China University of Technology.

*Alice Cheng* has served as a director since June 2007. Ms. Cheng has been the Chief Financial Officer of BBK Electronics Corp., Ltd., a PRC-based manufacturer of audio/visual equipment, since May 2005. From January 2002 to April 2005, she served as Financial Controller of Wistron Corporation, a Taiwanese original design manufacturer of notebook computers and other electronics. Prior to that, she held various positions with Acer Inc., a Taiwanese computer manufacturer, culminating in the position of Financial Controller. Ms. Cheng received a Bachelor of Accounting from the Chinese Culture University in Taiwan in 1983 and a Masters of Business Administration from the Thunderbird School of Global Management in Arizona in 2003. She is licensed as a certified public accountant in Taiwan and the PRC.

*Lun Feng* has served as a director since July 2005. He has been the Chairman of Beijing Vantone Real Estate Co., Ltd., a private real estate investment company in China, since 1991. Mr. Feng has a Juris Doctor from the Chinese Academy of Social Sciences, a Masters of Law degree from the Party School of the Chinese Communist Party and a Bachelor of Arts in Economics from Northwest University.

*Denny Lee* has served as a director since April 2002. Mr. Lee previously served as our Chief Financial Officer from April 2002 until June 2007 and as our Financial Controller from November 2001 until April 2002. Prior to joining our company, Mr. Lee worked in the Hong Kong office of KPMG for more than ten years, culminating in the position of Senior Manager in one of the audit departments where he specialized in auditing international clients. During his employment with KPMG, he also worked with a number of Chinese companies with respect to accounting and other aspects of their initial public offerings on the Hong Kong Stock Exchange, due diligence work in relation to potential investments in Chinese companies and financial and operational reviews of Chinese companies in connection with proposed investments in such companies by foreign investors. Mr. Lee serves as a director of New Oriental Education & Technology Group Inc., which is listed on the New York Stock Exchange. Mr. Lee graduated from the Hong Kong Polytechnic University majoring in accounting and is a member of The Hong Kong Institute of Certified Public Accountants and The Association of Chartered Certified Accountants.

*Michael Leung* has served as a director since July 2002. Mr. Leung held senior positions with Peregrine Capital (China) Limited, SG Securities (HK) Limited (previously known as Crosby Securities (Hong Kong) Limited), Swiss Bank Corporation, Hong Kong Branch, and Optima Capital Limited (previously known as Ke Capital (Hong Kong) Limited) where he provided financial advisory services. Mr. Leung was also a director at Emerging Markets Partnership (Hong Kong) Limited, which was the principal advisor to the AIG Asian Infrastructure Fund L.P. Mr. Leung serves as an independent non-executive director for China Ting Group Holdings Limited, Anhui Expressway Company Limited, Junefield Department Store Group Limited and Golden Harvest Entertainment (Holdings) Limited, all of which are companies listed on the Stock Exchange of Hong Kong Limited. Mr. Leung is also the Responsible Officer of North Asia Strategic Advisors, which provides corporate finance advices. Mr. Leung received a Bachelor's Degree in Social Sciences from the University of Hong Kong with a major in accounting, management and statistics.

*Joseph Tong* has been a director of, and management consultant to, Parworld Investment Management Limited, which provides financial and investment advisory services, since April 2004. From December 2002 until April 2004, Mr. Tong was engaged in establishing offices and operations in Hong Kong and China, setting up accounting and internal control policies and overseeing the overall operations for TLM Apparel Co., Ltd., a garment trading company operating in Hong Kong and China which he co-founded. Prior to that, from September 2000 to September 2002, he was the e-Commerce Director of the Asia Region for Universal Music



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Limited where he was responsible for forming e-business development strategies and overseeing new promotional opportunities. Mr. Tong has a Bachelor of Science degree and Second Honors Degree in Accounting and Statistics from the University of Southampton, England. He is a member of the American Institute of Certified Public Accountants and has served as a director since March 2003.

**Relationships Among Directors or Executive Officers; Right to Nominate Directors**

There are no family relationships among any of the directors or executive officers of our company. None of our directors were nominated pursuant to a contractual or other right.

**B. Compensation****Director Compensation**

In 2007, we paid each of Alice Cheng (a member of our board and our audit, compensation and nominating committees who joined us after Donghua Ding stepped down from such position in May 2007), Donghua Ding (a former member of our board and our audit, compensation and nominating committees who resigned in May 2007), Michael Leung and Joseph Tong the amount of US\$4,500 per month for their services as independent non-executive directors for a total of US\$160,630.

In addition, in 2007 we paid each of Denny Lee (commencing from July 2007) and Lun Feng US\$1,000 per month for their services as non-executive directors for a total of US\$18,000. We also paid Alice Cheng, Donghua Ding and Feng Lun US\$7,682, US\$5,261 and US\$2,377 for Chinese individual income taxes on their behalf, respectively. Other than the foregoing payments, we did not pay any other compensation in any form to our non-executive directors in 2007.

In 2007, we also granted stock options under our 2000 Stock Incentive Plan to certain executive officers, as set forth in the table entitled "Options Grants in Last Fiscal Year" below.

All of our current directors have entered into indemnification agreements in which we agree to indemnify, to the fullest extent allowed by Cayman Islands law, our charter documents or other applicable law, those directors from any liability or expenses, unless the liability or expense arises from the director's own willful negligence or willful default. The indemnification agreements also specify the procedures to be followed with respect to indemnification.

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### Executive Officer Compensation

The following table sets forth certain information concerning compensation paid during 2005, 2006 and 2007 to our executive officers:

| <u>Name and Principal Position</u>                         | <u>Fiscal Year</u> | <u>Annual Compensation</u> |                     | <u>Long-Term Compensation</u>            |                                      |
|--|--------------------|----------------------------|---------------------|--|--------------------------------------|
|  |                    | <u>Salary (US\$)</u>       | <u>Bonus (US\$)</u> | <u>Securities Underlying Options (#)</u> | <u>All Other Compensation (US\$)</u> |
| William Lei Ding<br>Chief Executive Officer and a Director | 2007               | 49,352                     | —                   | —  | —                                    |
|  | 2006               | 46,130                     | —                   | —  | —                                    |
|  | 2005               | 5,632                      | —                   | —  | —                                    |
| Denny Lee<br>a Director and former Chief Financial Officer | 2007               | 125,238(1)                 | —                   | —  | —                                    |
|  | 2006               | 249,215(1)                 | 200,000(2)          | —  | —                                    |
|  | 2005               | 248,342(1)                 | 240,000(2)          | 5,000,000                                | —                                    |
| Onward Choi<br>Acting Chief Financial Officer              | 2007               | 207,583(3)                 | 200,000(2)          | 1,250,000                                | 205,362(5)                           |
| Michael Tong<br>Co-Chief Operating Officer and a Director  | 2007               | 223,672(4)                 | 200,000(2)          | 1,875,000                                | 186,572(5)                           |
|  | 2006               | 225,673(4)                 | 200,000(2)          | —  | 54,623(5)                            |
|  | 2005               | 216,073(4)                 | 240,000(2)          | 5,000,000                                | —                                    |
| Zhonghui Zhan<br>Co-Chief Operating Officer                | 2007               | 80,608                     | 490,274(6)          | 2,000,000                                | —                                    |
|  | 2006               | 58,431                     | 350,974(7)          | —  | —                                    |
|  | 2005               | 49,069                     | 271,880(8)          | 1,020,000                                | —                                    |

- (1) Includes housing allowances of US\$30,542, US\$31,415 and US\$16,338 paid by our company on behalf of Mr. Lee in respect of 2005, 2006 and 2007, respectively, and a cash living allowance of US\$19,800, US\$19,800 and US\$9,900 paid to Mr. Lee in each of 2005, 2006 and 2007, respectively. Mr. Lee resigned from the position of our Chief Financial Officer in June 2007.
- (2) Represents discretionary bonuses in the year earned, rather than in the year in which such bonus amount was paid or is to be paid.
- (3) Includes housing allowances of US\$28,002 paid by our company on behalf of Mr. Choi and a cash living allowance of US\$10,450 paid to Mr. Choi in 2007.
- (4) Includes housing allowances of US\$24,073, US\$33,673 and US\$31,672 paid by our company on behalf of Mr. Tong in each of 2005, 2006 and 2007, respectively.
- (5) Represents PRC individual income taxes paid by our company on behalf of Mr. Tong and Mr. Choi.
- (6) Includes monthly bonuses in the year paid and fixed and discretionary year-end bonuses earned for the year of US\$409,916, US\$6,767 and US\$73,591, respectively.
- (7) Includes monthly bonuses in the year paid and fixed and discretionary year-end bonuses earned for the year of US\$326,884, US\$4,869 and US\$19,221, respectively.
- (8) Includes monthly bonuses in the year paid and fixed and discretionary year-end bonuses earned for the year of US\$235,319, US\$4,089 and US\$32,472, respectively.

### Employment Agreements

We have entered into employment and related agreements with William Lei Ding, Denny Lee, Onward Choi, Michael Tong and Zhonghui Zhan, as described below.

*William Lei Ding.* In August 1999, we entered into an employment agreement with Mr. Ding which provided for an initial annual salary of US\$85,000, plus a discretionary bonus, if any. This employment agreement was amended on May 1, 2003 to lower such salary to RMB1,000 per month and again on November 25, 2005 to increase his salary to RMB30,000 per month. Under this employment agreement, Mr. Ding is obligated to keep all proprietary information regarding our company confidential, except in limited

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circumstances. He is further precluded during his employment with us from carrying on or being employed by any business in China which is in competition with us or, directly or indirectly, solicit away from our company any of our existing or prospective clients or customers.

*Denny Lee.* In April 2002, we entered into a new employment agreement with Denny Lee in connection with his promotion to the position of Chief Financial Officer. This agreement provides for an annual salary of US\$158,000, plus a discretionary bonus to be determined by our company. With effect from January 1, 2004, his annual salary was increased from US\$158,000 to US\$198,000. Mr. Lee's discretionary bonuses in 2005, 2006 and 2007 were US\$240,000, US\$200,000 and nil, respectively. He is also entitled to receive a housing allowance and tax equalization benefits. If Mr. Lee's employment is terminated for any reason other than his death, disability or pursuant to one of the statutory bases for terminating employees without notice under Hong Kong law, he shall be entitled to severance pay in the amount of six months of his then current base salary. Mr. Lee resigned from the position of our Chief Financial Officer in June 2007.

This agreement also prohibits Mr. Lee, for the six month period following his termination of employment with us, from obtaining an ownership interest in (unless the total investment represents less than 5% of any single class of shares of the competitor and the competitor is a listed company), or employment with, any company which carries on a business in Hong Kong or China which competes with our company and in which Mr. Lee was involved at any time during the last two years of his employment or in relation to which he acquired any confidential information during the course of his employment. During that same period, he may not solicit, entice or hire any of our employees or customers. Mr. Lee has also entered into a proprietary information agreement which obligates him to keep all proprietary information regarding our company confidential, except in limited circumstances.

*Onward Choi.* In July 2007, we entered into a new employment agreement with Onward Choi in connection with his promotion to the position of Acting Chief Financial Officer. This agreement provides for an annual salary of RMB1,524,600, plus a discretionary bonus to be determined by our company. Mr. Choi's discretionary bonus in 2007 was US\$200,000. He is also entitled to receive a housing allowance and tax equalization benefits. If Mr. Choi is terminated without cause or resigns for good reason, he is entitled to receive a payment by us equal to his then-current monthly base salary multiplied by six plus the number of years between July 2007 and the termination date. He is also entitled to exercise his stock options which have vested at the time of his termination without cause or resignation for good reason (as such terms are defined in his employment agreement).

Mr. Choi is prohibited from directly or indirectly (i) being employed by or participate in the management or operation of any business or entity that is or may be directly competitive with and offering similar products or services as us, for a period of one year after termination of employment for any reason, (ii) soliciting for employment any person who was employed by us during his employment with us, for a period of two years after termination of employment for any reason or (iii) working for any customer or potential customer of ours during his employment with us, for a period of two years after termination of employment for any reason. Mr. Choi has also entered into a key employee invention assignment and confidentiality agreement in which he agrees to assign all rights in company-related inventions to us, and to keep our proprietary information confidential.

*Michael Tong.* Mr. Tong's employment agreement provides for an annual salary of US\$168,000, plus a discretionary bonus to be determined by our company. With effect from January 1, 2004, his annual salary was increased from US\$168,000 to US\$192,000. Mr. Tong's discretionary bonuses in 2005, 2006 and 2007 were US\$240,000, US\$200,000 and US\$200,000, respectively. He is also entitled to receive a housing allowance and tax equalization benefits. If Mr. Tong's employment is terminated for any reason other than his death, disability or pursuant to one of the statutory bases for terminating employees without notice under Hong Kong law, he shall be entitled to severance pay in the amount of three months of his then current base salary.

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This agreement also prohibits Mr. Tong, for the six month period following his termination of employment with us, from obtaining an ownership interest in (unless the total investment represents less than 5% of any single class of shares of the competitor and the competitor is a listed company), or employment with, any company which carries on a business in Hong Kong or China which competes with our company and in which Mr. Tong was involved at any time during the last two years of his employment or in relation to which he acquired any confidential information during the course of his employment. During that same period, he may not solicit, entice or hire any of our employees or customers. Mr. Tong has also entered into a proprietary information agreement which obligates him to keep all proprietary information regarding our company confidential, except in limited circumstances.

*Zhonghui Zhan.* In May 2006, we entered into a new employment agreement with Zhonghui Zhan in connection with his promotion to the position of Co-Chief Operating Officer. The employment agreement provides for an annual salary of RMB456,000, plus a discretionary bonus to be determined by our company. With effective from February 1, 2007, his annual salary was increased from RMB456,000 to RMB600,000. Mr. Zhan is also entitled to receive tax advisory services reimbursement up to RMB30,000 per year and a bonus equal to one-month's pay. If Mr. Zhan is terminated without cause or resigns for good reason, he is entitled to receive a payment by us equal to his then-current monthly base salary multiplied by six plus the number of years between May 2006 and the termination date. He is also entitled to exercise his stock options which have vested at the time of his termination without cause or resignation for good reason (as such terms are defined in his employment agreement).

Mr. Zhan is prohibited from directly or indirectly (i) being employed by or participate in the management or operation of any business or entity that is or may be directly competitive with and offering similar products or services as us, for a period of one year after termination of employment for any reason, (ii) soliciting for employment any person who was employed by us during his employment with us, for a period of two years after termination of employment for any reason or (iii) working for any customer or potential customer of ours during his employment with us, for a period of two years after termination of employment for any reason. Mr. Zhan has also entered into a key employee invention assignment and confidentiality agreement in which he agrees to assign all rights in company-related inventions to us, and to keep our proprietary information confidential.

### **Options Grants in Last Fiscal Year**

The following table sets forth information regarding stock options granted to our Chief Executive Officer, former Chief Financial Officer, Acting Chief Financial Officer and co-Chief Operating Officers during 2007:

| Name             | Individual Grants                               |  |                              |                 | Potential Realizable Value at Assumed Annual Rate of Stock Price Appreciation for Option Term (3) |             |
|------------------|---|--|------------------------------|-----------------|---|-------------|
|                  | Number of Securities Underlying Options Granted | % of Options Granted to Employees in Fiscal Year (1) | Exercise Price Per Share (2) | Expiration Date | 5%  | 10%         |
|                  |   |  |                              |                 |   |             |
| William Lei Ding | —   | —  | —                            | —               | —   | —           |
| Denny Lee (4)    | —   | —  | —                            | —               | —   | —           |
| Onward Choi      | 1,250,000                                       | 1.98%  | US\$0.728                    | 2012-3-14       | US\$251,416   | US\$555,564 |
| Michael Tong     | 1,875,000                                       | 2.97%  | US\$0.728                    | 2012-3-14       | US\$377,124   | US\$833,346 |
| Zhonghui Zhan    | 2,000,000                                       | 3.16%  | US\$0.728                    | 2012-3-14       | US\$402,266   | US\$888,903 |

- (1) Based on a total of 63,215,000 options granted to our employees in 2007, including options granted to the foregoing executive officers but excluding all options which were granted and terminated in that same year.
- (2) The exercise price per share of options granted represented the fair market value of the underlying ordinary shares on the date the options were granted.
- (3) The potential realizable value is net of exercise price and is calculated assuming that the stock price on the date of the grant appreciates at the indicated annual rate, compounded annually for the entire term of the

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options, and that the option is exercised and sold on its last day of its term for the appreciated stock price. The appreciated stock prices used in these calculations do not represent our projections or estimates of the price of our ordinary shares or ADSs. Tax consequences relating to stock option transactions have not been taken into account.

- (4) Mr. Lee resigned from the position of our Chief Financial Officer in June 2007.

### **Aggregate Option Exercises in Last Fiscal Year and Fiscal Year-End Option Values**

The following table sets forth certain information with respect to stock options exercised by our Chief Executive Officer, former Chief Financial Officer, Acting Chief Financial Officer and Co-Chief Operating Officers during 2007. In addition, the table sets forth the number of shares covered by stock options as of December 31, 2007, and the value of “in-the-money” stock options, which represents the difference between the exercise price of a stock option and the market price of the shares subject to such option on December 31, 2007.

| Name             | Shares<br>Acquired on<br>Exercise | Value<br>Realized<br>(US\$) (1) | Number of Securities<br>Underlying Unexercised<br>Options at<br>December 31, 2007 (#) |               | Value of Unexercised<br>In-the-Money Options at<br>December 31, 2007 (US\$) (2) |               |
|------------------|-----------------------------------|---------------------------------|---|---------------|---|---------------|
|                  |                                   |                                 | Exercisable   | Unexercisable | Exercisable   | Unexercisable |
| William Lei Ding | —                                 | —                               | —   | —             | —   | —             |
| Denny Lee (3)    | 7,000,000                         | 2,968,250                       | —   | 6,250,000     | —   | 2,398,875     |
| Onward Choi      | 925,000                           | 312,723                         | —   | 2,300,000     | —   | 388,565       |
| Michael Tong     | 8,750,000                         | 3,021,375                       | —   | 8,125,000     | —   | 2,469,375     |
| Zhonghui Zhan    | 2,500,000                         | 1,382,000                       | 3,510,000   | 4,010,000     | 1,513,671   | 901,421       |

- (1) The value realized upon the exercise of stock options represents the positive spread between the exercise price of stock options and the closing market price of the shares on the exercise date.
- (2) The value of unexercised in-the-money options is calculated based upon the closing price of US\$18.96 per ADS on the Nasdaq Global Select Market on December 31, 2007, less the exercise price of the applicable option.
- (3) Mr. Lee resigned from the position of our Chief Financial Officer in June 2007.

### **Amended and Restated 2000 Stock Incentive Plan**

#### **General**

Our shareholders approved the NetEase.com, Inc. Amended and Restated 2000 Stock Incentive Plan, or the Amended Plan, at our annual general meeting held on May 25, 2001. The Amended Plan replaced the 2000 Stock Incentive Plan, or the Prior Plan, in its entirety. Under the Prior Plan, a total of 223,715,000 of our ordinary shares were reserved for issuance. The Amended Plan increased the number of ordinary shares reserved for issuance to 323,715,000, which amount was automatically further increased to 504,756,924 ordinary shares in accordance with the provisions of that plan. On March 25, 2002, our board suspended any further automatic increases in the number of authorized shares reserved for issuance under the Amended Plan.

The purpose of the Amended Plan is to attract and retain the best available personnel, to provide additional incentive to employees, directors and consultants and to promote the success of our business. Our board of directors believes that our company’s long term success is dependent upon our ability to attract and retain superior individuals who, by virtue of their ability and qualifications, make important contributions to our business. The Amended Plan provides for the granting of incentive awards of our ordinary shares, options to purchase our ordinary shares and any other securities the value of which is derived from the value of our ordinary shares.

Grantees under the Amended Plan will not receive any account status reports. The Amended Plan is not subject to the U.S. Employee Retirement Income Security Act of 1974, as amended, nor is the Amended Plan a “qualified plan” within the meaning of Section 401(a) of the Code.

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The Amended Plan continues to be administered by our board, and it has delegated the power to award options under those plans for non-executive officers to NetEase's chief executive officer.

The Amended Plan provides that in the event of certain corporate transactions, including specified types of reorganizations and acquisition transactions, each outstanding award granted under the Amended Plan shall automatically become fully vested and exercisable and be released from any restrictions in transfer (other than transfer restrictions applicable to the award) and repurchase or forfeiture rights, immediately prior to the specified effective date of such corporate transaction, unless the award is assumed by the successor company or its parent company in connection with the corporate transaction. Upon consummation of such corporate transactions, each outstanding award shall be terminated unless the award is assumed by the successor company or its parent company in connection with the applicable corporate transaction. Our board of directors will determine whether an award was assumed in the manner contemplated by the Amended Plan.

Under the Amended Plan, awards can be issued to employees, directors or consultants of the company or our subsidiaries, although incentive stock options, referred to as ISOs, may only be issued to our employees or the employees of our subsidiaries.

Awards under the Amended Plan are evidenced by an award agreement which contains, among other things, provisions concerning exercisability and forfeiture upon termination of employment or consulting arrangement (by reason of death, disability, retirement or otherwise) as have been determined by our board. In addition, the award agreement also specifies whether the option constitutes an ISO or a non-incentive stock option, referred to as NQSOs, and may, but need not, include a provision whereby a grantee may at any time during his or her employment with us exercise any part or all of the award prior to full vesting of the award.

An option may be exercised by delivering written notice of such exercise to us. The option price to exercise the option for our ordinary shares must be paid at the time of exercise in full in cash or in check, by promissory note with such terms as the board deems appropriate or in whole ordinary shares with a fair market value at least equal to the option price (or in another appropriate manner approved by us, such as in a combination of cash and whole ordinary shares or by cashless exercise of options through a broker-dealer).

Under the Amended Plan, the exercise price for the options is specified in the award agreement for those options. In any event, the exercise price of ISOs cannot be less than the fair market value of our ordinary shares on the date of grant. However, in the case of an ISO granted to a grantee, who, at the time the ISO was granted, owned stock possessing more than 10% of the combined voting power of all classes of our share capital, the option price may not be less than 110% of the fair market value of our ordinary shares on the date of grant of such ISO. To the extent that the aggregate fair market value of shares subject to options granted as ISOs under the Amended Plan which become exercisable for the first time by a recipient during any calendar year exceeds US\$100,000, then options represented by ordinary shares in excess of the US\$100,000 limitation shall be treated as NQSOs.

NQSOs granted pursuant to the Amended Plan can have an exercise price of no less than 85% of the fair market value of our ordinary shares on the date of grant.

In the event of any extraordinary dividend, share dividend, recapitalization, share split, rights issuance, or combination or exchange of such shares, or other similar transactions, our board may equitably adjust the option price of our outstanding options so as to reflect such event.

The term of all ISOs and NQSOs will be stated in the applicable award agreement. The term of an ISO granted to a person, who, at the time the ISO was granted, owned stock possessing more than 10% of the combined voting power of all classes of our share capital, may not be more than five (5) years from the date of the grant of the award.

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Under the Amended Plan, if the employment, director or consultant relationship of a grantee with us terminates for cause, the grantee's right to exercise the option will expire upon the termination of such relationship. If the employment, director or consultant relationship of a grantee with us terminates without cause, all options then exercisable may be exercised within six months of the date of such termination or such shorter period as may be specified in the award agreement. Any ISO granted under the Amended Plan, if not exercised within the time period provided by law for the exercise of ISOs following the termination of a grantee's employment with us, shall automatically convert to a NQSO thereafter. If the termination of a grantee's employment, director or consultant relationship with us is (i) by reason of death or (ii) by reason of disability, all options then exercisable may be exercised by such grantee, such grantee's estate or by a person who acquired the right of exercise of such options by bequest or inheritance or otherwise by reason of death or disability of such grantee, at any time within a period not less than 12 months (but in no event later than the expiration date of the options) after the date of such termination.

Under the Amended Plan, our board may at any time terminate, suspend, or amend the Amended Plan in any respect, except that no termination, suspension or amendment will be effective without shareholder approval if such approval is required to comply with any law, regulation or stock exchange rule and no such change may adversely affect any award previously granted without the written consent of the recipient. The Amended Plan will expire in February 2010.

### **C. Board Practices**

At each annual general meeting of our shareholders, our shareholders are asked to elect the directors nominated to serve for the ensuing year or until their successors are elected and duly qualified or until such director's earlier death, bankruptcy, insanity, resignation or removal. For information regarding the period during which our officers and directors have served in their respective positions, please refer to Item 6.A. "Directors and Senior Management".

During the year 2007, our board met in person or passed resolutions by unanimous written consent 18 times. We have no specific policy with respect to director attendance at our annual general meetings of shareholders, and two of our directors attended the annual general meeting of shareholders held on September 7, 2007.

Our board has three committees, the audit committee, the compensation committee and the nominating committee. Alice Cheng, Michael Leung and Joseph Tong are currently the members of our audit, compensation and nominating committees.

In 2007, the audit committee met in person or passed resolutions by unanimous written consent four times. The board of directors has determined that Mr. Joseph Tong is an "audit committee financial expert" as defined by Item 16A of Form 20-F. The board of directors has adopted a written audit committee charter pursuant to which the audit committee is responsible for overseeing the accounting and financial reporting processes of our company, including the appointment, compensation and oversight of the work of our independent auditors, monitoring compliance with our accounting and financial policies and evaluating management's procedures and policies relative to the adequacy of our internal accounting controls.

In 2007, the compensation committee held one meeting. The board of directors has adopted a written compensation committee charter pursuant to which the compensation committee is responsible for, among other things, annually reviewing and approving our company's corporate goals and objectives relevant to the compensation of our chief executive officer, evaluating such officer's performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by our board), determining and approving the chief executive officer's compensation level based on this evaluation. The committee also annually reviews and makes recommendations to the board with respect to non-chief executive officer compensation, incentive-compensation plans and equity based-plans, administers our incentive-compensation plans and equity-based plans as in effect and as adopted from time to time by our board (the board retains, however, the authority to interpret such plans), and approves any new equity compensation plan or any material change to an existing plan where shareholders approval has not been obtained.



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In 2007, the nominating committee held one meeting. The board of directors has adopted a written nominating committee charter pursuant to which the nominating committee is responsible for monitoring the size and composition of our board and considering and making recommendations to our board with respect to the nominations or elections of directors of our company.

The audit, compensation and nominating committees are composed solely of non-employee directors, as such term is defined in Rule 16b-3 under the Exchange Act and the board of directors has determined that all such members are “independent” as that term is defined in Rule 4200(a)(15) of the Marketplace Rules of NASDAQ.

**Compensation Committee Interlocks**

No interlocking relationships have existed between our board of directors or compensation committee and the board of directors or compensation committee of any other company.

**D. Employees**

As of December 31, 2005, 2006 and 2007, we had 1,601, 2,304 and 2,368 full-time employees, respectively.

The following table sets forth information regarding our staff as of December 31, 2007:

|                                       |              |
|---------------------------------------|--------------|
| Accounting department                 | 34           |
| Administration                        | 28           |
| Advertising sales department          | 120          |
| Content                               | 386          |
| Customer service                      | 126          |
| Human resources                       | 17           |
| Internal audit department             | 5            |
| Investor relations                    | 1            |
| Legal                                 | 10           |
| Marketing                             | 18           |
| Network administration department     | 33           |
| Online game department                | 1,208        |
| Product quality control and promotion | 2            |
| Product development                   | 150          |
| Search engine development department  | 89           |
| Technology                            | 60           |
| Wireless department                   | 59           |
| Other                                 | 22           |
| Total                                 | <u>2,368</u> |

In addition, as of December 31, 2007, we had 90 part-time employees.

None of our employees are represented by a labor union.

All employees of our company and of our affiliated companies are employed under employment contracts which specify, among other things, the employee’s responsibilities, remuneration and grounds for termination of employment. Each employee signs a confidentiality agreement in respect of our intellectual property rights.

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The following table sets forth certain information known to us with respect to the beneficial ownership as of March 31, 2008 (unless otherwise indicated) by:

- all persons who are beneficial owners of five percent or more of our ordinary shares,
- each of our directors,
- our Chief Executive Officer, former Chief Financial Officer, Acting Chief Financial Officer and Co-Chief Operating Officers (referred to below as the Named Executive Officers), and
- all current directors and executive officers as a group.

As of March 31, 2008, 3,038,546,815 of our ordinary shares were outstanding. The amounts and percentages of ordinary shares beneficially owned are reported on the basis of regulations of the Securities and Exchange Commission, or the SEC, governing the determination of beneficial ownership of securities. Under the rules of the SEC, a person is deemed to be a “beneficial owner” of a security if that person has or shares “voting power,” which includes the power to vote or to direct the voting of such security, or “investment power,” which includes the power to dispose of or to direct the disposition of such security. A person is also deemed to be a beneficial owner of any securities of which that person has a right to acquire beneficial ownership within 60 days. Under these rules, more than one person may be deemed a beneficial owner of securities as to which such person has no economic interest. The shareholders listed below do not have different voting rights.

| <u>Name</u>   | <u>Number of Shares<br/>Beneficially Owned</u> |                   |
|---|--|-------------------|
|   | <u>Number</u>                                  | <u>Percentage</u> |
| <b>5% Shareholder</b>   |  |                   |
| Shining Globe International Limited/William Lei Ding (1)<br>c/o NetEase.com, Inc., 26/F, SP Tower D, Tsinghua Science<br>Park Building 8, No. 1 Zhongguancun East Road, Haidian<br>District, Beijing, People’s Republic of China 100084 | 1,406,000,000                                  | 46.3%             |
| LMM, LLC (2)<br>100 Light Street, Baltimore, Maryland 21202   | 168,795,000                                    | 5.6%              |
| <b>Executive Officers and Directors (3)</b>   |  |                   |
| Onward Choi (4)   | 687,500  | *                 |
| Michael Tong (5)  | 1,718,750                                      | *                 |
| Zhonghui Zhan (6)   | 6,865,000                                      | *                 |
| Alice Cheng   | —  | —                 |
| Michael Leung   | —  | —                 |
| Lun Feng  | —  | —                 |
| Denny Lee (7)   | 1,250,000                                      | *                 |
| Joseph Tong   | —  | —                 |
| All current directors and executive officers as a group (9 persons) (8)   | 1,416,521,250                                  | 46.6%             |

\* Less than 1%

- (1) Shining Globe International Limited is 100% owned by William Lei Ding, our founder, Chief Executive Officer and a director.
- (2) Represents 168,795,000 ordinary shares held by Legg Mason, Inc., which is affiliated with LMM, LLC. This share information is as of March 31, 2008 and is based upon a report on Form 13F filed by LMM, LLC with the SEC. We have no further information regarding the beneficial ownership of LMM, LLC.
- (3) The address of our current executive officers and directors is c/o NetEase.com, Inc., 26/F, SP Tower D, Tsinghua Science Park Building 8, No. 1 Zhongguancun East Road, Haidian District, Beijing, People’s Republic of China 100084.

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- (4) Includes 375,000 and 312,500 shares subject to stock options exercisable within 60 days of March 31, 2008, which have an exercise price of US\$0.4863 and US\$0.728 per ordinary share, respectively, and an expiration date of May 13, 2010 and March 14, 2012, respectively.
- (5) Includes 1,250,000 shares and 468,750 shares subject to stock options exercisable within 60 days of March 31, 2008, which have an exercise price of US\$0.4863 and US\$0.728 per ordinary share, respectively, and an expiration date of May 13, 2010 and March 14, 2012, respectively.
- (6) Includes 3,000,000, 765,000 and 500,000 shares subject to stock options exercisable within 60 days of March 31, 2008, which have an exercise price of US\$0.3001, US\$0.4863 and US\$0.728 per ordinary share, respectively, and an expiration date of August 16, 2009, May 13, 2010 and March 14, 2012, respectively.
- (7) Includes 1,250,000 shares subject to stock options exercisable within 60 days of March 31, 2008, which have an exercise price of US\$0.4863 per ordinary share, and an expiration date of May 13, 2010.
- (8) Shares owned by all of our current directors and executive officers as a group includes shares beneficially owned by William Lei Ding. This amount also includes 1,416,521,250 shares subject to stock options currently exercisable or exercisable within 60 days of March 31, 2008.

As of March 31, 2008, based on public filings with the SEC, there are no major shareholders holding 5% or more of our ordinary shares or ADSs representing ordinary shares, except as described above.

As of March 31, 2008, none of our ordinary shares were held by U.S. holders of record. On that date, a total of 65,135,558 ADSs were outstanding; and our ADSs were held by 23 U.S. holders of record.

To our knowledge, except as disclosed above, we are not owned or controlled, directly or indirectly, by another corporation, by any foreign government or by any other natural or legal person or persons, severally or jointly.

To our knowledge, there are no arrangements the operation of which may at a subsequent date result in us undergoing a change in control.

Our major shareholders do not have different voting rights than any of our other shareholders.

**Item 7. Major Shareholders and Related Party Transactions****A. Major Shareholders**

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

**B. Related Party Transactions**

Our business was founded in June 1997. In July 1999, we established a new holding company, NetEase.com, Inc., in the Cayman Islands. In September 1999, we restructured our operations in order to comply with increasing regulation of the Internet industry in China. As part of this restructuring, substantially all of Guangzhou NetEase's fixed and intangible assets and existing Internet applications, services and technologies were acquired by NetEase Information Technology (Beijing) Co., Ltd., or NetEase Beijing, a wholly owned subsidiary of NetEase formed in August 1999. Guangzhou NetEase, which is 90% owned by our founder, Chief Executive Officer, director and major shareholder, William Lei Ding, has received approval from the Guangzhou telecommunications administrative authorities to provide Internet content services, and its 80% owned subsidiary, Beijing Guangyitong Advertising Co., Ltd., or Guangyitong Advertising, holds a license to operate an advertising business.

NetEase and NetEase Beijing entered into a series of agreements with Guangzhou NetEase, Guangyitong Advertising and the shareholders of Guangzhou NetEase and Guangyitong Advertising under which we provide our Internet and e-commerce applications, services and technologies and advertising services to Guangzhou NetEase and Guangyitong Advertising, and Guangzhou NetEase and Guangyitong Advertising operate the

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NetEase websites and our online advertising business. We believe that the terms of each agreement are no less favorable than the terms that we could obtain from disinterested third parties and that the shareholders of Guangzhou NetEase and Guangyitong Advertising will not receive material benefits from these agreements except as shareholders of NetEase. These agreements are described below.

- *Domain Name License Agreement between NetEase and Guangzhou NetEase.* NetEase granted Guangzhou NetEase the right to use the domain names “netease.com,” “163.com,” “126.com,” “yeah.net” and “nease.net” on the NetEase websites in China for license fees of RMB10,000 per year. NetEase may waive this fee at any time.
- *Copyright License Agreement between NetEase Beijing and Guangzhou NetEase.* NetEase Beijing granted Guangzhou NetEase the right to use NetEase Beijing’s web page layout in China for a royalty of RMB10,000 per year. NetEase Beijing may waive this fee at any time.
- *Trademark License Agreement between NetEase Beijing and Guangzhou NetEase.* NetEase Beijing granted Guangzhou NetEase a license to use NetEase Beijing’s registered trademarks on the NetEase websites in China for license fees of RMB10,000 per year. NetEase Beijing may waive this fee at any time.
- *Cooperative Agreement between Guangzhou NetEase, Guangzhou Interactive and NetEase Beijing.* Under the Cooperative Agreement, Guangzhou Interactive has agreed to provide the following services:
  - computer software development (including but not limited to online games) and technical support and maintenance for the operation of the computer software;
  - provide technical support for systems related to point card generation and customer service, including but not limited to the development, update and maintenance of those systems; and
  - provide bandwidth.

Under the Cooperative Agreement, NetEase Beijing has also agreed to provide the following services:

- development of Internet communication products and Internet-related application software;
- provide technical service for Internet portal, including but not limited to the server maintenance and the development and update of server application software;
- provide technical service for e-commerce, including but not limited to the development and maintenance of NetEase’s e-commerce platform;
- provide technical support for e-publishing; and
- software development and maintenance related to online advertising.

Furthermore, Guangzhou NetEase has agreed to pay a monthly service fee to Guangzhou Interactive and NetEase Beijing in accordance with a formula based on the expenses incurred by the respective companies. The Cooperative Agreement was effective from January 2006 and will continue to be effective unless any one of the three parties object.

- *Cooperative Agreement between Guangzhou NetEase and Boguan.* Under the Cooperative Agreement, Boguan has agreed to provide the following services:
  - computer software development (including but not limited to online games) and technical support and maintenance for the operation of the computer software; and
  - provide bandwidth.

Guangzhou NetEase has agreed to pay a monthly service fee to Boguan in accordance with a formula based on its expenses incurred. The Cooperative Agreement was effective from January 2006 and will continue to be effective unless any one of the two parties object.

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- *Cooperative Agreement between Guangzhou NetEase and NetEase Hangzhou.* Under the Cooperative Agreement, NetEase Hangzhou has agreed to provide the following services:
  - computer software development (including but not limited to online games) and technical support and maintenance for the operation of the computer software; and
  - provide bandwidth.

Guangzhou NetEase has agreed to pay a monthly service fee to NetEase Hangzhou in accordance with a formula based on its expenses incurred. The Cooperative Agreement was effective from January 2007 and will continue to be effective unless any one of the two parties object.

- *Cooperative Agreement between NetEase Beijing and Guangyitong Advertising.* Under the Cooperative Agreement, NetEase Beijing has agreed to provide the following services:
  - computer software development (including but not limited to the publishing, delivery and management of online advertisement) and technical support and maintenance for the operation of the computer software;
  - software development and maintenance related to online advertising;
  - provide technical service for internet portal, including but not limited to the server maintenance and the development and update of server application software;
  - provide technical service for e-commerce, including but not limited to the development and maintenance of NetEase's e-commerce platform; and
  - provide technical support for e-publishing.

Guangyitong has agreed to pay a monthly service fee to NetEase Beijing in accordance with a formula based on its expenses incurred. The Cooperative Agreement was effective from January 2006 and will continue to be effective unless any one of the two parties object.

- *Cooperative Agreement between Guangzhou Interactive and Guangyitong Advertising.* Under the Cooperative Agreement, Guangzhou Interactive has agreed to provide the following services:
  - computer software development (including but not limited to the publishing, delivery and management of online advertisement) and technical support and maintenance for the operation of the computer software.

Guangyitong has agreed to pay a monthly service fee to Guangzhou Interactive in accordance with a formula based on its expenses incurred. The Cooperative Agreement was effective from January 2006 and will continue to be effective unless any one of the two parties objects.

- *Exclusive Advertising Agency Agreement between NetEase and Guangzhou NetEase.* Guangzhou NetEase appointed NetEase as its advertising agent to solicit advertising customers on behalf of Guangzhou NetEase in markets outside of China. NetEase pays Guangzhou NetEase 10% of the total advertising revenue under this agreement per month.
- *Online Advertising Agreement between Guangzhou NetEase and Guangyitong Advertising.* Guangzhou NetEase sells all of the banner space on the NetEase websites to Guangyitong Advertising and publishes the advertisements provided by Guangyitong Advertising on the banner space purchased by Guangyitong Advertising. Guangyitong Advertising pays Guangzhou NetEase RMB10,000 per year. Guangzhou NetEase may waive this fee at any time.

By supplemental agreements entered into between the relevant parties in August 2005, the respective terms of the foregoing agreements are automatically renewable for successive one year terms, unless NetEase objects to such renewal.

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- *Trademark Transfer Agreement between Guangzhou NetEase and NetEase Beijing.* Guangzhou NetEase has agreed to transfer its registered trademarks to NetEase Beijing.
- *Supplemental Agreement between NetEase Beijing and Guangzhou NetEase.* NetEase Beijing may not grant the license to use its domain name, copyright and trademark to any third party without Guangzhou NetEase's consent and may not provide technical service to any third party.
- *Operating Agreement among NetEase Beijing, Guangyitong and the ultimate shareholders of Guangyitong Advertising.* To ensure the successful performance of the various agreements between the parties, Guangyitong Advertising and its ultimate shareholders have agreed that they will not enter into any transaction, or fail to take any action, that would substantially affect the assets, liabilities, equity or operations of Guangyitong Advertising without the prior written consent of NetEase Beijing.

The parties have agreed that upon NetEase Beijing's determination and at any time when NetEase Beijing is able to obtain approval to invest in and operate all or any part of Guangyitong Advertising, NetEase Beijing may acquire all or any part of the assets or equity interests of Guangyitong Advertising, to the extent permitted by Chinese law. The consideration for such acquisitions will be based on the book value of Guangyitong Advertising at the time of acquisition.

NetEase Beijing has agreed that it will provide performance guarantees and guarantee loans for working capital purposes to the extent required by Guangyitong Advertising for its operations.

The ultimate shareholders of Guangyitong Advertising have agreed that upon instruction from NetEase Beijing, they will appoint or terminate Guangyitong Advertising's board members, General Manager, Chief Financial Officer and other senior officers.

NetEase Beijing has the right to transfer and sell its interests in the Operating Agreement or any other agreements between it and Guangyitong Advertising. The term of this agreement is 20 years from February 3, 2000.

- *Shareholder Voting Rights Trust Agreement among William Lei Ding, Bo Ding and NetEase Beijing.* Bo Ding irrevocably appoints NetEase Beijing to represent him to exercise all the voting rights to which he is entitled as a shareholder of Guangyitong Advertising and William Lei Ding and Bo Ding agree to cause Guangzhou NetEase to irrevocably appoint NetEase Beijing to represent Guangzhou NetEase to exercise all the voting rights to which Guangzhou NetEase is entitled as a shareholder of Guangyitong Advertising. The term of this agreement is ten years from May 12, 2000.
- *Agreement between NetEase Beijing and Guangzhou NetEase.* NetEase Beijing agrees to pay the operating costs of Guangzhou NetEase.
- *Letter of Agreement.* Each of William Lei Ding and Bo Ding have agreed that any amendments to be made to the Exclusive Consulting and Services Agreement, the Shareholder Voting Rights Trust Agreement, and the Operating Agreement described above, as well as all other agreements to which Guangzhou NetEase, Guangyitong Advertising and/or William Lei Ding and Bo Ding are parties, shall be subject to the approval by the vote of a majority of our board, excluding the vote of William Lei Ding. Messrs. Ding have also agreed that, if any amendments to the above mentioned agreements require a vote of the shareholders of NetEase, Guangzhou NetEase or Guangyitong Advertising, as applicable, both of them will vote in their capacity as direct or indirect shareholders of these companies to act based upon the instructions of our board. This letter of agreement was supplemented in May and July 2004 to extend to the agreements with Ling Yi and the agreements with Guangzhou Interactive.

In October 2003, we also established a new VIE, Ling Yi, and entered into a series of agreements with it to provide us with control over such company. Ling Yi was dissolved in August 2007.

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### *Lease of Property in Guangzhou*

We occupy a building in Guangzhou with floor space of approximately 20,000 square meters which is owned by a third party property developer. Title for the property has not yet been granted by the local government authorities, and William Lei Ding, our Chief Executive Officer, director and major shareholder, has agreed to indemnify our company for any losses or expenses we may incur due to the absence of the title. In addition, Mr. Ding has paid a deposit to the property developer and agreed to purchase the property once the title is issued. We and Mr. Ding are currently negotiating with the property developer to return Mr. Ding's deposit and grant us the right to purchase the property once the title is issued. From the date we commenced occupying this property in July 2006 until the present time, the developer has not demanded, and we have not paid, any rent for this property. We can provide no assurance if or when we will obtain title to such property or if we will be subject to future demands for past or current rental payments. In addition, we have incurred expenses for various improvements to the property and installation of equipment in the aggregate amount of approximately RMB60.6 million (US\$8.3 million) as of December 31, 2007. We may lose the value of these investments if we are unable to obtain title to the building. Moreover, although we are not currently being required to pay rent for this property, we have recorded an imputed rental expense on our financial statements which was calculated based on the estimated rental value of the property and totaled RMB9.4 million (US\$1.3 million) in 2007. See Item 5.A. "Operating and Financial Review and Prospects—Operating Results—Operating Expenses—General and Administrative Expenses."

### **C. Interests of Experts and Counsel**

Not applicable.

## **Item 8. Financial Information**

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

See Item 18. "Financial Statements" for our audited consolidated financial statements filed as part of this annual report.

### **A.7 Legal Proceedings**

There are no material legal proceedings pending or, to our knowledge, threatened against us. From time to time we become subject to legal proceedings and claims in the ordinary course of our business, including claims of alleged infringement of trademarks, copyrights and other intellectual property rights, and a variety of claims arising in connection with our email, message boards and other communications and community features, such as claims alleging defamation or invasion of privacy. However, such legal proceedings or claims, even if not meritorious, could result in the expenditure of significant financial and management resources.

### **A.8 Dividend Policy**

We have never declared or paid any cash dividends on our ordinary shares, but it is possible that we may declare dividends in the future. We have historically retained earnings to finance operations and the expansion of our business. Any future determination to pay cash dividends will be at the discretion of the board of directors and will be dependent upon our financial condition, operating results, capital requirements and such other factors as the board of directors deems relevant.

### **B. Significant Changes**

We have not experienced any significant changes since the date of our audited consolidated financial statements included in this annual report.



**Table of Contents****Item 9. The Offer and Listing**

Not applicable except for Item 9.A.4. and Item 9.C.

Our ADSs have been listed on the NASDAQ Global Select Market (formerly the NASDAQ National Market) since June 30, 2000. Information relating to our ADSs has been restated to give effect to the ADS ratio change from one ADS for every 100 ordinary shares to one ADS for every 25 ordinary shares effective March 27, 2006. The ADS ratio change had the effect of a four-for-one share split. Our ADSs trade under the symbol "NTES."

The following table provides the high and low prices for our ADSs on the NASDAQ Global Select Market for (1) each of the most recent five financial years, (2) each quarter in the two most recent financial years and the most recent quarter and (3) each of the most recent six months.

|                          | Sales Price |         |
|--------------------------|-------------|---------|
|                          | High        | Low     |
| Annual highs and lows    |             |         |
| 2003                     | \$18.00     | \$ 2.53 |
| 2004                     | \$14.62     | \$ 7.04 |
| 2005                     | \$24.00     | \$ 9.39 |
| 2006                     | \$25.25     | \$14.07 |
| 2007                     | \$24.00     | \$13.45 |
| Quarterly highs and lows |             |         |
| First Quarter 2006       | \$24.44     | \$14.07 |
| Second Quarter 2006      | \$25.25     | \$19.41 |
| Third Quarter 2006       | \$23.10     | \$15.32 |
| Fourth Quarter 2006      | \$18.95     | \$15.05 |
| First Quarter 2007       | \$21.86     | \$17.51 |
| Second Quarter 2007      | \$19.54     | \$16.52 |
| Third Quarter 2007       | \$19.35     | \$13.45 |
| Fourth Quarter 2007      | \$24.00     | \$16.49 |
| First Quarter 2008       | \$21.84     | \$16.23 |
| Monthly highs and lows   |             |         |
| December 2007            | \$21.18     | \$18.66 |
| January 2008             | \$19.63     | \$16.98 |
| February 2008            | \$21.72     | \$16.73 |
| March 2008               | \$21.84     | \$16.23 |
| April 2008               | \$22.79     | \$18.97 |
| May 2008                 | \$25.70     | \$22.02 |

**Item 10. Additional Information****A. Share Capital**

Not applicable.

**B. Memorandum and Articles of Association**

The following presents a description of the terms and provisions of our restated memorandum and articles of association.

*General*

We were incorporated in the Cayman Islands on July 6, 1999 and operate under the Cayman Islands Companies Law (2004 Revision), as revised and amended from time to time, or the Companies Law. Our corporate objectives and purpose are unrestricted.

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### *Directors*

A director may vote in respect of any contract or transaction in which he is interested provided however that the nature of the interest of any director in any such contract or transaction shall be disclosed by him at or prior to its consideration and any vote on that matter. A general notice or disclosure to the directors or otherwise contained in the minutes of a meeting or a written resolution of the directors or any committee thereof that a director is a shareholder of any specified firm or company and is to be regarded as interested in any transaction with such firm or company shall be sufficient disclosure and after such general notice it shall not be necessary to give special notice relating to any particular transaction.

The directors may determine remuneration to be paid to the directors. The directors may exercise all the powers of our company to borrow money and to mortgage or charge its undertaking, property and uncalled capital or any part thereof, to issue debentures, debenture stock and other securities whenever money is borrowed or as security for any of our debts, liabilities, or obligations or those of any third party.

There are no membership qualifications for directors. Further, there are no age limitations or retirement requirements and no share ownership qualifications for directors unless so fixed by shareholders in a general meeting.

### *Rights, Preferences and Restrictions of Ordinary Shares*

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

*Dividends.* The holders of ordinary shares are entitled to such dividends as may be declared by our board of directors.

*Voting Rights.* Each ordinary share is entitled to one vote on all matters upon which the ordinary shares are entitled to vote, including the election of directors. Voting at any meeting of shareholders is by show of hands unless a poll is demanded. A poll may be demanded by the Chairman or any other shareholder present in person or by proxy. A quorum required for a meeting of shareholders consists of at least two shareholders present or by proxy.

Any ordinary resolution to be made by the shareholders requires the affirmative vote of a simple majority of the votes attaching to the ordinary shares cast in a general meeting, while a special resolution requires the affirmative vote of no less than two-thirds of the votes cast attaching to the ordinary shares. A special resolution is required for matters such as a change of name. Holders of the ordinary shares may by ordinary resolution, among other things, elect directors, appoint auditors, and make changes in the amount of our authorized share capital.

*Liquidation.* On a return of capital on winding up or otherwise (other than on conversion, redemption or purchase of shares) assets available for distribution among the holders of ordinary shares shall be distributed among the holders of the ordinary shares pro rata. If the assets available for distribution are insufficient to repay all of the paid-up capital, the assets will be distributed so that the losses are borne by our shareholders proportionately.

*Calls on Shares and Forfeiture of Shares.* Our board of directors may from time to time make calls upon shareholders for any amounts unpaid on their shares in a notice served to such shareholders at least 14 days prior to the specified time and place of payment. The shares that have been called upon and remain unpaid are subject to forfeiture.

*Redemption of Shares.* We may issue shares on the terms that they are, or at our option or at the option of the holders are, subject to redemption on such terms and in such manner as we may determine by special resolution.

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### *Variations of Rights of Shares*

All or any of the special rights attached to any class of shares may, subject to the provisions of the Companies Law, be varied either with the consent in writing of the holders of three-fourths of the issued shares of that class or with the sanction of a special resolution passed at a general meeting of the holders of the shares of that class.

### *General Meetings of Shareholders*

The directors may whenever they think fit, and they shall on the requisition of our shareholders holding at the date of the deposit of the requisition not less than one-tenth of our paid-up capital as at the date of the deposit carries the right of voting at general meetings of the Company, proceed to convene a general meeting of the Company. If the directors do not within 21 days from the date of the deposit of the requisition duly proceed to convene a general meeting, the requisitionists, or any of them representing more than one-half of the total voting rights of all of them, may themselves convene a general meeting, but any meeting so convened shall not be held after the expiration of three months after the expiration of such 21 days. Advanced notice of at least five days is required for the convening of the annual general meeting and other shareholders meetings.

### *Limitations on the Right to Own Shares*

There are no limitations on the right to own our shares.

### *Limitations on Transfer of Shares*

There are no provisions in our restated memorandum or articles of association that would have an effect of delaying, deferring or preventing a change in control and that would operate only with respect to a merger, acquisition or corporate restructuring.

### *Disclosure of Shareholder Ownership*

There are no provisions in our restated memorandum or articles of association governing the ownership threshold above which shareholder ownership must be disclosed.

### *Changes in Capital*

We may from time to time by ordinary resolution increase the share capital by such sum, to be divided into shares of such amount, as the resolution shall prescribe. The new shares shall be subject to the same provisions with reference to the payment of calls, lien, transfer, transmission, forfeiture and otherwise as the shares in the original share capital. We may by ordinary resolution:

- (a) consolidate and divide all or any of our share capital into shares of larger amount than our existing shares;
- (b) sub-divide our existing shares, or any of them into shares of smaller amount than is fixed by our restated memorandum of association, subject nevertheless to the provisions of Section 12 of the Companies Law; and
- (c) cancel any shares which, at the date of the passing of the resolution, have not been taken or agreed to be taken by any person.

We may by special resolution reduce our share capital and any capital redemption reserve fund in any manner authorized by law.

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### *Differences in Corporate Law*

The Companies Law is modeled after that of the United Kingdom but does not follow recent United Kingdom statutory enactments and differs from laws applicable to United States corporations and their shareholders. Set forth below is a summary of the significant differences between the provisions of the Companies Law applicable to NetEase.com and the laws applicable to companies incorporated in the United States and their shareholders.

*Mergers and Similar Arrangements.* Cayman Islands law does not provide for mergers as that expression is understood under United States corporate law. However, there are statutory provisions that facilitate the reconstruction and amalgamation of companies, provided that the arrangement in question is approved by a majority in number of each class of shareholders and creditors with whom the arrangement is to be made, and who must in addition represent three-fourths in value of each such class of shareholders or creditors, as the case may be, that are present and voting either in person or by proxy at a meeting, or meetings convened for that purpose. The convening of the meetings and subsequently the arrangement must be sanctioned by the Grand Court of the Cayman Islands. While a dissenting shareholder would have the right to express to the court the view that the transaction ought not to be approved, the court can be expected to approve the arrangement if it satisfies itself that:

- the statutory provisions as to majority vote have been complied with;
- the shareholders have been fairly represented at the meeting in question;
- the arrangement is such as a businessman would reasonably approve; and
- the arrangement is not one that would more properly be sanctioned under some other provision of the Companies Law.

When a take-over offer is made and accepted by holders of 90% of the shares within four months, the offeror may, within a two month period, require the holders of the remaining shares to transfer such shares on the terms of the offer. An objection can be made to the Grand Court of the Cayman Islands but this is unlikely to succeed unless there is evidence of fraud, bad faith or collusion.

If the arrangement and reconstruction is thus approved, the dissenting shareholder would have no rights comparable to appraisal rights, which would otherwise ordinarily be available to dissenting shareholders of United States corporations, providing rights to receive payment in cash for the judicially determined value of the shares.

*Shareholders' Suits.* Our Cayman Islands counsel is not aware of any reported class action or derivative action having been brought in a Cayman Islands court. In principle, we will normally be the proper plaintiff and a derivative action may not be brought by a minority shareholder. However, based on English authorities, which would in all likelihood be of persuasive authority in the Cayman Islands, exceptions to the foregoing principle apply in circumstances in which:

- a company is acting or proposing to act illegally or ultra vires;
- the act complained of, although not ultra vires, could be effected only if authorized by more than a simple majority vote;
- the individual rights of the plaintiff shareholder have been infringed or are about to be infringed; or
- those who control the company are perpetrating a "fraud on the minority."

*Indemnification.* Cayman Islands law does not (other than as set forth hereafter) limit the extent to which a company's organizational documents may provide for indemnification of officers and directors, except to the extent any such provision may be held by the Cayman Islands courts to be contrary to public policy, such as to provide indemnification against civil fraud or the consequences of committing a crime. Our Articles of Association provide for indemnification of officers and directors for losses, damages, costs and expenses incurred in their capacities as such, except through their own willful neglect or default.

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Insofar as indemnification or liability arising under the Securities Act of 1933 may be permitted to directors, officers or persons controlling the registrant pursuant to the foregoing provisions, we have been informed that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Securities Act of 1933 and is therefore unenforceable.

### **C. Material Contracts**

We have not entered into any material contracts other than in the ordinary course of business and other than those described in Item 4. "Information on the Company" or elsewhere in this annual report.

### **D. Exchange Controls**

China's government imposes control over the convertibility of Renminbi into foreign currencies. Under the current unified floating exchange rate system, the People's Bank of China publishes a daily exchange rate for Renminbi, or the PBOC Exchange Rate, based on the previous day's dealings in the inter-bank foreign exchange market. Financial institutions authorized to deal in foreign currency may enter into foreign exchange transactions at exchange rates within an authorized range above or below the PBOC Exchange Rate according to market conditions.

Pursuant to the Foreign Exchange Control Regulations issued by the State Council on January 29, 1996 and effective as of April 1, 1996 (and amended on January 14, 1997) and the Administration of Settlement, Sale and Payment of Foreign Exchange Regulations which came into effect on July 1, 1996 regarding foreign exchange control, or the Regulations, conversion of Renminbi into foreign exchange by foreign investment enterprises for current account items, including the distribution of dividends and profits to foreign investors of joint ventures, is permissible. Foreign investment enterprises are permitted to remit foreign exchange from their foreign exchange bank account in China on the basis of, inter alia, the terms of the relevant joint venture contracts and the board resolutions declaring the distribution of the dividend and payment of profits. Conversion of Renminbi into foreign currencies and remittance of foreign currencies for capital account items, including direct investment, loans and security investment, is still subject to the approval of the State Administration of Foreign Exchange, or SAFE, in each such transaction. On January 14, 1997, the State Council amended the Foreign Exchange Control Regulations to provide, among other things, that the State shall not impose restrictions on recurring international payments and transfers.

Under the Regulations, foreign investment enterprises are required to open and maintain separate foreign exchange accounts for capital account items (but not for other items). In addition, foreign investment enterprises may only buy, sell and/or remit foreign currencies at those banks authorized to conduct foreign exchange business upon the production of valid commercial documents and, in the case of capital account item transactions, document approval from SAFE.

Currently, foreign investment enterprises are required to apply to SAFE for "foreign exchange registration certificates for foreign investment enterprises." With such foreign exchange registration certificates (which are granted to foreign investment enterprises upon fulfilling specified conditions and which are subject to review and renewal by SAFE on an annual basis) or with the foreign exchange sales notices from the SAFE (which are obtained on a transaction-by-transaction basis), foreign-invested enterprises may enter into foreign exchange transactions at banks authorized to conduct foreign exchange business to obtain foreign exchange for their needs.

In addition, pursuant to regulations recently promulgated by SAFE, PRC subsidiaries of offshore parent companies may be prohibited from making distributions of profits to such offshore parent companies and from paying the offshore parent companies proceeds from any reduction in capital, share transfer or liquidation in respect of such PRC subsidiaries, if PRC shareholders with a direct or indirect stake in the offshore parent company fail to make the required SAFE registrations.

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These regulations require PRC residents to file with the competent SAFE offices information about offshore companies in which they have directly or indirectly invested (including with respect to investments already made as of the inception of the new regulation) and to make follow-up filings in connection with certain material transaction involving such offshore companies, such as mergers or acquisitions, capital increases or decreases, and external equity investments or equity transfers. For additional information on the new SAFE regulations and the related risks to our company, see Item 3.D. “Risk Factors—Risks Related to Doing Business in China—The Chinese government has strengthened the regulation of investments made by Chinese residents in offshore companies and reinvestments in China made by these offshore companies. Our business may be adversely affected by these new restrictions.”

### **E. Taxation**

The following summary of the material Cayman Islands and United States federal income tax consequences relevant to the purchase, ownership or sale of our ADSs is based upon laws and relevant interpretations thereof in effect as of the date of this annual report, all of which are subject to change. To the extent that the discussion relates to matters of Cayman Islands tax law, it represents the opinion of Maples and Calder, special Cayman Islands counsel to us. To the extent the discussion relates to matters of United States law or legal conclusions and subject to the qualifications herein, it represents the opinion of Morrison & Foerster LLP, our special U.S. counsel.

#### **Cayman Islands Taxation**

The Cayman Islands currently levies no taxes on individuals or corporations based upon profits, income, gains or appreciation and there is no taxation in the nature of inheritance tax or estate duty. There are no other taxes likely to be material to us levied by the Government of the Cayman Islands except for stamp duties which may be applicable on instruments executed in, or after execution brought within the jurisdiction of the Cayman Islands. The Cayman Islands is not party to any double tax treaties. There are no exchange control regulations or currency restrictions in the Cayman Islands.

#### **United States Federal Income Taxation**

The following is a summary of the material U.S. federal income tax consequences of the ownership and disposition of ordinary shares or ADSs. The following discussion is not exhaustive of all possible tax considerations. This summary is based upon the Internal Revenue Code of 1986, as amended, or the Code, regulations promulgated under the Code by the U.S. Treasury Department (including proposed and temporary regulations), rulings, current administrative interpretations and official pronouncements of the Internal Revenue Service, or the IRS, and judicial decisions, all as currently in effect and all of which are subject to differing interpretations or to change, possibly with retroactive effect. Such change could materially and adversely affect the tax consequences described below. No assurance can be given that the IRS will not assert, or that a court will not sustain, a position contrary to any of the tax consequences described below.

This discussion does not address state, local, or foreign tax consequences of the ownership and disposition of ordinary shares or ADSs. See “—Cayman Islands Taxation” above. The United States does not have an income tax treaty with the Cayman Islands.

This summary is for general information only and does not address all aspects of the U.S. federal income taxation that may be important to a particular holder in light of its investment or tax circumstances or to holders subject to special tax rules, such as: banks; financial institutions; insurance companies; dealers in stocks, securities, or currencies; traders in securities that elect to use a mark-to-market method of accounting for their securities holdings; tax-exempt organizations; real estate investment trusts; regulated investment companies; qualified retirement plans, individual retirement accounts, and other tax-deferred accounts; expatriates of the United States; persons subject to the alternative minimum tax; persons holding ordinary shares or ADSs as part

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of a straddle, hedge, conversion transaction, or other integrated transaction; persons who acquired ordinary shares or ADSs pursuant to the exercise of any employee stock option or otherwise as compensation for services; persons actually or constructively holding 10% or more of our voting stock; and U.S. Holders (as defined below) whose functional currency is other than the U.S. dollar.

This discussion is not a comprehensive description of all of the U.S. federal tax consequences that may be relevant with respect to the ownership and disposition of ordinary shares or ADSs. We urge you to consult your own tax advisor regarding your particular circumstances and the U.S. federal income and estate tax consequences to you of owning and disposing of ordinary shares or ADSs, as well as any tax consequences arising under the laws of any state, local, or foreign or other tax jurisdiction and the possible effects of changes in U.S. federal or other tax laws.

This summary is directed solely to persons who hold their ordinary shares or ADSs as capital assets within the meaning of Section 1221 of the Code, which generally means as property held for investment. For purposes of this discussion, the term “U.S. Holder” means a beneficial owner of ordinary shares or ADSs that is any of the following:

- a citizen or resident of the United States or someone treated as a U.S. citizen or resident for U.S. federal income tax purposes;
- a corporation (or other entity taxable as a corporation for U.S. federal income tax purposes) created or organized in or under the laws of the United States, any state thereof, or the District of Columbia;
- an estate, the income of which is subject to U.S. federal income taxation regardless of its source;
- a trust if a U.S. court can exercise primary supervision over the trust’s administration and one or more U.S. persons have the authority to control all substantial decisions of the trust; or
- a trust in existence on August 20, 1996 that has a valid election in effect under applicable Treasury Regulations to be treated as a U.S. person.

The term “Non-U.S. Holder” means a beneficial owner of ordinary shares or ADSs that is not a U.S. Holder. As described in “Taxation of Non-U.S. Holders” below, the tax consequences to a Non-U.S. Holder may differ substantially from the tax consequences to a U.S. Holder.

If a partnership (including for this purpose any entity treated as a partnership for U.S. federal income tax purposes) is a beneficial owner of ordinary shares or ADSs, the U.S. federal income tax consequences to a partner in the partnership will generally depend on the status of the partner and the activities of the partnership. A holder of ordinary shares or ADSs that is a partnership and the partners in such partnership should consult their own tax advisors regarding the U.S. federal income tax consequences of the ownership and disposition of ordinary shares or ADSs.

**ADSs**

As relates to the ADSs, this discussion is based in part upon the representations of the depositary and the assumption that each obligation in the deposit agreement and any related agreement will be performed in accordance to its terms.

Generally, a holder of ADSs will be treated as the owner of the underlying ordinary shares represented by those ADSs for U.S. federal income tax purposes. Accordingly, no gain or loss will be recognized if the holder exchanges ADSs for the underlying ordinary shares represented by those ADSs. The holder’s adjusted tax basis in the ordinary shares will be the same as the adjusted tax basis of the ADSs surrendered in exchange therefor, and the holding period for the ordinary shares will include the holding period for the surrendered ADSs.



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**Table of Contents****TAXATION OF U.S. HOLDERS**

The discussion in “—Distributions on Ordinary Shares or ADSs” and “—Dispositions of Ordinary Shares or ADSs” below assumes that we will not be treated as a passive foreign investment company or PFIC, for U.S. federal income tax purposes. For a discussion of the rules that apply if we are treated as a PFIC, see the discussion in “Passive Foreign Investment Company” below.

**Distributions on Ordinary Shares or ADSs**

*General.* Subject to the discussion in “Passive Foreign Investment Company” below, if you actually or constructively receive a distribution on ordinary shares or ADSs, you must include the distribution in gross income as a taxable dividend on the date of your (or in the case of ADSs, the depository’s) receipt of the distribution, but only to the extent of our current or accumulated earnings and profits, as calculated under U.S. federal income tax principles. Such amount must be included without reduction for any foreign tax withheld. Dividends paid by us generally will not be eligible for the dividends received deduction allowed to corporations with respect to dividends received from certain domestic corporations. Dividends paid by us may or may not be eligible for preferential rates applicable to qualified dividend income, as described below.

To the extent a distribution exceeds our current and accumulated earnings and profits, it will be treated first as a non-taxable return of capital to the extent of your adjusted tax basis in the ordinary shares or ADSs, and thereafter as capital gain. Preferential tax rates for long-term capital gain may be applicable to non-corporate U.S. Holders.

We do not intend to calculate our earnings and profits under U.S. federal income tax principles. Therefore, you should expect that a distribution will generally be reported as a dividend even if that distribution would otherwise be treated as a non-taxable return of capital or as capital gain under the rules described above.

*Qualified Dividend Income.* With respect to non-corporate U.S. Holders (i.e., individuals, trusts, and estates), for taxable years beginning before January 1, 2011, dividends that are treated as qualified dividend income or QDI, are taxable at a maximum tax rate of 15%. Among other requirements, dividends generally will be treated as QDI if either (i) our ordinary shares or ADSs are readily tradable on an established securities market in the United States, or (ii) we are eligible for the benefits of a comprehensive income tax treaty with the United States which includes an information exchange program and which is determined to be satisfactory by the U.S. Treasury. It is expected that our ADSs will be “readily tradable” as a result of being listed on the Nasdaq Global Select Market. However, if you exchange your ADSs for underlying ordinary shares, dividends received by you will not be treated as QDI because the ordinary shares are not readily tradable on an established securities market in the United States.

In addition, for dividends to be treated as QDI, we must not be a PFIC (as discussed below) for either the taxable year in which the dividend was paid or the preceding taxable year. We do not believe that we will be a PFIC for our current taxable year. However, please see the discussion under “—Passive Foreign Investment Company” below. Additionally, in order to qualify for QDI treatment, you generally must have held the ordinary shares or ADSs for more than 60 days during the 121-day period beginning 60 days prior to the ex-dividend date. However, your holding period will be reduced for any period during which the risk of loss is diminished.

Moreover, a dividend will not be treated as QDI to the extent you are under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property. Since the QDI rules are complex, you should consult your own tax advisor regarding the availability of the preferential tax rates for dividends paid on ordinary shares or ADSs.

*Foreign Currency Distributions.* A dividend paid in foreign currency (e.g., Renminbi) must be included in your income as a U.S. dollar amount based on the exchange rate in effect on the date such dividend is received, regardless of whether the payment is in fact converted to U.S. dollars. If the dividend is converted to U.S. dollars

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on the date of receipt, you generally will not recognize a foreign currency gain or loss. However, if you convert the foreign currency to U.S. dollars on a later date, you must include in income any gain or loss resulting from any exchange rate fluctuations. The gain or loss will be equal to the difference between (i) the U.S. dollar value of the amount you included in income when the dividend was received and (ii) the amount that you receive on the conversion of the foreign currency to U.S. dollars. Such gain or loss will generally be ordinary income or loss and U.S. source for U.S. foreign tax credit purposes.

***In-Kind Distributions.*** Distributions to you of new ordinary shares or ADSs or rights to subscribe for new ordinary shares or ADSs that are received as part of a pro rata distribution to all of our shareholders will not be subject to U.S. federal income tax. The adjusted tax basis of the new ordinary shares or ADSs or rights so received will be determined by allocating your adjusted tax basis in the old ordinary shares or ADSs between the old ordinary shares or ADSs and the new ordinary shares or ADSs or rights received, based on their relative fair market values on the date of distribution. However, in the case of a distribution of rights to subscribe for ordinary shares or ADSs, the adjusted tax basis of the rights will be zero if the fair market value of the rights is less than 15% of the fair market value of the old ordinary shares or ADSs on the date of distribution and you do not make an election to determine the adjusted tax basis of the rights by allocation as described above. Your holding period for the new ordinary shares or ADSs or rights will generally include the holding period for the old ordinary shares or ADSs on which the distribution was made.

***Foreign Tax Credits.*** Subject to certain conditions and limitations, any foreign taxes paid on or withheld from distributions from us and not refundable to you may be credited against your U.S. federal income tax liability or, alternatively, may be deducted from your taxable income. This election is made on a year-by-year basis and applies to all foreign taxes paid by you or withheld from you that year.

Distributions will constitute foreign source income for foreign tax credit limitation purposes. The foreign tax credit limitation is calculated separately with respect to two specific classes of income. For this purpose, distributions characterized as dividends distributed by us will generally constitute "passive category income" or, in the case of certain U.S. Holders, "general category income." Special limitations may apply if a dividend is treated as QDI (as defined above).

Special rules may apply to electing individuals whose foreign source income during the taxable year consists entirely of "qualified passive income" and whose creditable foreign taxes paid or accrued during the taxable year do not exceed US\$300 (US\$600 in the case of a joint return).

In certain circumstances, a U.S. Holder that (i) has held ordinary shares or ADSs for less than a specified minimum period during which it is not protected from risk of loss, (ii) is obligated to make payments related to the dividends, or (iii) holds ordinary shares or ADSs in arrangements in which the U.S. Holder's expected economic profit, after foreign taxes, is insubstantial, will not be allowed a foreign tax credit for foreign taxes imposed on dividends paid on ordinary shares or ADSs.

Since the rules governing foreign tax credits are complex, you should consult your own tax advisor regarding the availability of foreign tax credits in your particular circumstances.

The U.S. Treasury has expressed concerns that parties to whom ADSs are pre-released may be taking actions that are inconsistent with the claiming of foreign tax credits by U.S. Holders of ADSs. Such actions would also be inconsistent with the claiming of the preferential tax rates applicable to QDI, as defined above. Accordingly, the creditability of foreign taxes and the availability of such preferential tax rates could be affected by future actions that may be taken by the U.S. Treasury or parties to whom ADSs are pre-released.

### **Dispositions of Ordinary Shares or ADSs**

Subject to the discussion in "—Passive Foreign Investment Company" below, you generally will recognize taxable gain or loss realized on the sale or other taxable disposition of ordinary shares or ADSs equal to the

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difference between the U.S. dollar value of (i) the amount realized on the disposition (i.e., the amount of cash plus the fair market value of any property received), and (ii) your adjusted tax basis in the ordinary shares or ADSs. Such gain or loss will be capital gain or loss.

If you have held the ordinary shares or ADSs for more than one year at the time of disposition, such capital gain or loss will be long-term capital gain or loss. Preferential tax rates for long-term capital gain (currently, with a maximum rate of 15% for taxable years beginning before January 1, 2011) will apply to non-corporate U.S. Holders. If you have held the ordinary shares or ADSs for one year or less, such capital gain or loss will be short-term capital gain or loss taxable as ordinary income at your marginal income tax rate. The deductibility of capital losses is subject to limitations.

Generally, any gain or loss recognized will not give rise to foreign source income for U.S. foreign tax credit purposes.

You should consult your own tax advisor regarding the U.S. federal income tax consequences if you receive currency other than U.S. dollars upon the disposition of ordinary shares or ADSs.

**Passive Foreign Investment Company**

We generally will be a PFIC under Section 1297 of the Code if, for a taxable year, either (a) 75% or more of our gross income for such taxable year is passive income or the income test, or (b) 50% or more of the average percentage, generally determined by fair market value, of our assets during such taxable year either produce passive income or are held for the production of passive income (the “asset test”). “Passive income” includes, for example, dividends, interest, certain rents and royalties, certain gains from the sale of stock and securities, and certain gains from commodities transactions.

Certain “look through” rules apply for purposes of the income and asset tests described above. If we own, directly or indirectly, 25% or more of the total value of the outstanding shares of another corporation, we will be treated as if we (a) held directly a proportionate share of the other corporation’s assets, and (b) received directly a proportionate share of the other corporation’s income. In addition, passive income does not include any interest, dividends, rents, or royalties that are received or accrued by us from a “related person” (as defined in Section 954(d)(3) of the Code), to the extent such items are properly allocable to income of such related person that is not passive income.

Under the income and asset tests, whether or not we are a PFIC will be determined annually based upon the composition of our income and the composition and valuation of our assets, all of which are subject to change. In addition, our determination is based on a current valuation of our assets, including goodwill. In calculating goodwill, we have valued our total assets based on our market capitalization, determined using the market price of our ordinary shares and ADSs. Such market price may fluctuate. If our market capitalization is less than anticipated or subsequently declines, this will decrease the value of our goodwill and we may become a PFIC. Furthermore, we have made a number of assumptions regarding the amount of value allocable to goodwill. We believe our valuation approach is reasonable. However, it is possible that the IRS will challenge the valuation of our goodwill, which may result in our being a PFIC.

We do not believe that we are currently a PFIC. However, because the PFIC determination is highly fact intensive and made at the end of each taxable year, there can be no assurance that we will not be a PFIC for the current or any future taxable year or that the IRS will not challenge our determination concerning our PFIC status.

*Default PFIC Rules under Section 1291 of the Code.* If we are a PFIC, the U.S. federal income tax consequences to a U.S. Holder of the ownership and disposition of ordinary shares or ADSs will depend on whether such U.S. Holder makes an election to treat us as a qualified electing fund, or QEF, under Section 1295

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of the Code, or QEF Election, or a mark-to-market election under Section 1296 of the Code, or Mark-to-Market Election. A U.S. Holder owning ordinary shares or ADSs while we were or are a PFIC that has not made either a QEF Election or a Mark-to-Market Election will be referred to in this summary as a “Non-Electing U.S. Holder.”

If you are a Non-Electing U.S. Holder, you will be subject to the default tax rules of Section 1291 of the Code with respect to:

- any “excess distribution” paid on ordinary shares or ADSs, which means the excess (if any) of the total distributions received by you during the current taxable year over 125% of the average distributions received by you during the three preceding taxable years (or during the portion of your holding period for the ordinary shares or ADSs prior to the current taxable year, if shorter); and
- any gain recognized on the sale or other taxable disposition (including a pledge) of ordinary shares or ADSs.

Under these default tax rules:

- any excess distribution or gain will be allocated ratably over your holding period for the ordinary shares or ADSs;
- the amount allocated to the current taxable year and any period prior to the first day of the first taxable year in which we were a PFIC will be treated as ordinary income in the current taxable year;
- the amount allocated to each of the other years will be treated as ordinary income and taxed at the highest applicable tax rate in effect for that year; and
- the resulting tax liability from any such prior years will be subject to the interest charge applicable to underpayments of tax.

In addition, notwithstanding any election you may make, dividends that you receive from us will not be eligible for the preferential tax rates applicable to QDI (as discussed above in “Distributions on Ordinary Shares or ADSs”) if we are a PFIC either in the taxable year of the distribution or the preceding taxable year, but will instead be taxable at rates applicable to ordinary income.

Special rules for Non-Electing U.S. Holders will apply to determine U.S. foreign tax credits with respect to foreign taxes imposed on distributions on ordinary shares or ADSs.

If we are a PFIC for any taxable year during which you hold ordinary shares or ADSs, we will continue to be treated as a PFIC with respect to you for all succeeding years during which you hold ordinary shares or ADSs, regardless of whether we actually continue to be a PFIC. You may terminate this deemed PFIC status by electing to recognize gain (which will be taxed under the default tax rules of Section 1291 of the Code discussed above) as if your ordinary shares or ADSs had been sold on the last day of the last taxable year for which we were a PFIC.

If we are a PFIC in any year with respect to you, you will be required to file an annual return on IRS Form 8621 regarding distributions received on ordinary shares or ADSs and any gain realized on the disposition of ordinary shares or ADSs.

*QEF Election.* If you make a QEF Election, you generally will not be subject to the default rules of Section 1291 of the Code discussed above. Instead, you will be subject to current U.S. federal income tax on your pro rata share of our ordinary earnings and net capital gain, regardless of whether such amounts are actually distributed to you by us. However, you can make a QEF Election only if we agree to furnish you annually with certain tax information, and we currently do not intend to prepare or provide such information.

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*Mark-to-Market Election.* U.S. Holders may make a Mark-to-Market Election, but only if our ordinary shares or ADSs are marketable stock. Our ordinary shares are not currently listed on any exchange, but our ADSs will be “marketable stock” as long as they remain listed on the Nasdaq Global Select Market and are regularly traded. Stock is “regularly traded” for any calendar year during which it is traded (other than in de minimis quantities) on at least 15 days during each calendar quarter. There can be no assurances, however, that our ADSs will be treated, or continue to be treated, as regularly traded.

If you make a Mark-to-Market Election, you generally will not be subject to the default rules of Section 1291 of the Code discussed above. Rather, you generally will be required to recognize ordinary income for any increase in the fair market value of the ADSs for each taxable year that we are a PFIC. You will also be allowed to deduct as an ordinary loss any decrease in the fair market value to the extent of net marked-to-market gain previously included in prior years. Your adjusted tax basis in the ADSs will be adjusted to reflect the amount included or deducted.

The Mark-to-Market Election will be effective for the taxable year for which the election is made and all subsequent taxable years, unless our ADSs cease to be marketable stock or the IRS consents to the revocation of the election. You should consult your own tax advisor regarding the availability of, and procedure for making, a Mark-to-Market Election.

Since the PFIC rules are complex, you should consult your own tax advisor regarding them and how they may affect the U.S. federal income tax consequences of the ownership and disposition of ordinary shares or ADSs.

### **Information Reporting and Backup Withholding**

Generally, information reporting requirements will apply to distributions on ordinary shares or ADSs or proceeds from the disposition of ordinary shares or ADSs paid within the United States (and, in certain cases, outside the United States) to a U.S. Holder unless such U.S. Holder is an exempt recipient, such as a corporation. Furthermore, backup withholding (currently at 28%) may apply to such amounts unless such U.S. Holder (i) is an exempt recipient that, if required, establishes its right to an exemption, or (ii) provides its taxpayer identification number, certifies that it is not currently subject to backup withholding, and complies with other applicable requirements. A U.S. Holder may generally avoid backup withholding by furnishing a properly completed IRS Form W-9.

Backup withholding is not an additional tax. Rather, amounts withheld under the backup withholding rules may be credited against your U.S. federal income tax liability. Furthermore, you may obtain a refund of any excess amounts withheld by filing an appropriate claim for refund with the IRS and furnishing any required information in a timely manner.

### **TAXATION OF NON-U.S. HOLDERS**

#### **Distributions on Ordinary Shares or ADSs**

Subject to the discussion in “Information Reporting and Backup Withholding” below, as a Non-U.S. Holder, you generally will not be subject to U.S. federal income tax, including withholding tax, on distributions received on ordinary shares or ADSs, unless the distributions are effectively connected with your conduct of a trade or business in the United States and (if an applicable income tax treaty so requires) attributable to a permanent establishment that you maintain in the United States.

If distributions are effectively connected with a U.S. trade or business and (if applicable) attributable to a U.S. permanent establishment, you generally will be subject to tax on such distributions in the same manner as a U.S. Holder, as described in “Taxation of U.S. Holders—Distributions on ordinary shares or ADSs” above. In addition, any such distributions received by a corporate Non-U.S. Holder may also, under certain circumstances, be subject to an additional “branch profits tax” at a 30% rate or such lower rate as may be specified by an applicable income tax treaty.

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### **Dispositions of Ordinary Shares or ADSs**

Subject to the discussion in “Information Reporting and Backup Withholding” below, as a Non-U.S. Holder, you generally will not be subject to U.S. federal income tax, including withholding tax, on any gain recognized on a sale or other taxable disposition of ordinary shares or ADSs, unless (i) the gain is effectively connected with your conduct of a trade or business in the United States and (if an applicable income tax treaty so requires) attributable to a permanent establishment that you maintain in the United States, or (ii) you are an individual and are present in the United States for at least 183 days in the taxable year of the disposition, and certain other conditions are met.

If you meet the test in clause (i) above, you generally will be subject to tax on any gain that is effectively connected with your conduct of a trade or business in the United States in the same manner as a U.S. Holder, as described in “Taxation of U.S. Holders—Dispositions of ordinary shares or ADSs” above. Effectively connected gain realized by a corporate Non-U.S. Holder may also, under certain circumstances, be subject to an additional “branch profits tax” at a 30% rate or such lower rate as may be specified by an applicable income tax treaty.

If you meet the test in clause (ii) above, you generally will be subject to tax at a 30% rate on the amount by which your U.S. source capital gain exceeds your U.S. source capital loss.

### **Information Reporting and Backup Withholding**

Payments to Non-U.S. Holders of distributions on, or proceeds from the disposition of, ordinary shares or ADSs are generally exempt from information reporting and backup withholding. However, a Non-U.S. Holder may be required to establish that exemption by providing certification of non-U.S. status on an appropriate IRS Form W-8.

Backup withholding is not an additional tax. Rather, amounts withheld under the backup withholding rules may be credited against your U.S. federal income tax liability. Furthermore, you may obtain a refund of any excess amounts withheld by filing an appropriate claim for refund with the IRS and furnishing any required information in a timely manner.

### **Enforcement of Civil Liabilities**

We are incorporated in the Cayman Islands because of the following benefits found there:

- political and economic stability;
- an effective judicial system;
- a favorable tax system;
- the absence of exchange control or currency restrictions; and
- the availability of professional and support services.

However, certain disadvantages accompany incorporation in the Cayman Islands. These disadvantages include:

- (1) the Cayman Islands has a less developed body of securities laws as compared to the United States and provides significantly less protection to investors; and
- (2) Cayman Islands companies may not have standing to sue before the federal courts of the United States.

Our constituent documents do not contain provisions requiring that disputes, including those arising under the securities laws of the United States, between us, our officers, directors and shareholders be arbitrated.

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A substantial portion of our current operations is conducted in China through our wholly-owned subsidiaries which are incorporated in China or the British Virgin Islands. All or most of our assets are located in China. We have appointed CT Corporation System, 111 Eighth Avenue, New York, NY 10011, as our agent upon whom process may be served in any action brought against us under the securities laws of the United States. A majority of our directors and officers are nationals or residents of jurisdictions other than the United States and a substantial portion of their assets are located outside the United States. As a result, it may be difficult for a shareholder to effect service of process within the United States upon these persons, or to enforce against us or them judgments obtained in United States courts, including judgments predicated upon the civil liability provisions of the securities laws of the United States or any state in the United States.

Maples and Calder, our counsel as to Cayman Islands law, and King and Wood, our counsel as to Chinese law, have advised us that there is uncertainty as to whether the courts of the Cayman Islands or China would:

- (1) recognize or enforce judgments of United States courts obtained against us or our directors or officers predicated upon the civil liability provisions of the securities laws of the United States or any state in the United States; or
- (2) entertain original actions brought in the Cayman Islands or China against us or our directors or officers predicated upon the securities laws of the United States or any state in the United States.

Maples and Calder has further advised us that a final and conclusive judgment in the federal or state courts of the United States under which a sum of money is payable, other than a sum payable in respect of taxes, fines, penalties or similar charges, may be subject to enforcement proceedings as a debt in the courts of the Cayman Islands under the common law doctrine of obligation.

King and Wood has advised us further that the recognition and enforcement of foreign judgments are provided for under Chinese Civil Procedures Law. Chinese courts may recognize and enforce foreign judgments in accordance with the requirements of Chinese Civil Procedures Law based either on treaties between China and the country where the judgment is made or on reciprocity between jurisdictions.

**F. Dividends and Paying Agents**

Not applicable.

**G. Statement by Experts**

Not applicable.

**H. Documents on Display**

We have previously filed with the Commission our registration statement on Form F-1 and prospectus under the Securities Act of 1933, as amended, with respect to our ADSs.

We are subject to the periodic reporting and other informational requirements of the Securities Exchange Act of 1934, as amended, or the Exchange Act. Under the Exchange Act, we are required to file reports and other information with the Securities and Exchange Commission. Specifically, we are required to file annually a Form 20-F no later than six months after the close of each fiscal year, which is December 31. Copies of reports and other information, when so filed, may be inspected without charge and may be obtained at prescribed rates at the public reference facilities maintained by the Securities and Exchange Commission at 100 F Street, N.E., Washington, D.C. 20549. You can request copies of these documents upon payment of a duplicating fee, by writing to the SEC. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference rooms. The SEC also maintains a website at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements, and other information regarding registrants that make electronic filings with the SEC using its



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EDGAR system. As a foreign private issuer, we are exempt from the rules under the Exchange Act prescribing the furnishing and content of quarterly reports and proxy statements, and officers, directors and principal shareholders are exempt from the reporting and short-swing profit recovery provisions contained in Section 16 of the Exchange Act.

Our financial statements have been prepared in accordance with U.S. GAAP.

We will furnish our shareholders with annual reports, which will include a review of operations and annual audited consolidated financial statements prepared in conformity with U.S. GAAP.

**I. Subsidiary Information**

Not applicable.

**Item 11. Quantitative and Qualitative Disclosures About Market Risk**

Please refer to Item 5.F. "Operating and Financial Review and Prospects—Quantitative and Qualitative Disclosures About Market Risk."

**Item 12. Description of Securities Other than Equity Securities**

Not Applicable.

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[Table of Contents](#)**PART II****Item 13. Defaults, Dividend Arrearages and Delinquencies**

Not Applicable.

**Item 14. Material Modifications to the Rights of Security Holders and Use of Proceeds****Use of Proceeds**

The following "Use of Proceeds" information relates to the registration statement on Form F-1 (File No. 333-11724), or the Registration Statement, for our initial public offering of 4,500,000 ADSs, each representing 100 of our ordinary shares (without taking into account our ADR ratio change effected on March 27, 2006), for an aggregate offering price of US\$69.75 million. Our Registration Statement was declared effective by the SEC on June 29, 2000.

We received net proceeds of approximately US\$64.9 million from our initial public offering (taking into account underwriting discounts of US\$4.88 million, but not taking into account transaction expenses of approximately US\$2.7 million). None of the transaction expenses included payments to directors or officers of our company or their associates, persons owning 10% or more of our equity securities or our affiliates.

From the effective date of the Registration Statement to July 6, 2000, we did not use any of the proceeds from our initial public offering. Net proceeds from the offering have been invested in highly liquid money market instruments, short-term time deposits and similar instruments. Since July 6, 2000, we have used the net proceeds from our initial public offering to satisfy past indebtedness and reduce our accounts payable and to fund expenses primarily for marketing, employee compensation, and capital expenditures. None of the net proceeds from the initial public offering were paid, directly or indirectly, to any of our directors or officers of our company or their associates, persons owning 10% or more of our equity securities or our affiliates.

Merrill Lynch Far East Limited, Merrill Lynch, Pierce, Fenner & Smith Incorporated, Deutsche Bank Securities Inc., Chase Securities Inc., Salomon Smith Barney Inc., and UBS Warburg LLC were the underwriters for our initial public offering.

**Item 15. Controls and Procedures****Evaluation of Disclosure Controls and Procedures**

William Lei Ding, our Chief Executive Officer, and Onward Choi, our Acting Chief Financial Officer, have performed an evaluation of our disclosure controls and procedures, as that term is defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act, as of the end of the fiscal year covered by this annual report. They have concluded that such disclosure controls and procedures were effective to ensure that information required to be disclosed in our periodic reports filed under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified by the Securities and Exchange Commission's rules and regulations.

**Management's Report on Internal Control over Financial Reporting**

Our management's report on internal control over financial reporting and the related report of our independent registered public accounting firm are included in this Report on pages F-1 and F-2, respectively.

**Changes in Internal Controls**

There were no changes in our internal controls over financial reporting identified in connection with the evaluation required by Rules 13a-15 or 15d-15 that occurred during the period covered by this annual report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

[Table of Contents](#)**Item 16. Reserved****Item 16A. Audit Committee Financial Expert**

Our board of directors has determined that Mr. Joseph Tong qualifies as an Audit Committee Financial Expert as defined by the applicable rules of the SEC and that Mr. Tong is “independent” as that term is defined in Rule 4200 of the listing standards of the Marketplace Rules of the NASDAQ Stock Market, Inc.

**Item 16B. Code of Ethics**

We have adopted a Code of Business Conduct which applies to our employees, officers and non-employee directors, including our principal executive officer, principal financial officer, principal accounting officer or controller, and persons performing similar functions. This code is intended to qualify as a “code of ethics” within the meaning of the applicable rules of the SEC.

**Item 16C. Principal Accountant Fees and Services****Disclosure of Fees Charged by Independent Accountants**

The following table summarizes the fees charged by PricewaterhouseCoopers Zhong Tian CPAs Limited Company for certain services rendered to our company during 2006 and 2007.

|                        | For the year ended<br>December 31, |          |
|------------------------|------------------------------------|----------|
|                        | 2006 (1)                           | 2007 (1) |
|                        | (in thousands of U.S. dollars)     |          |
| Audit fees (2)         | \$ 1,520                           | \$ 1,250 |
| Audit-related fees (3) | 420                                | —        |
| Tax fees (4)           | 110                                | 23       |
| Others (5)             | —                                  | 58       |
| Total                  | \$ 2,050                           | \$ 1,331 |

- (1) The fees disclosed are exclusive of out-of-pocket expenses and taxes on the amounts paid, which totaled US\$240,000 in 2006 and US\$142,000 in 2007.
- (2) “Audit fees” means the aggregate fees billed in each of the fiscal years listed for professional services rendered by our principal auditors for the audit of our annual financial statements.
- (3) “Audit-related fees” means the aggregate fees billed in each of the fiscal years listed for professional services rendered by our principal auditors related to the audit of our financial statements that are not reported under “Audit Fees” and consultation on accounting standards or transactions.
- (4) “Tax fees” means the aggregate fees billed in each of the fiscal years listed for professional services rendered by our principal auditors for tax compliance and tax advice.
- (5) “Others” means the aggregate fees billed in each of the fiscal years listed for professional services rendered by our principal auditors for services not reported above.

**Audit Committee Pre-approval Policies and Procedures**

Our audit committee has adopted procedures which set forth the manner in which the committee will review and approve all audit and non-audit services to be provided by PricewaterhouseCoopers Zhong Tian CPAs Limited Company before that firm is retained for such services. The pre-approval procedures are as follows:

- Any audit or non-audit service to be provided to us by the independent accountant must be submitted to the audit committee for review and approval, with a description of the services to be performed and the fees to be charged.
- The audit committee in its sole discretion then approves or disapproves the proposed services and documents such approval, if given, through written resolutions or in the minutes of meetings, as the case may be.

[Table of Contents](#)**Item 16D. Exemptions from the Listing Standards for Audit Committees**

We have not sought an exemption from the applicable listing standards for the audit committee of our board of directors.

**Item 16E. Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

| <u>Period</u>                          | <u>Total Number<br/>of ADSs<br/>Purchased (1)</u> | <u>Average<br/>Price Paid<br/>Per ADS<br/>US\$</u> | <u>ADSs Purchased<br/>as Part of Publicly<br/>Announced Plans<br/>or Programs</u> | <u>Dollar Value<br/>of ADSs that<br/>May Yet Be<br/>Purchased<br/>Under the<br/>Programs</u> |
|--|---|--|---|--|
| January 1 through January 31, 2007     | —   | —  | —   | —  |
| February 1 through February 28, 2007   | —   | —  | —   | —  |
| March 1 through March 31, 2007 (2)     | 1,143,318   | 18.2049  | 1,143,318   | 79,186,029   |
| April 1 through April 30, 2007         | 1,664,526   | 17.9849  | 2,807,844   | 49,249,731   |
| May 1 through May 31, 2007             | 1,845,926   | 17.8717  | 4,653,770   | 16,259,892   |
| June 1 through June 30, 2007           | 660,774   | 18.1717  | 5,314,544   | 4,252,483  |
| July 1 through July 31, 2007           | 323,440   | 17.3363  | 5,637,984   | 114,392,732  |
| August 1 through August 31, 2007       | 885,795   | 15.5756  | 6,523,779   | 100,595,982  |
| September 1 through September 30, 2007 | 658,734   | 17.2907  | 7,182,513   | 89,205,992   |
| October 1 through October 31, 2007     | 286,200   | 17.0667  | 7,468,713   | 84,321,506   |
| November 1 through November 30, 2007   | —   | —  | 7,468,713   | 84,321,506   |
| December 1 through December 31, 2007   | —   | —  | 7,468,713   | 84,321,506   |
| <b>Total</b>                           | <b>7,468,713</b>                                  | <b>17.5969</b>                                     | <b>7,468,713</b>  |  |

(1) Our ADS to ordinary share ratio is one ADS for every 25 ordinary shares.

(2) During 2007, we announced two share repurchase programs authorized by our board of directors with details set out as follows:

| <u>Share Repurchase Program authorized in 2007</u> | <u>Amount<br/>Authorized<br/>(US\$)</u> | <u>Expiration<br/>Date</u> |
|--|---|----------------------------|
| March 13   | 100,000,000                             | June 12, 2007              |
| July 2   | 120,000,000                             | July 1, 2008               |

[Table of Contents](#)**PART III****Item 17. Financial Statements**

The Company has elected to provide financial statements pursuant to Item 18.

**Item 18. Financial Statements**

The consolidated financial statements for NetEase.com, Inc. and its subsidiaries are included at the end of this annual report.

**Item 19. Exhibits**

| <b>Exhibit<br/>Number</b> | <b>Document</b>  |
|---------------------------|--|
| 1.1                       | Amended and Restated Memorandum of Association of NetEase.com, Inc. (incorporated by reference to Exhibit 3.1 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)   |
| 1.2                       | Amended and Restated Articles of Association of NetEase.com, Inc. (incorporated by reference to Exhibit 3.2 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)   |
| 1.3                       | Amendment to Amended and Restated Articles of Association of NetEase.com, Inc. dated as of June 5, 2003 (incorporated by reference to Exhibit 3.2 to the company's annual report on Form 20-F for the year ended December 31, 2002 filed with the Securities and Exchange Commission on June 27, 2003)   |
| 2.1                       | Specimen American Depositary Receipt of NetEase.com, Inc. (incorporated by reference to Exhibit 4.1 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)   |
| 2.2                       | Specimen Stock Certificate of NetEase.com, Inc. (incorporated by reference to Exhibit 4.2 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)   |
| 3.1                       | Shareholder Voting Rights Trust Agreement dated May 12, 2000 among William Lei Ding, Bo Ding and NetEase Information Technology (Beijing) Co., Ltd. (incorporated by reference to Exhibit 10.40 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000) |
| 4.1                       | Amended and Restated 2000 Stock Incentive Plan and Form of Stock Option Agreement (including standard and non-standard form) (incorporated by reference to Exhibit 4.2 to the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the Securities and Exchange Commission on August 31, 2001)                                  |
| 4.2                       | Employment Agreement dated August 13, 1999 between NetEase.com, Inc. and William Lei Ding (incorporated by reference to Exhibit 10.2 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)   |
| 4.3                       | Addendum to Employment Agreement between NetEase.com, Inc. and William Lei Ding dated November 25, 2005 (incorporated by reference to Exhibit 4.3 to the company's Annual Report on Form 20-F for the year ended December 31, 2005 filed with the Securities and Exchange Commission on June 29, 2006)   |
| 4.4                       | Employment Agreement dated July 1, 2007 between NetEase.com Inc. and Onward Choi.  |

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| <b>Exhibit<br/>Number</b> | <b>Document</b>   |
|---------------------------|---|
| 4.5                       | Employment Agreement dated June 25, 2002 between NetEase.com, Inc. and Michael Tong (incorporated by reference to Exhibit 4.7 to the company's annual report on Form 20-F for the year ended December 31, 2002 filed with the Securities and Exchange Commission on June 27, 2003)  |
| 4.6                       | Employment Agreement dated May 17, 2006 between NetEase.com, Inc. and Zhonghui Zhan (incorporated by reference to Exhibit 4.6 to the company's Annual Report on Form 20-F for the year ended December 31, 2005 filed with the Securities and Exchange Commission on June 29, 2006)  |
| 4.7                       | Domain Name License Agreement dated February 3, 2000 between NetEase.com, Inc. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.7 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)   |
| 4.8                       | Copyright License Agreement dated February 3, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.8 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)  |
| 4.9                       | Trademark License Agreement dated February 3, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.9 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)  |
| 4.10                      | Supplemental Agreement (to Copyright License Agreement and Domain Name License Agreement) dated April 27, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd (incorporated by reference to Exhibit 10.10 to Amendment No.1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)                                    |
| 4.11                      | Notice of Renewal dated April 2, 2001 relating to the Copyright License Agreement and the Trademark License Agreement each dated February 3, 2000 and made between NetEase Information Technology (Beijing) Co., Ltd and Guangzhou NetEase Computer System Co., Ltd (incorporated by reference to Exhibit 4.14 to the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the Securities and Exchange Commission on August 31, 2001) |
| 4.12                      | Exclusive Advertising Agency Agreement dated February 3, 2000 between Guangzhou NetEase Computer System Co., Ltd. and NetEase.com, Inc. (incorporated by reference to Exhibit 10.13 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)   |
| 4.13                      | Notice of Renewal dated April 2, 2001 relating to the Exclusive Advertising Agency Agreement dated February 3, 2000 between Guangzhou NetEase Computer System Co., Ltd. and NetEase.com, Inc. (incorporated by reference to Exhibit 4.18 to the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the Securities and Exchange Commission on August 31, 2001)   |
| 4.14                      | Trademark Transfer Agreement dated March 29, 2000 between Guangzhou NetEase Computer System Co., Ltd. and NetEase Information Technology (Beijing) Co., Ltd. (incorporated by reference to Exhibit 10.14 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)   |
| 4.15                      | Online Advertising Agreement dated February 15, 2000 between Guangzhou NetEase Computer System Co., Ltd. and Beijing Guangyitong Advertising Co., Ltd. (incorporated by reference to Exhibit 10.15 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)  |

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| <b>Exhibit<br/>Number</b> | <b>Document</b>  |
|---------------------------|--|
| 4.16                      | Notice of Renewal dated April 2, 2001 relating to the Online Advertising Agreement dated February 15, 2000 and made between Guangzhou NetEase Computer System Co., Ltd. and Beijing Guangyitong Advertising Co., Ltd. (incorporated by reference to Exhibit 4.21 to the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the Securities and Exchange Commission on August 31, 2001)            |
| 4.17                      | Tenancy Agreement dated January 5, 2006 between NetEase Information Technology (Beijing) Co., Ltd. and Beijing Torch Innovation Technology Development Co., Ltd. (incorporated by reference to Exhibit 4.20 to the company's Annual Report on Form 20-F for the year ended December 31, 2005 filed with the Securities and Exchange Commission on June 29, 2006)   |
| 4.18                      | Supplemental Agreement dated May 10, 2000 (amending the Domain Name License Agreement) between NetEase.com, Inc. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.37 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)  |
| 4.19                      | Agreement dated May 12, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.41 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)   |
| 4.20                      | Operating Agreement dated May 10, 2000 among NetEase Information Technology (Beijing) Co., Ltd., Beijing Guangyitong Advertising Co., Ltd., Bo Ding and William Lei Ding (incorporated by reference to Exhibit 10.42 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)  |
| 4.21                      | Supplemental Agreement dated May 12, 2000 (supplementing the Online Advertising Agreement dated February 15, 2000) between Guangzhou NetEase Computer System Co., Ltd. and Beijing Guangyitong Advertising Co., Ltd. (incorporated by reference to Exhibit 10.47 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)    |
| 4.22                      | Supplemental Agreement dated May 15, 2000 (supplementing the Domain Name License Agreement dated February 3, 2000) between NetEase.com, Inc. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.48 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)                            |
| 4.23                      | Letter of Agreement, dated June 6, 2000, among William Lei Ding, Bo Ding and NetEase.com, Inc. (incorporated by reference to Exhibit 10.49 to Amendment No. 2 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on June 15, 2000)   |
| 4.24                      | Supplemental Agreement dated June 15, 2000 (supplementing the Online Advertising Agreement dated February 15, 2000), between Beijing Guangyitong Advertising Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.50 to Amendment No. 2 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on June 15, 2000) |
| 4.25                      | Trademark Assignment Agreement dated August 17, 2001 between Guangzhou NetEase Computer System Co., Ltd. and NetEase Information Technology (Beijing) Co., Ltd and its Supplemental Agreement dated August 27, 2001 (incorporated by reference to Exhibit 4.53 to the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the Securities and Exchange Commission on August 31, 2001)              |



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| <b>Exhibit<br/>Number</b> | <b>Document</b>   |
|---------------------------|---|
| 4.26                      | Indenture, dated as of July 14, 2003, by and between NetEase.com, Inc. and The Bank of New York (incorporated by reference to Exhibit 4.4 to the company's Registration Statement on Form F-3 (file no. 333-109628) filed with the Securities and Exchange Commission on October 10, 2003)  |
| 4.27                      | Assignment Agreement dated May 17, 2004 by and among NetEase Information Technology (Beijing) Co., Ltd., NetEase Information Technology (Shanghai) Co., Inc. and Guangzhou NetEase Interactive Entertainment Ltd. (incorporated by reference to Exhibit 4.38 to the company's Annual Report on Form 20-F for the year ended December 31, 2005 filed with the Securities and Exchange Commission on June 27, 2005)   |
| 4.28                      | Supplemental Letter of Agreement dated May 17, 2004 (supplementing the Letter Agreement dated June 6, 2000 by and among William Lei Ding, Bo Ding and NetEase.com, Inc.) by and among William Lei Ding, Bo Ding, Jun Liang and NetEase.com, Inc. (incorporated by reference to Exhibit 4.39 to the company's Annual Report on Form 20-F for the year ended December 31, 2005 filed with the Securities and Exchange Commission on June 27, 2005)  |
| 4.29                      | Second Supplemental Letter of Agreement dated July 15, 2004 (supplementing the Letter Agreement dated June 6, 2000 by and among William Lei Ding, Bo Ding and NetEase.com, Inc., as supplemented by the Supplemental Letter of Agreement dated May 17, 2004 by and among William Lei Ding, Bo Ding, Jun Liang and NetEase.com, Inc.) by and among William Lei Ding, Bo Ding, Jun Liang and NetEase.com, Inc. (incorporated by reference to Exhibit 4.40 to the company's Annual Report on Form 20-F for the year ended December 31, 2005 filed with the Securities and Exchange Commission on June 27, 2005)  |
| 4.30                      | No. 3 Supplemental Letter of Agreement dated July 20, 2004 (supplementing the Letter Agreement dated June 6, 2000 by and among William Lei Ding, Bo Ding and NetEase.com, Inc., as supplemented by the Supplemental Letter of Agreement dated May 17, 2004 and the Second Supplemental Letter of Agreement dated July 15, 2004, each by and among William Lei Ding, Bo Ding, Jun Liang and NetEase.com, Inc.) by and among William Lei Ding, Bo Ding, Jun Liang and NetEase.com, Inc. (incorporated by reference to Exhibit 4.41 to the company's Annual Report on Form 20-F for the year ended December 31, 2005 filed with the Securities and Exchange Commission on June 27, 2005) |
| 4.31                      | Cooperative Agreement between Guangzhou NetEase Computer System Co., Ltd. and NetEase (Hangzhou) Network Co., Ltd. effective as of January 1, 2007 (incorporated by reference to Exhibit 4.32 to the company's Annual Report on Form 20-F for the year ended December 31, 2006 filed with the Securities and Exchange Commission on June 26, 2007)  |
| 4.32                      | Cooperative Agreement between Guangzhou NetEase Computer System Co., Ltd., Guangzhou NetEase Interactive Entertainment Limited and NetEase Information Technology (Beijing) Co., Ltd. effective as of January 1, 2006 (incorporated by reference to Exhibit 4.33 to the company's Annual Report on Form 20-F for the year ended December 31, 2006 filed with the Securities and Exchange Commission on June 26, 2007)   |
| 4.33                      | Cooperative Agreement between Guangzhou NetEase Computer System Co., Ltd. and Guangzhou Boguan Telecommunication Technology Limited effective as of January 1, 2006 (incorporated by reference to Exhibit 4.34 to the company's Annual Report on Form 20-F for the year ended December 31, 2006 filed with the Securities and Exchange Commission on June 26, 2007)   |
| 4.34                      | Cooperative Agreement between NetEase Information Technology (Beijing) Co., Ltd and Beijing Guangyitong Advertising Co., Ltd. effective as of January 1, 2006 (incorporated by reference to Exhibit 4.35 to the company's Annual Report on Form 20-F for the year ended December 31, 2006 filed with the Securities and Exchange Commission on June 26, 2007)   |

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| <b>Exhibit<br/>Number</b> | <b>Document</b>   |
|---------------------------|---|
| 4.35                      | Cooperative Agreement between Guangzhou NetEase Interactive Entertainment Ltd and Beijing Guangyitong Advertising Co., Ltd. effective as of January 1, 2006 (incorporated by reference to Exhibit 4.36 to the company's Annual Report on Form 20-F for the year ended December 31, 2006 filed with the Securities and Exchange Commission on June 26, 2007) |
| 8.1                       | Subsidiaries of NetEase.com, Inc.   |
| 11.1                      | Code of Business Conduct (incorporated by reference to Exhibit 11.1 to the company's Annual Report on Form 20-F for the year ended December 31, 2006 filed with the Securities and Exchange Commission on June 26, 2007)  |
| 12.1                      | Certification of Chief Executive Officer Required by Rule 13a-14(a)   |
| 12.2                      | Certification of Acting Chief Financial Officer Required by Rule 13a-14(a)  |
| 13.1                      | Certification of Chief Executive Officer Required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code  |
| 13.2                      | Certification of Acting Chief Financial Officer Required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code   |
| 15.1                      | Charter of Audit Committee of the Board of Directors of the Registrant (incorporated by reference to Exhibit 15.1 to the company's Annual Report on Form 20-F for the year ended December 31, 2006 filed with the Securities and Exchange Commission on June 26, 2007)  |
| 15.2                      | Consent of PricewaterhouseCoopers Zhong Tian CPAs Limited Company, Independent Registered Public Accounting Firm  |
| 15.3                      | Consent of Maples and Calder  |
| 15.4                      | Consent of King and Wood  |

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[Table of Contents](#)**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

**NETEASE.COM, INC.**

By:           /s/  WILLIAM LEI DING          

**William Lei Ding**  
**Chief Executive Officer**

Date: June 26, 2008

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**Table of Contents****Management's Report on Internal Control over Financial Reporting**

The management of NetEase.com, Inc., or the Company, is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) and 15d-15(f) promulgated under the Securities Exchange Act of 1934, as amended.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company's management, with the participation of the Company's principal executive and principal financial officer, assessed the effectiveness of the Company's internal control over financial reporting as of end of the most recent fiscal year, December 31, 2007. In making this assessment, the Company's management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework*. Based on its assessment, management concluded that, as of the end of the Company's most recent fiscal year, December 31, 2007, the Company's internal control over financial reporting is effective based on those criteria.

PricewaterhouseCoopers Zhong Tian CPAs Limited Company, our independent registered public accounting firm, has audited the effectiveness of the Company's internal control over financial reporting as of December 31, 2007, as stated in their report, which is included herein.

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**Table of Contents****Report of Independent Registered Public Accounting Firm****To the Board of Directors and Shareholders of NetEase.com, Inc.:**

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations and comprehensive income, of shareholders' equity and of cash flows expressed in Chinese Renminbi ("RMB") present fairly, in all material respects, the financial position of NetEase.com, Inc. and its subsidiaries at December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the related Financial Statements Schedule I as of December 31, 2007 and 2006 and for each of the three years in the period ended December 31, 2007 presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007 based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and Financial Statements Schedule I, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control over Financial Reporting appearing on Page F-1 of Form 20-F. Our responsibility is to express opinions on these financial statements, on Financial Statements Schedule I and on the Company's internal control over financial reporting based on our audits which were integrated audits in 2007 and 2006. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits (which were integrated audits in 2007 and 2006) provide a reasonable basis for our opinions.

As discussed in Note 2 (l) to the consolidated financial statements, the Company changed the manner in which it accounts for stock-based compensation in 2006.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers Zhong Tian CPAs Limited Company

Beijing, People's Republic of China  
June 26, 2008

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[Table of Contents](#)**Consolidated Balance Sheets**

|  | <b>Note</b> | <b>December 31,<br/>2006<br/>RMB</b> | <b>December 31,<br/>2007<br/>RMB</b> | <b>December 31,<br/>2007<br/>US\$</b> |
|--|-------------|--------------------------------------|--------------------------------------|---------------------------------------|
| <b>Assets</b>  |             |                                      |                                      |                                       |
| Current assets:  |             |                                      |                                      |                                       |
| Cash   |             | 1,206,476,526                        | 2,482,820,821                        | 340,364,218                           |
| Time deposits  |             | 2,731,396,687                        | 1,675,813,944                        | 229,733,494                           |
| Accounts receivable, net   | 4           | 131,724,899                          | 166,727,514                          | 22,856,293                            |
| Prepayments and other current assets   | 5           | 33,913,350                           | 45,143,728                           | 6,188,650                             |
| Deferred tax assets  | 10(c)       | 25,674,468                           | 65,787,113                           | 9,018,605                             |
| Total current assets   |             | <u>4,129,185,930</u>                 | <u>4,436,293,120</u>                 | <u>608,161,260</u>                    |
| Non-current assets:  |             |                                      |                                      |                                       |
| Non-current rental deposit   |             | 3,353,209                            | 3,033,171                            | 415,810                               |
| Property, equipment and software, net  | 6           | 224,207,833                          | 183,471,666                          | 25,151,710                            |
| Prepayment for land use right  | 7           | —                                    | 26,956,800                           | 3,695,446                             |
| Deferred tax assets  | 10(c)       | 5,502,361                            | 19,060,225                           | 2,612,923                             |
| Other long-term assets   | 8           | 11,458,497                           | 16,844,399                           | 2,309,160                             |
| Total non-current assets   |             | <u>244,521,900</u>                   | <u>249,366,261</u>                   | <u>34,185,049</u>                     |
| Total assets   |             | <u>4,373,707,830</u>                 | <u>4,685,659,381</u>                 | <u>642,346,309</u>                    |
| <b>Liabilities and Shareholders' Equity</b>  |             |                                      |                                      |                                       |
| Current liabilities:   |             |                                      |                                      |                                       |
| Zero-coupon convertible subordinated notes due July 15, 2023   | 14          | —                                    | 641,778,908                          | 87,980,000                            |
| Accounts payable   |             | 105,555,248                          | 89,143,868                           | 12,220,529                            |
| Salary and welfare payable   | 9           | 54,924,038                           | 68,653,742                           | 9,411,584                             |
| Taxes payable  | 11          | 95,476,498                           | 92,438,670                           | 12,672,205                            |
| Deferred revenue   | 13          | 385,720,720                          | 354,966,697                          | 48,661,571                            |
| Deferred tax liabilities   | 10(c)       | 3,391,754                            | —                                    | —                                     |
| Accrued liabilities  | 12          | 31,340,217                           | 29,844,067                           | 4,091,255                             |
| Total current liabilities  |             | <u>676,408,475</u>                   | <u>1,276,825,952</u>                 | <u>175,037,144</u>                    |
| Long-term Payable:   |             |                                      |                                      |                                       |
| Zero-coupon convertible subordinated notes due July 15, 2023   | 14          | 780,253,918                          | —                                    | —                                     |
| Other long-term payable  |             | 11,377,256                           | 10,200,000                           | 1,398,295                             |
| Total long-term payable  |             | <u>791,631,174</u>                   | <u>10,200,000</u>                    | <u>1,398,295</u>                      |
| Total liabilities  |             | <u>1,468,039,649</u>                 | <u>1,287,025,952</u>                 | <u>176,435,439</u>                    |
| Commitments and contingencies  | 18          | —                                    | 207,798                              | 28,487                                |
| Minority interests   |             | —                                    | 207,798                              | 28,487                                |
| Shareholders' equity:  |             |                                      |                                      |                                       |
| Ordinary shares, US\$0.0001 par value:   |             |                                      |                                      |                                       |
| 1,000,300,000,000 shares authorized, 3,195,024,725 shares issued and 3,158,385,050 outstanding as of December 31, 2006 and 3,036,270,590 shares issued and outstanding as of December 31, 2007 | 15,19       | 2,645,941                            | 2,525,952                            | 346,277                               |
| Additional paid-in capital   | 15,19       | 590,597,648                          | —                                    | —                                     |
| Treasury stock   | 19          | (188,802,099)                        | —                                    | —                                     |
| Statutory reserves   |             | 163,117,928                          | 168,729,214                          | 23,130,701                            |
| Accumulated other comprehensive income   |             | —                                    | 1,332,300                            | 182,642                               |
| Retained earnings  |             | <u>2,338,108,763</u>                 | <u>3,225,838,165</u>                 | <u>442,222,763</u>                    |
| Total shareholders' equity   |             | <u>2,905,668,181</u>                 | <u>3,398,425,631</u>                 | <u>465,882,383</u>                    |
| Total liabilities and shareholders' equity   |             | <u>4,373,707,830</u>                 | <u>4,685,659,381</u>                 | <u>642,346,309</u>                    |

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



[Table of Contents](#)**Consolidated Statements of Operations and Comprehensive Income**

|   | <b>Note</b> | <b>For the year ended December 31,</b> |                      |                      |                      |
|---|-------------|--|----------------------|----------------------|----------------------|
|   |             | <b>2005</b>                            | <b>2006</b>          | <b>2007</b>          | <b>2007</b>          |
|   |             | <b>RMB</b>                             | <b>RMB</b>           | <b>RMB</b>           | <b>US\$</b>          |
| <b>Revenues:</b>  |             |  |                      |                      |                      |
| Online game services  |             | 1,379,475,803                          | 1,856,062,971        | 1,932,634,947        | 264,940,497          |
| Advertising services  |             | 241,200,444                            | 285,772,653          | 305,057,556          | 41,819,641           |
| Wireless value-added services and others                        |             | 73,742,136                             | 75,406,121           | 68,018,461           | 9,324,495            |
|   |             | <u>1,694,418,383</u>                   | <u>2,217,241,745</u> | <u>2,305,710,964</u> | <u>316,084,633</u>   |
| Business taxes  | 10(b)       | (82,054,902)                           | (52,882,275)         | (92,424,200)         | (12,670,222)         |
| Net revenues  |             | <u>1,612,363,481</u>                   | <u>2,164,359,470</u> | <u>2,213,286,764</u> | <u>303,414,411</u>   |
| Cost of revenues  |             | <u>(275,236,973)</u>                   | <u>(381,298,181)</u> | <u>(415,453,046)</u> | <u>(56,953,506)</u>  |
| <b>Gross profit</b>   |             | <u>1,337,126,508</u>                   | <u>1,783,061,289</u> | <u>1,797,833,718</u> | <u>246,460,905</u>   |
| <b>Operating expenses:</b>                                      |             |  |                      |                      |                      |
| Selling and marketing expenses                                  |             | (152,192,422)                          | (170,142,691)        | (235,318,304)        | (32,259,247)         |
| General and administrative expenses                             |             | (117,942,605)                          | (179,879,602)        | (176,178,740)        | (24,151,940)         |
| Research and development expenses                               |             | <u>(90,170,092)</u>                    | <u>(153,162,158)</u> | <u>(180,734,713)</u> | <u>(24,776,508)</u>  |
| Total operating expenses  |             | <u>(360,305,119)</u>                   | <u>(503,184,451)</u> | <u>(592,231,757)</u> | <u>(81,187,695)</u>  |
| <b>Operating profit</b>   |             | <u>976,821,389</u>                     | <u>1,279,876,838</u> | <u>1,205,601,961</u> | <u>165,273,210</u>   |
| Other income (expenses):  |             |  |                      |                      |                      |
| Investment income   |             | 1,301,975                              | 340,721              | 474,446              | 65,041               |
| Interest income   |             | 58,070,148                             | 94,364,852           | 112,599,994          | 15,436,075           |
| Interest expense  |             | (344,859)                              | —                    | —                    | —                    |
| Exchange losses   |             | (8,360,834)                            | (958,435)            | (50,891,094)         | (6,976,543)          |
| Other, net  |             | <u>(540,628)</u>                       | <u>1,239,105</u>     | <u>(1,084,240)</u>   | <u>(148,636)</u>     |
| <b>Profit before tax</b>  |             | <u>1,026,947,191</u>                   | <u>1,374,863,081</u> | <u>1,266,701,067</u> | <u>173,649,147</u>   |
| Income tax  | 10(a)       | (94,957,022)                           | (132,485,543)        | (2,689,309)          | (368,671)            |
| <b>Profit after tax</b>   |             | <u>931,990,169</u>                     | <u>1,242,377,538</u> | <u>1,264,011,758</u> | <u>173,280,476</u>   |
| Minority interests  |             | —                                      | 400,046              | 74,364               | 10,194               |
| <b>Net profit</b>   |             | <u>931,990,169</u>                     | <u>1,242,777,584</u> | <u>1,264,086,122</u> | <u>173,290,670</u>   |
| Unrealized gains on investments                                 |             | —                                      | —                    | 1,332,300            | 182,642              |
| <b>Comprehensive Income</b>                                     |             | <u>931,990,169</u>                     | <u>1,242,777,584</u> | <u>1,265,418,422</u> | <u>173,473,312</u>   |
| Earnings per share, basic                                       | 17          | <u>0.29</u>                            | <u>0.38</u>          | <u>0.41</u>          | <u>0.06</u>          |
| Earnings per ADS, basic   |             | <u>7.22</u>                            | <u>9.61</u>          | <u>10.24</u>         | <u>1.40</u>          |
| Earnings per share, diluted                                     | 17          | <u>0.26</u>                            | <u>0.36</u>          | <u>0.38</u>          | <u>0.05</u>          |
| Earnings per ADS, diluted                                       |             | <u>6.59</u>                            | <u>8.91</u>          | <u>9.55</u>          | <u>1.31</u>          |
| Weighted average number of ordinary shares outstanding, basic   | 17          | <u>3,225,684,510</u>                   | <u>3,231,832,008</u> | <u>3,086,451,412</u> | <u>3,086,451,412</u> |
| Weighted average number of ADS outstanding, basic               |             | <u>129,027,380</u>                     | <u>129,273,280</u>   | <u>123,458,056</u>   | <u>123,458,056</u>   |
| Weighted average number of ordinary shares outstanding, diluted | 17          | <u>3,565,412,019</u>                   | <u>3,498,405,110</u> | <u>3,307,538,379</u> | <u>3,307,538,379</u> |
| Weighted average number of ADS outstanding, diluted             |             | <u>142,616,481</u>                     | <u>139,936,204</u>   | <u>132,301,535</u>   | <u>132,301,535</u>   |

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

[Table of Contents](#)**Consolidated Statements of Shareholders' Equity**

|  | Ordinary shares |            | Additional paid-in capital | Treasury stock |                 | Deferred compensation | Statutory reserves | Retained earnings | Accumulated other comprehensive income | Total shareholders' equity |
|--|-----------------|------------|----------------------------|----------------|-----------------|-----------------------|--------------------|-------------------|--|----------------------------|
|  | Share           | Amount RMB |                            | Share          | Amount RMB      |                       |                    |                   |  |                            |
| Balance as of December 31, 2004                                | 3,184,167,189   | 2,635,419  | 1,023,954,160              | —              | —               | (13,835)              | 90,882,108         | 235,576,830       | 210,838                                | 1,353,245,520              |
| Ordinary shares issued upon exercise of employee stock options | 79,317,800      | 64,954     | 105,617,445                | —              | —               | —                     | —                  | —                 | —                                      | 105,682,399                |
| Ordinary shares issued upon conversion of convertible notes    | 41,536          | 34         | 161,404                    | —              | —               | —                     | —                  | —                 | —                                      | 161,438                    |
| Share-based compensation costs                                 | —               | —          | —                          | —              | —               | 13,835                | —                  | —                 | —                                      | 13,835                     |
| Appropriation to statutory reserves                            | —               | —          | —                          | —              | —               | —                     | 44,356,727         | (44,356,727)      | —                                      | —                          |
| Net profit   | —               | —          | —                          | —              | —               | —                     | —                  | 931,990,169       | —                                      | 931,990,169                |
| Balance as of December 31, 2005                                | 3,263,526,525   | 2,700,407  | 1,129,733,009              | —              | —               | —                     | 135,238,835        | 1,123,210,272     | 210,838                                | 2,391,093,361              |
| Ordinary shares issued upon exercise of employee stock options | 44,488,200      | 35,338     | 44,092,079                 | —              | —               | —                     | —                  | —                 | —                                      | 44,127,417                 |
| Repurchase of shares   | —               | —          | —                          | (149,629,675)  | (873,406,019)   | —                     | —                  | —                 | —                                      | (873,406,019)              |
| Cancellation of repurchased shares                             | (112,990,000)   | (89,804)   | (684,514,116)              | 112,990,000    | 684,603,920     | —                     | —                  | —                 | —                                      | —                          |
| Share-based compensation cost (Note 16(a))                     | —               | —          | 101,286,676                | —              | —               | —                     | —                  | —                 | —                                      | 101,286,676                |
| Appropriation to statutory reserves                            | —               | —          | —                          | —              | —               | —                     | 27,879,093         | (27,879,093)      | —                                      | —                          |
| Net profit   | —               | —          | —                          | —              | —               | —                     | —                  | 1,242,777,584     | —                                      | 1,242,777,584              |
| Reversal of translation adjustment                             | —               | —          | —                          | —              | —               | —                     | —                  | —                 | (210,838)                              | (210,838)                  |
| Balance as of December 31, 2006                                | 3,195,024,725   | 2,645,941  | 590,597,648                | (36,639,675)   | (188,802,099)   | —                     | 163,117,928        | 2,338,108,763     | —                                      | 2,905,668,181              |
| Ordinary shares issued upon exercise of employee stock options | 39,681,250      | 32,052     | 43,201,379                 | —              | —               | —                     | —                  | —                 | —                                      | 43,233,431                 |
| Ordinary shares issued upon conversion of convertible notes    | 24,922,115      | 19,195     | 92,405,555                 | —              | —               | —                     | —                  | —                 | —                                      | 92,424,750                 |
| Repurchase of shares   | —               | —          | —                          | (186,717,825)  | (1,003,747,328) | —                     | —                  | —                 | —                                      | (1,003,747,328)            |
| Cancellation of repurchased shares                             | (223,357,500)   | (171,236)  | (821,632,757)              | 223,357,500    | 1,192,549,427   | —                     | —                  | (370,745,434)     | —                                      | —                          |
| Share-based compensation cost (Note 16(a))                     | —               | —          | 95,428,175                 | —              | —               | —                     | —                  | —                 | —                                      | 95,428,175                 |

|                                     |                      |                  |          |          |          |          |                    |                      |                  |                      |
|-------------------------------------|----------------------|------------------|----------|----------|----------|----------|--------------------|----------------------|------------------|----------------------|
| Appropriation to statutory reserves | —                    | —                | —        | —        | —        | —        | 5,611,286          | (5,611,286)          | —                | —                    |
| Net profit                          | —                    | —                | —        | —        | —        | —        | —                  | 1,264,086,122        | —                | 1,264,086,122        |
| Unrealized gains on investments     | —                    | —                | —        | —        | —        | —        | —                  | —                    | 1,332,300        | 1,332,300            |
| Balance as of December 31, 2007     | <u>3,036,270,590</u> | <u>2,525,952</u> | <u>—</u> | <u>—</u> | <u>—</u> | <u>—</u> | <u>168,729,214</u> | <u>3,225,838,165</u> | <u>1,332,300</u> | <u>3,398,425,631</u> |

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

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[Table of Contents](#)**Consolidated Statements of Cash Flows**

|   | For the year ended December 31, |                 |                 |               |
|---|---------------------------------|-----------------|-----------------|---------------|
|   | 2005                            | 2006            | 2007            | 2007          |
|   | RMB                             | RMB             | RMB             | US\$          |
| <b>Cash flows from operating activities:</b>                                      |                                 |                 |                 |               |
| Net profit  | 931,990,169                     | 1,242,777,584   | 1,264,086,122   | 173,290,670   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |                 |                 |               |
| Depreciation  | 40,904,586                      | 78,370,029      | 99,110,799      | 13,586,872    |
| Share-based compensation cost   | 13,835                          | 101,286,676     | 95,428,175      | 13,082,029    |
| (Reversal)/provision for doubtful debts   | 3,561,765                       | 7,487,619       | (5,334,898)     | (731,349)     |
| Amortization of issuance cost of convertible notes                                | 7,755,532                       | 4,331,016       | —               | —             |
| Loss on disposal of property, equipment and software                              | —                               | 586,254         | 830,169         | 113,806       |
| Write-off of property, equipment and software                                     | —                               | 13,663,387      | —               | —             |
| Unrealized exchange losses  | 8,360,834                       | 584,612         | 50,891,094      | 6,976,543     |
| Share of loss by minority interests   | —                               | (400,046)       | (74,364)        | (10,194)      |
| Net equity share of loss from an associated company                               | —                               | —               | 551,042         | 75,541        |
| Others  | —                               | —               | 278,322         | 38,155        |
| Changes in operating assets and liabilities:                                      |                                 |                 |                 |               |
| Accounts receivable   | (16,888,544)                    | (69,580,977)    | (29,756,151)    | (4,079,203)   |
| Prepayments and other current assets  | (13,134,958)                    | (13,921,921)    | (16,535,099)    | (2,266,755)   |
| Deferred assets   | 326,670                         | —               | —               | —             |
| Deferred tax assets—current   | (19,929,499)                    | (5,744,969)     | (40,112,645)    | (5,498,951)   |
| Deferred tax assets—non-current   | —                               | (5,502,361)     | (13,557,864)    | (1,858,617)   |
| Accounts payable  | 12,823,515                      | 45,117,500      | 945,594         | 129,629       |
| Salary and welfare payables   | 10,355,713                      | 9,411,771       | 13,216,566      | 1,811,829     |
| Taxes payable   | 39,819,520                      | 23,434,362      | (2,750,313)     | (377,034)     |
| Deferred revenue  | 96,774,108                      | 154,049,749     | (30,754,023)    | (4,215,999)   |
| Deferred tax liabilities—current  | 3,940,854                       | (549,100)       | (3,391,754)     | (464,968)     |
| Accrued liabilities   | (1,884,669)                     | 10,707,608      | (3,168,330)     | (434,339)     |
| Net cash provided by operating activities   | 1,104,789,431                   | 1,596,108,793   | 1,379,902,442   | 189,167,665   |
| <b>Cash flows from investing activities</b>                                       |                                 |                 |                 |               |
| Purchase of property, equipment and software                                      | (92,608,975)                    | (142,513,502)   | (71,515,551)    | (9,803,903)   |
| Proceeds from sale of property, equipment and software                            | —                               | 148,076         | 55,675          | 7,632         |
| Prepayment for land use right   | —                               | —               | (26,956,800)    | (3,695,446)   |
| Decrease in held-to-maturity investments  | 165,532,000                     | —               | —               | —             |
| Investment in an associated company   | —                               | —               | (2,500,000)     | (342,719)     |
| Net cash paid upon closure of a variable interest entity                          | —                               | —               | (1,217,831)     | (166,950)     |
| Net change in time deposits with terms of three months                            | (637,492,419)                   | (563,980,613)   | 160,300,370     | 21,975,210    |
| Placement/rollover of matured time deposits                                       | (1,054,979,194)                 | (1,600,926,277) | (636,577,729)   | (87,266,982)  |
| Uplift of matured time deposits   | —                               | 1,125,107,444   | 1,530,798,027   | 209,853,594   |
| Net (increase)/decrease in other assets   | 799,232                         | (36,077,586)    | (87,737)        | (12,028)      |
| Net cash (used in)/provided by investing activities                               | (1,618,749,356)                 | (1,218,242,458) | 952,298,424     | 130,548,408   |
| <b>Cash flows from financing activities:</b>                                      |                                 |                 |                 |               |
| Proceeds from employees exercising stock options                                  | 105,692,433                     | 44,127,417      | 43,232,921      | 5,926,702     |
| Repurchase of company shares  | —                               | (873,406,019)   | (1,003,747,328) | (137,601,421) |
| Decrease in other long-term payable   | (195,067)                       | (177,256)       | (177,256)       | (24,300)      |
| Minority interests  | —                               | 400,046         | 282,162         | 38,681        |
| Net cash (used in)/provided by financing activities                               | 105,497,366                     | (829,055,812)   | (960,409,501)   | (131,660,338) |
| <b>Effect of exchange rate changes on cash held in foreign currencies</b>         | (29,684,897)                    | (28,078,078)    | (95,447,070)    | (13,084,620)  |
| <b>Net increase/(decrease) in cash</b>  | (438,147,456)                   | (479,267,555)   | 1,276,344,295   | 174,971,115   |
| <b>Cash, beginning of the year</b>  | 2,123,891,537                   | 1,685,744,081   | 1,206,476,526   | 165,393,103   |
| <b>Cash, end of the year</b>  | 1,685,744,081                   | 1,206,476,526   | 2,482,820,821   | 340,364,218   |
| <b>Supplemental disclosures of cash flow information:</b>                         |                                 |                 |                 |               |
| Cash paid for income taxes, net of tax refund                                     | 67,993,005                      | 125,238,532     | 71,797,010      | 9,842,488     |
| Interest paid   | 3,230,173                       | —               | —               | —             |
| <b>Supplemental schedule of non-cash investing and financing activities:</b>      |                                 |                 |                 |               |
| Treasury stock cancellation   | —                               | 684,603,920     | 1,192,549,427   | 163,483,868   |
| Fixed asset purchases financed by accounts payable                                | 604,874                         | 20,051,899      | 6,112,886       | 838,002       |
| Conversion of convertible notes to ordinary shares                                | 161,438                         | —               | 92,424,750      | 12,670,297    |

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

[Table of Contents](#)**Notes to the Consolidated Financial Statements**

(Amounts expressed in Renminbi (“RMB”), unless otherwise stated)

**1. Organization and Nature of Operations****(a) The Group**

NetEase.com, Inc. (the “Company”) was incorporated in the Cayman Islands on July 6, 1999. The Company has been listed on the Nasdaq National Market in the United States of America since July 2000. As of December 31, 2007, the Company had eight subsidiaries and three variable interest entities (“VIEs”) for which the Company is the primary beneficiary. The Company, its subsidiaries and VIEs are hereinafter collectively referred to as the “Group” or the “Company”.

Details of the controlled entities and VIEs are described below:

| <u>Name</u>  | <u>Effective interest held</u> | <u>Place and date of incorporation</u>   |
|--|--------------------------------|--|
| <b><i>Controlled entities:</i></b>   |                                |  |
| NetEase Information Technology (Beijing) Co., Ltd. (“NetEase Beijing”)   | 100%                           | Beijing, China<br>August 30, 1999        |
| NetEase Interactive Entertainment Ltd. (“NetEase Interactive”)   | 100%                           | British Virgin Islands<br>April 12, 2002 |
| Guangzhou NetEase Interactive Entertainment Ltd. (“Guangzhou Interactive”)   | 100%                           | Guangzhou, China<br>October 15, 2002     |
| Guangzhou Boguan Telecommunication Technology Ltd. (“Boguan”)  | 100%                           | Guangzhou, China<br>December 8, 2003     |
| NetEase Yodao Information Technology (Beijing) Co., Ltd. (Formerly known as Beijing Hulian Kaiwu Technology Co., Ltd.) (“Yodao Information”) | 73.7%                          | Beijing, China<br>March 21, 2006         |
| NetEase (Hangzhou) Network Co., Ltd. (“NetEase Hangzhou”)  | 100%                           | Hangzhou, China<br>June 2, 2006          |
| Hong Kong NetEase Interactive Entertainment Limited (“Hong Kong NetEase Interactive”)  | 100%                           | Hong Kong, China<br>November 26, 2007    |
| NetEase (Hong Kong) Limited (“NetEase Hong Kong”)  | 100%                           | Hong Kong, China<br>November 26, 2007    |
| <b><i>VIEs:</i></b>  |                                |  |
| Guangzhou NetEase Computer System Co., Ltd. (“Guangzhou NetEase”)  | 100%                           | Guangzhou, China<br>June 24, 1997        |
| Beijing Guangyitong Advertising Co., Ltd. (“Guangyitong Advertising”)  | 100%                           | Beijing, China<br>November 8, 1999       |
| Beijing NetEase Yodao Computer System Co., Ltd. (“Yodao Computer”)   | 73.7%                          | Beijing, China<br>September 4, 2007      |

In September 2007, Guangzhou NetEase and three Chinese citizens incorporated a domestic enterprise, Yodao Computer, for the purpose of applying for an internet content provider license under the applicable Chinese telecommunication laws to operate the Group’s own proprietary internet search engine, Yodao

In November 2007, the Company incorporated two new investment holding companies in Hong Kong, namely Hong Kong NetEase Interactive and NetEase Hong Kong. These new investment holding companies have become the intermediate holding companies of the Company’s various foreign investment enterprises in China.

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**Table of Contents****1. Organization and Nature of Operations (Cont'd)****(a) The Group (Cont'd)**

The Group dissolved two wholly-owned subsidiaries, NetEase (U.S.) Inc. and NetEase Information Technology (Shanghai) Co., Ltd. (NetEase Shanghai) in December 2005 and February 2006, respectively. Guangzhou Ling Yi Electronics Technology Ltd., a VIE of the Group, was dissolved in August 2007.

The Group is principally engaged in developing and providing a range of Internet-related services including online games, advertising and wireless value-added services and others in China. Details of the Group's business are described in Note 1(b).

**(b) Nature of operations**

The industry in which the Group operates is subject to a number of industry-specific risk factors, including, but not limited to, rapidly changing technologies; stringent rules imposed by the mobile operators; significant numbers of new entrants; dependence on key individuals; competition of similar services from larger companies; customer preferences; and the need for the continued successful development, marketing and selling of its services.

The Group is currently targeting the Chinese market. The Chinese government regulates Internet access, telecommunications services, the distribution of news and other information and the provision of commerce through strict business licensing requirements and other governmental regulations, which include, among others, those restricting foreign ownership in Chinese companies providing Internet advertising and other Internet or telecommunications value-added services. To comply with the existing Chinese laws and regulations, the Company and certain of its subsidiaries have entered into a series of contractual arrangements with certain VIEs (see Note 2(a)) with respect to the operation of the NetEase websites in connection with the provision of online games, Internet content and wireless value-added services, as well as the provision of advertising services. The revenue earned by the VIEs largely flows through to the Company and its subsidiaries pursuant to the series of contractual arrangements. Based on these agreements, NetEase Beijing, Guangzhou Interactive, Boguan and NetEase Hangzhou provide technical consulting and related services to the VIEs. Guangzhou NetEase, Guangyitong Advertising, and Ling Yi (dissolved in August 2007) are legally owned by two citizens of China, one of whom is the principal shareholder of the Company and the other is his brother. Management believes that the Group's present operations are structured to comply with Chinese law. However, many Chinese regulations are subject to extensive interpretive powers of governmental agencies and commissions. The Group cannot be certain that the Chinese government will not take action to prohibit or restrict its business activities. Future changes in Chinese government policies affecting the provision of information services, including the provision of online services, Internet access, e-commerce services and online advertising, may impose additional regulatory requirements on the Group or its service providers or otherwise harm its business.

**2. Principal Accounting Policies****(a) Basis of consolidation**

The consolidated financial statements include the financial statements of the Company, its subsidiaries and VIEs for which the Company is the primary beneficiary with the ownership interests of minority investors reported as minority interests. All significant transactions and balances among the Company, its subsidiaries and VIEs have been eliminated upon consolidation. On January 1, 2004, the Company adopted Financial Accounting Standards Board ("FASB") Interpretation No. 46: "Consolidation of Variable Interest Entities, an interpretation of ARB 51" ("FIN 46"), which was further revised in December 2003 ("FIN 46-R"). FIN 46-R requires a Company to consolidate a VIE if that Company will absorb a majority of the entities' expected losses, receive a majority of the entity's expected residual returns, or both.

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**Table of Contents****2. Principal Accounting Policies (Cont'd)****(b) Basis of presentation**

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("US GAAP"). The consolidated financial statements are prepared based on the historical cost convention. This basis of accounting differs from that used in the statutory accounts of the Company's controlled entities and VIEs incorporated in China, which are prepared in accordance with accounting principles and the relevant financial regulations applicable to enterprises established in China ("PRC GAAP").

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the balance sheet dates and the reported amounts of revenues and expenses during the reporting periods. Actual results might differ from those estimates.

**(c) Revenue recognition**

The Group recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collectibility is reasonably assured.

Revenues presented in the consolidated statements of operations and comprehensive income represent revenues from online game services, advertising services and wireless value-added services and others recognized by Guangzhou NetEase, Guangyitong Advertising and Ling Yi net of sales discount.

**(i) Online game services**

The Group sells prepaid point cards through Guangzhou NetEase to the end user. Customers can purchase physical prepaid point cards in different locations in China, including Internet cafés, software stores, convenience stores and bookstores. Customers can also purchase "virtual" prepaid points from vendors who register the points in the Group's system and "virtual" prepaid cards online via debit cards or bank transfers, and receive the prepaid point information over the Internet. Customers can use the points to play the Group's online games and use other fee-based services. The Group recognizes the related revenue when the registered points are consumed for online game services and the usage of other fee-based services. The Group effectively charges players according to their playtime of the online games and usage of the fee-based services.

**(ii) Advertising services**

The Group derives its advertising revenues principally from short-term advertising contracts. With respect to the advertising contracts that do not include a fixed delivery pattern for the advertising services, recognition of revenues is deferred until completion of the contracts. For the advertising contracts with a fixed delivery pattern, revenues are recognized ratably over the period in which the advertisement is displayed and only if collection of the resulting receivables is probable. The Group's obligations may also include guarantees of a minimum number of impressions or times that an advertisement appears in pages viewed by users. To the extent that minimum guaranteed impressions are not met within the contractual time period, the Group defers recognition of the corresponding revenues until the remaining guaranteed impression levels are achieved. In addition, Guangyitong Advertising occasionally enters into "cost per action" ("CPA") advertising contracts and receives fees when an online user performs a specific action such as purchasing a product from or registering with the advertiser. Revenue for CPA contracts is recognized when the specific action is completed.

The Group has adopted the consensus reached in Emerging Issue Task Force ("EITF") 99-17 to account for barter transactions. According to EITF 99-17, revenue and expense should be recognized at fair value from a barter transaction involving advertising services provided by the Group only if the fair value of the advertising services surrendered in the transaction is determinable based on the entity's own historical practice of receiving



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**Table of Contents****2. Principal Accounting Policies (Cont'd)****(c) Revenue recognition (Cont'd)****(ii) Advertising services (Cont'd)**

cash, marketable securities, or other consideration that is readily convertible to a known amount of cash for similar advertising from buyers unrelated to the counterparty in the barter transaction. For the years ended December 31, 2005, 2006 and 2007, the recognized revenues and expenses derived from barter transactions were approximately RMB50,000, RMB nil and RMB nil, respectively. For the years ended December 31, 2005, 2006 and 2007, the Group also engaged in certain advertising barter transactions for which the fair value was not determinable within the limits of EITF 99-17 and therefore no revenues or expenses derived from these barter transactions were recognized. These transactions primarily involved exchanges of advertising services rendered by the Group for advertising, promotional benefits, information content, consulting services and software provided by the counterparties.

**(iii) Wireless value-added services and others**

A substantial portion of the Group's revenue from wireless value-added services ("WVAS") is predominantly derived from activities related to short messaging services ("SMS") and non-SMS services such as multimedia messaging, wireless application protocol and interactive voice response services. The Group derives WVAS revenues principally from providing value-added services such as friends matching, news and information services, ring-tone and logo downloads and various other related products to mobile phone users under co-operative arrangements with mobile phone operators. WVAS revenues recognized by the Group represent its share of the revenues under these co-operative arrangements net of the amounts retained by the mobile phone operators for their services performed. The Group recognizes revenue under these co-operative arrangements in the month in which the services are performed based on the monthly confirmation from the mobile phone operators for the service period when the message, content or service is delivered. Where a confirmation has not been received from a mobile phone operator, the Group estimates the revenue, as well as the amounts of billing and transmission failures, applicable to the services provided through that operator and recognizes the estimated revenue net of estimated billing and transmission failures.

Other fee-based premium services revenues are derived principally from providing premium e-mail, friends matching and dating services and photo services, which are all operated on a monthly subscription basis. Prepaid subscription revenues are deferred and are recognized by the Group on a straight-line basis over the period in which the services are provided.

**(d) Cost of revenues**

Costs of online game services, advertising services and wireless value-added services and others consist primarily of staff costs of those departments directly involved in providing such services, depreciation and amortization of computers and software, server custody fees, bandwidth, business tax paid by the Company and its subsidiaries on intra-group revenues from the VIEs and other direct costs of providing these services. These costs are charged to the consolidated statements of operations and comprehensive income as incurred.

**(e) Research and development costs**

The Group recognizes costs to develop its online game products in accordance with Statement of Financial Accounting Standards ("SFAS") No. 86, "Accounting for Costs of Computer Software to be Sold, Leased or Otherwise Marketed". Costs incurred for the development of online game products prior to the establishment of technological feasibility are expensed when incurred. Once an online game has reached technological feasibility with a proven ability to operate in the Chinese market, all subsequent online game development costs are capitalized until that game is marketed. Technical feasibility is evaluated on a product-by-product basis, but

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**Table of Contents****2. Principal Accounting Policies (Cont'd)****(e) Research and development costs (Cont'd)**

typically encompasses both technical design and game design documentation. For the years ended December 31, 2005, 2006 and 2007, the cost incurred for development of on-line game products was not capitalized because of the uncertainty in technological feasibility.

The Group recognizes website and internally used software development costs in accordance with Statement of Position ("SOP") No. 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use". Accordingly, the Group expenses all costs that are incurred in connection with the planning and implementation phases of development and costs that are associated with repair or maintenance of the existing websites and software. Direct costs incurred to develop the software during the application development stage that can provide future benefits are capitalized.

**(f) Cash and time deposits**

Cash represents cash on hand and demand deposits placed with large reputable commercial banks or financial institutions in China and Hong Kong with terms less than three months. As of December 31, 2006, there were demand deposits with terms of less than three months denominated in US dollars and Hong Kong dollars amounting to US\$67.2 million and HK\$3.0 million, respectively (equivalent to approximately RMB490.5 million and RMB2.8 million, respectively). As of December 31, 2007, there were demand deposits with terms of less than three months denominated in US dollars and HK dollars amounting to US\$265.6 million and approximately HK\$17,000, respectively (equivalent to approximately RMB1.9 billion and RMB16,000, respectively).

Time deposits represent time deposits placed with banks with original maturities of three months or more. There were no foreign currency time deposits held by the Company as of December 31, 2006. As of December 31, 2007, there were time deposits denominated in US dollars amounting to US\$0.4 million (equivalent to approximately RMB2.6 million).

As of December 31, 2006, the Company had a lien in an amount of US\$50,000 on its deposit balance with respect to its corporate credit card servicing agreement with a commercial bank in Hong Kong. The lien was cancelled as a result of the Company's termination of the corporate credit card servicing agreement with the commercial bank in December 2007.

**(g) Financial instruments**

The Group's financial instruments, including cash and time deposits with maturity terms no longer than one year, accounts receivable and accounts payable, are carried at cost as of the balance sheet dates. The carrying values approximate their fair values due to the short maturity of these instruments.

Investment in unlisted debt securities is classified as available-for-sale, included in other long-term assets and reported at fair value using the specific identification method. Unrealized gains and losses are excluded from earnings and reported as a component of other comprehensive income (loss), net of related estimated tax provisions or benefits. The Company assesses its available-for-sale investments for other-than-temporary impairment by considering factors including, but not limited to, current economic and market conditions, the operating performance of the companies including current earnings trends and undiscounted cash flows and other company-specific information. The valuation process is based on information that the Company receives from the privately-held company. This information is not subject to the same disclosure requirements as U.S. publicly traded companies, and as such, the basis for valuation is subject to the timing and the accuracy of the data received from this company. A decline in fair value that is considered other-than-temporary is recorded as an impairment of investment in the consolidated statements of operations and comprehensive income.

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### **2. Principal Accounting Policies (Cont'd)**

#### **(h) Investment in an associated company**

Investment in an associated company is accounted for under the equity accounting method and is included in other long-term assets on the consolidated balance sheets.

#### **(i) Property, equipment and software**

Property, equipment and software are stated at cost less accumulated depreciation. Depreciation is calculated on the straight-line basis over the following estimated useful lives, taking into account any estimated residual value:

|  |  |
|--|--|
| Building                                 | 15 years   |
| Leasehold improvements                   | lesser of the term of the lease and the estimated useful lives of the assets |
| Furniture, fixtures and office equipment | 5-10 years   |
| Vehicles                                 | 5 years  |
| Computers                                | 3 years  |
| Software                                 | 2-3 years  |

Costs associated with the Company's current project for the construction of a research and development center in Hangzhou are capitalized in construction in progress to the extent they are incurred for the purposes of bringing the construction development to a usable state.

Repairs and maintenance expenditures, which are not considered improvement and do not extend the useful life of the property and equipment, are expensed as incurred.

When the Company retires or disposes its property, equipment and software, it records any gain or loss arising from the retirement or disposal under Other, net in its consolidated statements of operations and comprehensive income.

#### **(j) Advertising expenses**

The Group recognizes advertising expenses in accordance with AICPA SOP 93-7 "Reporting on Advertising Costs". As such, the Group expenses the costs of producing advertisements at the time production occurs, and expenses the cost of communicating advertising in the period in which the advertising space or airtime is used. Advertising expenses totaled approximately RMB35.3 million, RMB20.7 million and RMB52.1 million for the years ended December 31, 2005, 2006 and 2007, respectively.

#### **(k) Foreign currency translation**

The functional currency of the Group is RMB. Transactions denominated in currencies other than RMB are translated into RMB at the exchange rates quoted by the People's Bank of China (the "PBOC") prevailing at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are translated into RMB using the applicable exchange rates quoted by the PBOC at the balance sheet dates. The resulting exchange differences are included in the consolidated statements of operations and comprehensive income.

The financial records of one of the Company's previously owned subsidiary were maintained in US dollars, which was its functional currency. For consolidation purposes, the assets and liabilities of such entity were translated at the exchange rates at the balance sheet dates, equity accounts were translated at historical exchange rates and revenues, expenses, gains and losses were translated using the average exchange rate for the year. Translation adjustments were reported as cumulative translation adjustments and were shown as a separate component of the accumulated other comprehensive income in the consolidated statements of shareholders' equity. The cumulative translation adjustments of RMB210,838 were charged to the consolidated statements of operations and comprehensive income upon the dissolution of that subsidiary in 2006.

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**Table of Contents****2. Principal Accounting Policies (Cont'd)****(k) Foreign currency translation (Cont'd)**

Translations of amounts from RMB into United States dollars for the convenience of the reader were calculated at the noon buying rate of US\$1.00 = RMB7.2946 on December 31, 2007 in The City of New York for cable transfers of RMB as certified for customs purposes by the Federal Reserve Bank of New York. No representation is made that the RMB amounts could have been, or could be, converted into United States dollars at such rate.

**(l) Stock-based compensation**

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123 (revised 2004), "Stock-Based Payment" ("SFAS 123R"), which revises SFAS 123, "Accounting-Based Compensation" ("SFAS 123") and supersedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). Under the fair value recognition provisions of SFAS 123R, the Company is required to measure the cost of employee services received in exchange for stock-based compensation measured at the grant date fair value of the award.

The Company recognizes the stock-based compensation costs, net of a forfeiture rate, on a straight-line basis over the requisite service period of the award, which is the vesting term (generally three to four years for stock options). In March 2005, the Securities & Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123R. The Company has applied the provisions of SAB 107 in its adoption of SFAS 123R.

The Company adopted the Black-Scholes option pricing model to determine the fair value of stock options under SFAS 123R. The Company elected to implement SFAS 123R using the modified-prospective method, with no restatement of prior results. Under the modified prospective method, the valuation provisions of SFAS 123R applied to new grants and to grants that were outstanding as of the effective date. Estimated compensation expense for grants that were outstanding as of the effective date is recognized over the remaining service period using the compensation cost estimated for the SFAS 123 pro forma disclosures.

SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on the Company's historical experience over the last five years. Differences between actual and estimated forfeitures are expensed in the period that the differences occur. Prior to the adoption of SFAS 123R, the Company accounted for forfeitures as they occurred. See Note 16 for further information regarding stock-based compensation assumptions and expense, including pro forma disclosures for the year ended December 31, 2005.

**(m) Taxation**

Deferred income taxes are provided using the balance sheet liability method. Under this method, deferred income taxes are recognized for the tax consequences of significant temporary differences by applying enacted statutory rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided to reduce the amount of deferred tax assets if it is considered more likely than not that some portion of, or all of, the deferred tax assets will not be realized.

The Company adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109" ("FIN 48"), on January 1, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in the Company's financial statements in accordance with FASB Statement 109, "Accounting for Income Taxes", and prescribes a more likely than not threshold for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also

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**Table of Contents****2. Principal Accounting Policies (Cont'd)**  
**(m) Taxation (Cont'd)**

provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, accounting for income taxes in interim periods, and income tax disclosures. The Company did not have any adjustment to the opening balance of retained earnings as of January 1, 2007, as a result of the implementation of FIN 48. As of December 31, 2007, the Company did not have any significant unrecognized uncertain tax positions. For the year ended December 31, 2007, the Company did not incur any interest and penalties associated with tax positions.

The Company classifies deferred tax liabilities and assets into current and non-current based on the classification of the related asset or liability for financial reporting. A deferred tax liability or asset that is not related to an asset or liability for financial reporting, including deferred tax assets related to tax loss carryforwards, shall be classified according to the expected reversal date of the temporary difference pursuant to SFAS No. 37, "Balance Sheet Classification of Deferred Income Taxes". The valuation allowance for a particular tax jurisdiction is allocated between current and non-current deferred tax assets for that tax jurisdiction on a pro rata basis. For a particular tax-paying component of an enterprise and within a particular tax jurisdiction, (a) all current deferred tax liabilities and assets are offset and presented as a single amount and (b) all non-current deferred tax liabilities and assets are offset and presented as a single amount. The Company does not offset deferred tax liabilities and assets attributable to different tax-paying components of the enterprise or to different tax jurisdictions.

**(n) Net earnings per share ("EPS") and per American Depositary Share ("ADS")**

In accordance with SFAS No. 128, "Computation of Earnings Per Share," basic EPS is computed by dividing net profit attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the year. Diluted EPS is calculated using the weighted average number of ordinary and dilutive ordinary equivalent shares outstanding during the year. Ordinary equivalent shares consist of the ordinary shares issuable upon conversion of the Convertible Notes (using the if-converted method) and ordinary shares issuable upon the exercise of outstanding stock options (using the treasury stock method).

Effective from March 27, 2006, the Company changed its ADS to ordinary share ratio from the one ADS for every 100 ordinary shares to one ADS for every 25 ordinary shares. Therefore, the basic and diluted earnings per ADS as well as the basic and diluted weighted average number of ADS outstanding for the year ended December 31, 2005 have been retrospectively restated.

When calculating the fully diluted earnings per ADS for the years ended December 31, 2005, 2006 and 2007, the Company adopted the consensus reached on EITF Issue No. 04-08, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share". EITF 04-08 is applicable to the Company because the conversion of its Convertible Notes depends on, among other things, whether the market price of the Company's ADS exceeds a pre-scripted conversion price. Application of the consensus requires the dilutive impact of the Convertible Notes to be included in the calculation of diluted earnings per share, notwithstanding whether the Company's market prices of the Company's ADS exceeds the pre-scripted conversion price of the Convertible Notes.

**(o) Statutory reserves**

The Company's subsidiaries and VIEs incorporated in China are required to make appropriations to certain non-distributable statutory reserves. In accordance with the laws applicable to China's Foreign Investment Enterprises, its subsidiaries have to make appropriations from its after-tax profit as reported in their PRC Statutory Accounts to non-distributable statutory reserves including (i) general reserve fund, (ii) enterprise expansion fund and (iii) staff bonus and welfare fund. The appropriation to the general reserve fund is at least 10% of the after-tax profits as reported in the PRC Statutory Accounts. Appropriation is not required if the reserve fund has reached 50% of the registered capital of the respective company. The appropriation to the other

**Table of Contents****2. Principal Accounting Policies (Cont'd)****(o) Statutory reserves (Cont'd)**

two reserve funds is at the discretion of the board of directors of the respective company. At the same time, the Company's VIEs, in accordance with the China Company Laws, must make appropriations from its after-tax profit as reported in their PRC Statutory Accounts to non-distributable statutory reserves including (i) statutory surplus fund, (ii) statutory public welfare fund and (iii) discretionary surplus fund. The appropriation to the statutory surplus fund is at least 10% of the after-tax profits as reported in their PRC Statutory Accounts. Appropriation is not required if the statutory surplus fund has reached 50% of the registered capital of the respective company. Appropriation to the statutory public welfare fund is 5% to 10% of the after-tax profits as reported in their PRC Statutory Accounts. Under the revised China Company Laws effective January 1, 2006, appropriation to the statutory public welfare fund is no longer mandatory. Appropriation to the discretionary surplus fund is made at the discretion of the board of directors of the respective companies.

The general reserve fund and statutory surplus fund are restricted for set off against losses, expansion of production and operation or increase in the registered capital of the respective companies. The enterprise expansion fund can be used to expand production or to increase capital. The staff bonus and welfare fund are available to fund payments of special bonuses to staff and for collective welfare benefits. The statutory public welfare fund is restricted for the capital expenditures for the collective welfare of employees. Upon approval by the Board of Directors, the discretionary surplus can be used to offset accumulated losses or to increase capital.

The staff bonus and welfare fund is a liability in nature. The other statutory reserves are not transferable to the Company in the form of cash dividends, loans or advances, and therefore, are not available for distribution except in liquidation.

The Company's subsidiaries and VIEs incorporated in China did not make appropriation to enterprise expansion fund, staff bonus and welfare fund, statutory public welfare fund or discretionary surplus fund for the years ended December 31, 2005, 2006 and 2007.

The following table presents the Group's appropriations to general reserve fund and statutory surplus fund for the years ended December 31, 2005, 2006 and 2007:

|                   | For the year ended December 31, |              |              |
|-------------------|---------------------------------|--------------|--------------|
|                   | 2005                            | 2006         | 2007         |
|                   | RMB                             | RMB          | RMB          |
|                   | (in million)                    | (in million) | (in million) |
| NetEase Beijing   | 44.4                            | 23.6         | —            |
| Boguan            | —                               | 2.1          | —            |
| Guangzhou NetEase | —                               | 2.2          | 0.9          |
| NetEase Hangzhou  | —                               | —            | 4.7          |
|                   | <u>44.4</u>                     | <u>27.9</u>  | <u>5.6</u>   |

For the year ended December 31, 2007, NetEase Beijing, Guangzhou Interactive and Boguan did not make appropriations to statutory reserves as their cumulative appropriations in the past have already reached the statutory limit, namely 50% of the registered capital of the respective companies. The Company's other controlled entities and VIEs incorporated in China did not make appropriations to statutory reserves for the years ended December 31, 2005, 2006 and 2007 as a result of their respective accumulated loss position.

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**Table of Contents****2. Principal Accounting Policies (Cont'd)****(p) Related parties**

Parties are considered to be related if one party has the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or significant influence.

**(q) Comprehensive income**

Comprehensive income is defined as the change in equity of the Company during a period arising from transactions and other events and circumstances excluding transactions resulting from investments by shareholders and distributions to shareholders.

There was no income tax expense/benefit associated with the reported component of other comprehensive income for the years ended December 31, 2005, 2006 and 2007.

**(r) Segment reporting**

SFAS No. 131 "Disclosures about Segments of an Enterprise and Related Information" ("SFAS 131"), establishes standards for reporting information about operating segments on a basis consistent with the Group's internal organizational structure as well as information about geographical areas, business segments and major customers in financial statements (see Note 20) for details on the Group's business segments.

**(s) Recently issued accounting pronouncements**

In December 2007, the SEC issued Staff Accounting Bulletin No. 110 ("SAB 110"), codified as SAB Topic 14, "Share-based payment." SAB No. 110 states that the SEC staff will continue to accept, under certain circumstances, the use of the simplified method in developing an estimate of expected term of "plain vanilla" share options in accordance with SFAS No. 123 (revised 2004 and SAB No. 107 beyond December 31, 2007). The adoption of SAB No. 110 did not require any adjustments to the Group's consolidated financial statements for the year ended December 31, 2007.

In September 2006, FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The Company will adopt SFAS 157 at the beginning of its fiscal year 2008, and it does not expect the adoption of SFAS No 157 will have a material impact on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115" ("SFAS 159"). This standard permits an entity to choose to measure many financial instruments and certain other items at fair value. Most of the provisions in SFAS 159 are elective; however, the amendment to FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities," applies to all entities with available-for-sale and trading securities. Under SFAS 159, all entities are allowed to choose to measure eligible items at fair value at specified election dates. A business entity will report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option (a) may be applied instrument by instrument, with a few exceptions, such as investments otherwise accounted for by the equity method, (b) is irrevocable (unless a new election date occurs), and (c) is applied only to the entire arrangement and not to a portion of an instrument. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The Company will adopt SFAS 159 at the beginning of its fiscal year 2008 and will not make any elections for fair value accounting. Therefore, the Company will not be recording a cumulative-effect adjustment to its opening retained earnings balance.



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**Table of Contents****2. Principal Accounting Policies (Cont'd)****(s) Recently issued accounting pronouncements (Cont'd)**

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" ("SFAS 141R"). This statement establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statement to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for fiscal years beginning after December 15, 2008. Adoption is prospective and early adoption is not permitted. Accordingly, any business combinations the Company engages in will be recorded and disclosed following existing US GAAP until January 1, 2009. Adoption of SFAS 141R will not impact the Company's accounting for business combinations closed prior to its adoption, but given the nature of the changes noted above, the Company is currently assessing the potential impact of SFAS 141R on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51" ("SFAS 160"). This Statement amends Accounting Research Bulletin No. 51, Consolidated Financial Statements, to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. It requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. This statement establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation. SFAS 160 is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the impact of SFAS 160 on its consolidated financial position, results of operations and cash flows.

In May 2008, the FASB issued FASB Staff Position No. APB 14-1 ("FSP"), which clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants". Additionally, this FSP specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. This FSP applies to convertible debt instruments that, by their stated terms, may be settled in cash, including partial cash settlement, unless the embedded conversion option is required to be separately accounted for as a derivative under FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities". This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The Company is currently evaluating the impact of this FSP on its consolidated financial statements.

**3. Concentrations****(a) Bandwidth and server custody service provider**

The Group relies on two telecommunications service providers and their affiliates for bandwidth and server custody service.

**(b) Credit risk**

Accounts receivable are typically unsecured and are generally derived from revenue earned from advertising services.

**Table of Contents****3. Concentrations (Cont'd)****(b) Credit risk (Cont'd)**

The Group's significant customers with a receivable balance exceeding 10% of the total accounts receivable balance as of December 31, 2006 and 2007 were as follows:

|            | <u>December 31,<br/>2006</u> | <u>December 31,<br/>2007</u> |
|------------|------------------------------|------------------------------|
| Customer A | 12.4%                        | —                            |
| Customer B | 12.6%                        | —                            |
| Customer C | 10.2%                        | 10.4%                        |

With respect to the account receivable balances of the above-mentioned significant customers, the Company set up an allowance for doubtful accounts totaling RMB5.6 million and approximately RMB40,000 as of December 31, 2006 and 2007, respectively.

**(c) Major Customers**

No single customer represented 10% or more of the Company's total revenues for the years ended December 31, 2005, 2006 and 2007.

**4. Allowance for Doubtful Accounts**

The following table sets out the movements of the allowance for doubtful accounts for the years ended December 31, 2006 and 2007:

|      | <u>Balance at<br/>January 1<br/>RMB</u> | <u>Charged to<br/>(write-back<br/>against) cost<br/>and expenses<br/>RMB</u> | <u>Write-off of<br/>receivable<br/>balances and<br/>corresponding<br/>provisions<br/>RMB</u> | <u>Balance at<br/>December 31<br/>RMB</u> |
|------|---|--|--|---|
| 2006 | 21,673,437                              | 7,487,619  | (5,093,832)  | 24,067,224                                |
| 2007 | 24,067,224                              | (5,334,898)  | (6,099,416)  | 12,632,910                                |

**5. Prepayments and Other Current Assets**

The following is a summary of prepayments and other current assets:

|                              | <u>December 31,<br/>2006<br/>RMB</u> | <u>December 31,<br/>2007<br/>RMB</u> |
|------------------------------|--------------------------------------|--------------------------------------|
| Interest receivable          | 14,964,930                           | 8,517,856                            |
| Prepayments                  | 9,408,228                            | 26,759,129                           |
| Employee advances            | 4,797,095                            | 3,389,976                            |
| Consumables                  | 2,036,301                            | 1,201,133                            |
| Security and rental deposits | 1,321,780                            | 2,960,514                            |
| Other                        | 1,385,016                            | 2,315,120                            |
|                              | <u>33,913,350</u>                    | <u>45,143,728</u>                    |

In connection with the Company's expressed intent to purchase an office building in Guangzhou, China (see Note 6), the Company paid the third party developer company an amount of RMB5.2 million during the first quarter of 2007 and recorded the payment under prepayments and other current assets in its consolidated balance sheets.

[Table of Contents](#)**5. Prepayments and Other Current Assets (Cont'd)**

The amount of employee advances listed above included staff housing loan balances of RMB0.7 million and RMB2.2 million repayable within 12 months from December 31, 2006 and 2007, respectively (see Note 8).

No advances were made directly or indirectly to the Company's executive officers for their personal benefit for the years ended December 31, 2006 and 2007.

**6. Property, Equipment and Software**

The following is a summary of property, equipment and software:

|  | December 31,<br>2006 | December 31,<br>2007 |
|--|----------------------|----------------------|
|  | RMB                  | RMB                  |
| Building                                 | 6,800,000            | 6,800,000            |
| Leasehold improvements                   | 64,679,489           | 66,425,573           |
| Furniture, fixtures and office equipment | 20,805,941           | 24,005,783           |
| Vehicles                                 | 1,919,384            | 2,109,341            |
| Computers                                | 301,740,167          | 334,952,146          |
| Software                                 | 24,487,113           | 25,455,213           |
| Construction in progress                 | —                    | 3,479,318            |
|  | 420,432,094          | 463,227,374          |
| Less: Accumulated depreciation           | (196,224,261)        | (279,755,708)        |
| Net book value                           | 224,207,833          | 183,471,666          |

Depreciation expense was RMB40.9 million, RMB78.4 million and RMB99.1 million for the years ended 2005, 2006 and 2007, respectively. The Company has entered into certain operating lease agreements for the purpose of leasing office machines with terms ranging from one to three years since 2006. Total lease payments for office machines amounted to approximately RMB0.1 million for the year ended December 31, 2007. The Company recorded an insignificant amount of rental expense for office machines for the year ended December 31, 2006.

The Company occupies a building in Guangzhou, China with a floor space of approximately 20,000 square meters. The building has been developed by a third party property developer company. Currently the developer is still awaiting the local government authorities to complete the necessary legal and administrative procedures before it could obtain the title certificate from the relevant local government land office. William Ding, the Company's Chief Executive Officer, director and major shareholder, has agreed to indemnify the Company for any losses or expenses it may incur due to the absence of the title. As of December 31, 2007, the Company has not yet signed any agreement for the purchase of the building with the developer. From the date the Company commenced occupying the property in July 2006 till present, the developer has not demanded, and the Company has not paid, any rent for the use of this property. The Company reported imputed rent (based on the prevailing market rental) in the amount of approximately RMB3.7 million and RMB9.4 million under general and administrative expenses in its consolidated statements of operations and comprehensive income for the years ended December 31, 2006 and 2007, respectively, even though it had no legal obligation to pay such rent. The provision of the imputed rent was reported under accounts payable in the Company's consolidated balance sheets.

The Company is currently constructing a new research and development center in Hangzhou, China. As of December 31, 2007, the Company capitalized professional service fees totaling RMB3.5 million in connection with the construction project and reported the costs as construction in progress.

**Table of Contents****7. Prepayment for land use right**

In connection with the construction of a new research and development center in Hangzhou, China, the Company recorded a payment of RMB27.0 million for the land use right for the land on which the building will be constructed and reported it as prepayment for land use right in the consolidated balance sheets. Amortization of the prepayment for the land use right will be made over the remaining term of the land use right period of 50 years and is expected to begin in 2008 as and when the Company obtains the land use permit from the local authorities.

**8. Other Long-term Assets**

The following is a summary of other long-term assets:

|                                     | <u>December 31,<br/>2006</u> | <u>December 31,<br/>2007</u> |
|-------------------------------------|------------------------------|------------------------------|
|                                     | <u>RMB</u>                   | <u>RMB</u>                   |
| Investment in an associated company | —                            | 1,948,958                    |
| Available-for-sale investment       | 7,804,100                    | 8,626,900                    |
| Staff housing loans                 | <u>3,654,397</u>             | <u>6,268,541</u>             |
|                                     | <u>11,458,497</u>            | <u>16,844,399</u>            |

During August 2007, Guangzhou NetEase contributed RMB2.5 million to participate in a venture with certain Chinese citizens in the formation of a domestic limited company, known as Shenzhen Shangyoo Network Technology Limited (“Shangyoo”), located in Shenzhen, China. As a result of making this investment, representing an equity share of 25% in Shangyoo, the Company reported a net equity share of loss from Shangyoo of approximately RMB0.6 million in its consolidated statements of operations and comprehensive income for the year ended December 31, 2007.

During February 2006, the Company acquired at par value of US\$1 million interest-bearing convertible notes (“the notes”) issued by a privately-held enterprise. The notes maturing on February 10, 2010 bear interest at the United States federal funds rate payable annually. The notes are classified as available-for-sale investments. The fair value of the notes was approximately RMB7.8 million and RMB8.6 million as of December 31, 2006 and 2007, respectively. As a result, the Company recorded unrealized gains of RMB nil and RMB1.3 million associated with the investment as part of its comprehensive income for the years ended December 31, 2006 and 2007, respectively.

The staff housing loans primarily represent loans that were granted to the Company’s employees (excluding executive officers) for house purchases via a third-party commercial bank in China. The Company extended housing loans to its employees totaling RMB4.7 million and RMB5.3 million for the years ended December 31, 2006 and 2007, respectively. Individual staff housing loan is secured either by the property for which the loan is extended or by approved personal guarantees for the loan amount granted. The repayment term ranges between two to five years from the date of drawdown. The interest rate was 2.25% and 3.6% per annum for the years ended December 31, 2006 and 2007, respectively.

The current portion of the staff housing loans amounted to RMB0.7 million and RMB2.2 million repayable within 12 months from December 31, 2006 and 2007, respectively, are reported under prepayments and other current assets in the consolidated balance sheets (see Note 5).

**9. Employee Benefits**

The Company’s subsidiaries and VIEs incorporated in China participate in a government-mandated multi-employer defined contribution plan pursuant to which certain retirement, medical, housing and other welfare benefits are provided to employees. Chinese labor regulations require the Company’s Chinese subsidiaries and

[Table of Contents](#)**9. Employee Benefits (Cont'd)**

VIEs to pay to the local labor bureau a monthly contribution at a stated contribution rate based on the monthly basic compensation of qualified employees. The relevant local labor bureau is responsible for meeting all retirement benefit obligations, hence, the Company has no further commitments beyond its monthly contribution.

The following table presents the Group's employee welfare benefits for the years ended December 31, 2005, 2006 and 2007:

|  | For the year ended December 31 |               |               |
|--|--------------------------------|---------------|---------------|
|  | 2005                           | 2006          | 2007          |
|  | RMB                            | RMB           | RMB           |
| (in millions)                                | (in millions)                  | (in millions) | (in millions) |
| Contributions to medical and pension schemes | 21.7                           | 30.1          | 36.8          |
| Other employee benefits                      | 8.4                            | 12.2          | 17.6          |
|  | <u>30.1</u>                    | <u>42.3</u>   | <u>54.4</u>   |

**10. Taxation****(a) Income taxes***Cayman Islands*

Under the current laws of the Cayman Islands, the Company is not subject to tax on income or capital gain. Additionally, upon payments of dividends by the Company to its shareholders, no Cayman Islands withholding tax will be imposed.

*British Virgin Islands ("BVI")*

NetEase Interactive is exempted from income tax on its foreign-derived income in the BVI. There are no withholding taxes in the BVI.

*Hong Kong*

Hong Kong NetEase Interactive and NetEase Hong Kong are subject to 17.5% income tax on their taxable income generated from operation in Hong Kong. The payment of dividends by Hong Kong NetEase Interactive and NetEase Hong Kong to the Company are not subject to any Hong Kong withholding tax.

*China*

In accordance with the "Income Tax Law of China for Enterprises with Foreign Investment and Foreign Enterprises" and local income tax laws prevailing prior to January 1, 2008, foreign invested enterprises were generally subject to a national and local enterprise income tax ("EIT") at the statutory rates of 30% and 3%, respectively.

On March 16, 2007, the National People's Congress of PRC enacted a new tax law, under which Foreign Investment Enterprises ("FIEs") and domestic companies would be subject to EIT at a uniform rate of 25%. Preferential tax treatments will continue to be granted to entities which conduct businesses in certain encouraged sectors and to entities otherwise classified as "Software Enterprises" and/or "High and New Technology Enterprises", whether FIEs or domestic companies. The new tax law became effective on January 1, 2008.

The new tax law provides a five-year transition period for certain entities that enjoyed a favorable income tax rate of less than 25% under the previous Income Tax Law and was established before March 16, 2007, to gradually increase their rates to 25% over five years. In addition, the new tax law provides grandfather treatment for High and New Technology Enterprises that received special tax holidays under the old Income Tax Law to continue to enjoy their tax holidays until expiration.

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**Table of Contents****10. Taxation (Cont'd)****(a) Income taxes (Cont'd)**

As of December 31, 2007, the new tax law, however, does not define “High and New Technology Enterprises Strongly Supported by the State”, nor does it specify which encouraged sectors will be eligible for preferential tax treatments. Because the detailed implementing rules for the new tax law have not yet been promulgated, it is not certain, and the Company will continue to assess whether the subsidiary or the VIEs will be classified as “High and New Technology Enterprises Strongly Supported by the State” or an enterprise that conducts business in encouraged sectors, and be entitled to the preferential EIT rate of 15% after the five years transition period expires. The Company will continue to assess the tax implication of the new tax law. As of December 31, 2007, the Company is required under applicable accounting standards to report its deferred tax assets at the new statutory income tax rate of 25% except for certain entities which are still under tax holiday.

NetEase Beijing, being a foreign invested enterprise and located in the New Technology Industrial Development Experimental Zone in Beijing, has been recognized as a “High and New Technology Enterprise”. According to an approval granted by the Haidian State Tax Bureau in November 2000, NetEase Beijing is entitled to a reduced EIT rate of 15% commencing from year 2000. In addition, the approval also granted NetEase Beijing with a full exemption from EIT from 2000 to 2002, a 50% reduction in EIT from 2003 to 2005, and a full exemption from the local income tax from 2000 onwards. Consequently, NetEase Beijing was exempted from EIT and local income tax for the years ended December 31, 2000 to 2002, and enjoyed a 50% reduction in EIT for each of the years ended December 31, 2003, 2004 and 2005. According to the approval granted by the Haidian State Tax Bureau on April 14, 2006, NetEase Beijing has been recognized as an “Advanced Technology Enterprise” and entitled to a reduced EIT rate of 10% for 2006 to 2007 and a full exemption from the local income tax for 2006 and 2007.

Guangzhou Interactive was recognized as a “Newly Established New and High Technology Enterprise” in April 2003. According to an approval granted by the Guangzhou Tian He State Tax Bureau, Guangzhou Interactive was entitled to a full exemption from EIT from 2003 to 2004. Since June and December 2004, Guangzhou Interactive has been recognized as a “Software Enterprise” and a “New and High Technology Enterprise” respectively and subject to a reduced EIT rate of 7.5% from 2005 to 2007. In 2006, Guangzhou Interactive received tax-exemption from the local tax rate of 3% from 2005 to 2007.

Boguan was recognized as a “Software Enterprise” on September 2005. It was exempted from EIT on its profits for 2006 and 2007, and subject to a 50% reduction in EIT from 2008 to 2010. Boguan was subject to a 3% local income tax rate for 2006 and it was exempted from the 3% local income tax for 2007.

NetEase Hangzhou was recognized as a “Newly Established High and New Technology Enterprise” in September 2007. It has been exempted from EIT on its profits from 2007 and 2008, and a 50% reduction in EIT from 2009 to 2011. NetEase Hangzhou was subject to a 3% local income tax rate for 2007.

For the year ended December 31, 2006, Yodao Information was subject to EIT at the rate of 30% with no local income tax being imposed by the local tax authority. Yodao Information was recognized as a “Newly Established New and High Technology Enterprise” in May 2007. According to an approval granted by the Haidian State Tax Bureau in August 2007, Yodao Information is entitled to a full exemption from EIT from 2007 and 2008 and a 50% reduction in EIT from 2009 to 2011.

Guangyitong Advertising, Ling Yi (dissolved in August 2007) and Yodao Computer (formed in September 2007) are subject to EIT at an overall income tax rate of 33%. Guangzhou NetEase was recognized as a “High and New Technology Enterprise” in December 2004. Hence, Guangzhou NetEase was subject to a reduced income tax rate of 15% from 2004 to 2007.

[Table of Contents](#)**10. Taxation (Cont'd)****(a) Income taxes (Cont'd)**

The following table presents the increase to net income resulting from the combined effects of EIT exemptions and reductions enjoyed by the Group for the years ended December 31, 2005, 2006 and 2007:

|                                    | For the year ended December 31, |             |             |
|------------------------------------|---------------------------------|-------------|-------------|
|                                    | 2005                            | 2006        | 2007        |
|                                    | RMB                             | RMB         | RMB         |
| NetEase Beijing                    | 123,722,278                     | 147,620,463 | 108,490,470 |
| Guangzhou Interactive              | 155,006,890                     | 184,338,309 | 182,582,163 |
| Boguan                             | —                               | 61,667,029  | 53,846,047  |
| NetEase Hangzhou                   | —                               | —           | 14,801,867  |
| Guangzhou NetEase                  | —                               | —           | 332,179     |
| Aggregate amount                   | 278,729,168                     | 393,625,801 | 360,052,726 |
| Earnings per share effect, basic   | 0.09                            | 0.12        | 0.12        |
| Earnings per share effect, diluted | 0.08                            | 0.11        | 0.11        |

The following table sets forth the component of income tax expenses of the Company for the years ended December 31, 2005, 2006 and 2007:

|   | For the year ended December 31, |              |              |
|---|---------------------------------|--------------|--------------|
|   | 2005                            | 2006         | 2007         |
| Current tax expense   | 106,699,043                     | 144,281,973  | 114,144,437  |
| Deferred tax benefit, net of deferred tax expense                                     | (11,742,021)                    | (11,796,430) | (405,416)    |
| Reinvestment incentive tax refund   | —                               | —            | (54,360,610) |
| Adjustments of a deferred tax asset for enacted changes in tax laws (see Note 10 (c)) | —                               | —            | (41,564,699) |
| Adjustments of a deferred tax asset for changes in the tax status of the enterprises  | —                               | —            | (15,124,403) |
| Income tax expenses   | 94,957,022                      | 132,485,543  | 2,689,309    |

The following table presents a reconciliation of the differences between the statutory income tax rate and the Company's effective income tax rate for the years ended December 31, 2005, 2006 and 2007:

|  | For the year ended December 31, |        |        |
|--|---------------------------------|--------|--------|
|  | 2005                            | 2006   | 2007   |
|  | %                               | %      | %      |
| Statutory income tax rate  | 33.0                            | 33.0   | 33.0   |
| Permanent differences  | 2.4                             | 0.7    | 0.7    |
| Effect due to tax-exempt entities  | 2.5                             | 3.1    | 3.4    |
| Effect of lower tax rate applicable to new and high technology and advanced technology enterprises | (28.7)                          | (27.4) | (28.5) |
| Effect of tax loss utilized  | —                               | (0.3)  | —      |
| Effect of incentive tax refund   | —                               | —      | (4.7)  |
| Change in valuation allowance  | —                               | 0.5    | (0.3)  |
| Effect of enacted changes in tax laws  | —                               | —      | (2.2)  |
| Effect of changes in the tax status of the enterprises   | —                               | —      | (1.2)  |
| Effective income tax rate  | 9.2                             | 9.6    | 0.2    |



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**Table of Contents****10. Taxation (Cont'd)****(a) Income taxes (Cont'd)**

\* Note: Permanent differences for the years ended December 31, 2005 primarily represented operating expenses incurred by the Group's companies incorporated outside China. Such entities are tax-exempt both in China and their country of incorporation. Effective 2006, the tax effect of net expenses recorded by such tax-exempt entities is reported in the above reconciliation under the caption "Effect due to tax-exempt entities" for the years ended December 31, 2005, 2006 and 2007. Permanent differences shown above refer to non-deductible or non-taxable items adjusted for PRC tax reporting purposes.

As of December 31, 2007, certain subsidiaries of the Group had net operating loss carryforwards available to offset future taxable income totaling approximately RMB4.2 million and RMB22.7 million, which will expire by 2011 and 2012, respectively.

**(b) Business tax and cultural development fee**

In China, business taxes are imposed by the government on the revenues reported by the selling entities for the provision of taxable services in China, transfer of intangible assets and the sale of immovable properties in China. The business tax rate varies depending on the nature of the revenues. The applicable business tax rate for the Company's revenues generally ranges from 3% to 5%. The Company is also subject to cultural development fee on the provision of advertising services in China. The applicable tax rate is 3% of the advertising services revenue.

In December 2007, Guangzhou NetEase received an approval from the Guangzhou local tax authority allowing it to deduct the service fees paid to its cooperative partners from its gross wireless value-added services revenue in deriving the amount of business taxes payable in accordance with the relevant rules, implemented with retroactive effect from January 1, 2003. As a result, Guangzhou NetEase received a business tax refund in June 2008 of approximately RMB147 million for the excess amount paid in previous years. Guangzhou NetEase will calculate its business taxes on this basis in future periods, subject to any change of policy by the local tax authority.

[Table of Contents](#)**10. Taxation (Cont'd)****(c) Deferred tax assets and liabilities**

The following table presents the tax impact of significant temporary differences between the tax and financial statement bases of assets and liabilities that gave rise to deferred tax assets and liabilities as of December 31, 2006 and 2007:

|  | <b>December 31,<br/>2006<br/>RMB</b> | <b>December 31,<br/>2007<br/>RMB</b> |
|--|--------------------------------------|--------------------------------------|
| Deferred tax assets—Current:   |                                      |                                      |
| Deferred revenue, primarily for advances from customers for online game services | 25,674,468                           | 62,868,714                           |
| Net operating loss carry forward   | 6,949,734                            | —                                    |
| Provision for doubtful accounts and others                                       | —                                    | 1,891,060                            |
| Accruals   | —                                    | 1,027,339                            |
| Total  | 32,624,202                           | 65,787,113                           |
| Less: valuation allowance  | (6,949,734)                          | —                                    |
| Deferred tax assets  | 25,674,468                           | 65,787,113                           |
| Deferred tax assets—Non-current:   |                                      |                                      |
| Depreciation of fixed assets and others  | 5,502,361                            | 19,060,225                           |
| Net operating loss carry forward   | —                                    | 3,276,955                            |
| Total  | 5,502,361                            | 22,337,180                           |
| Less: valuation allowance  | —                                    | (3,276,955)                          |
| Deferred tax assets  | 5,502,361                            | 19,060,225                           |
| Deferred tax liabilities—Current:  |                                      |                                      |
| Provision for doubtful accounts and others                                       | (2,406,723)                          | —                                    |
| Revenue recognition, primarily for advertising contracts                         | 5,798,477                            | —                                    |
| Deferred tax liabilities   | 3,391,754                            | —                                    |

The following table sets forth the movement of the aggregate valuation allowances for deferred assets for the periods presented:

|      | <b>Balance at<br/>January 1<br/>RMB</b> | <b>Provision<br/>(write-back)<br/>for the year<br/>RMB</b> | <b>Balance at<br/>December 31<br/>RMB</b> |
|------|---|--|---|
| 2006 | —                                       | 6,949,734  | 6,949,734                                 |
| 2007 | 6,949,734                               | (3,672,779)  | 3,276,955                                 |

Historically, deferred tax assets were valued using the previous statutory tax rate of 33% or applicable preferential tax rate of 7.5%, 10% or 15% of the respective legal entities.

As of December 31, 2007, the Company is required under applicable accounting standards to report the deferred tax assets at the new statutory tax rate of 25%, enacted on March 16, 2007, except for certain entities which are still under tax holiday. The application of the increased statutory tax rate to 25% from the preferential tax rates applicable to the Company's subsidiaries or VIEs resulted in a tax benefit of approximately RMB41.6 million being recorded in 2007. It is expected that the Company will report a higher tax charge in future accounting periods if and when confirmation is received from the Chinese tax authorities that such preferential tax treatments will be allowed to continue for the relevant terms, as a result of a reduction to the deferred tax assets to reflect the lower preferred tax rates.

**Table of Contents****10. Taxation (Cont'd)****(c) Deferred tax assets and liabilities (Cont'd)**

The new tax law also imposes a withholding income tax of 10% on dividends distributed by a FIE to its immediate holding company outside of China. A lower withholding income tax rate of 5% is applied if the FIE's immediate holding company is registered in Hong Kong or other jurisdictions that have a tax treaty arrangement with China. Such withholding income tax was exempted under the old Income Tax Law.

On February 22, 2008, the Ministry of Finance and State Tax Bureau jointly issued a circular which stated that for FIEs, all profits accumulated up to December 31, 2007 are exempted from withholding tax when they are distributed to foreign investors.

As of December 31, 2007, the Company determined that its FIEs would not declare any dividend should the withholding tax on dividends be applied. Accordingly, as of December 31, 2007, the Company did not record any withholding tax on the retained earnings of its FIEs in China.

**11. Taxes Payable**

The following is a summary of taxes payable as of December 31, 2006 and 2007:

|                                       | <b>December 31,<br/>2006</b> | <b>December 31,<br/>2007</b> |
|---------------------------------------|------------------------------|------------------------------|
|                                       | <b>RMB</b>                   | <b>RMB</b>                   |
| Business tax                          | 16,121,642                   | 11,180,879                   |
| Individual income taxes for employees | 5,926,295                    | 7,201,568                    |
| Enterprise income taxes               | 69,234,068                   | 68,999,729                   |
| Others                                | 4,194,493                    | 5,056,494                    |
|                                       | <u>95,476,498</u>            | <u>92,438,670</u>            |

**12. Accrued Liabilities**

The following is a summary of accrued liabilities as of December 31, 2006 and 2007:

|   | <b>December 31,<br/>2006</b> | <b>December 31,<br/>2007</b> |
|---|------------------------------|------------------------------|
|   | <b>RMB</b>                   | <b>RMB</b>                   |
| Marketing expenses                                | 2,092,816                    | 3,671,811                    |
| Content fees                                      | 1,100,957                    | 4,374,472                    |
| Professional fees                                 | 15,394,694                   | 5,671,043                    |
| Server custody fees and telecommunication charges | 385,562                      | 2,668,454                    |
| Accrued revenue sharing                           | 10,348,198                   | 12,424,891                   |
| Others  | 2,017,990                    | 1,033,396                    |
|   | <u>31,340,217</u>            | <u>29,844,067</u>            |

**13. Deferred Revenue**

Deferred revenue represents sales proceeds from prepaid debit point cards sold and prepaid subscription fees for Internet value-added services for which services are yet to be provided as of the balance sheet dates.

**14. Zero Coupon Convertible Subordinated Notes**

The Company issued and sold US\$75 million and US\$25 million aggregate principal amounts of Zero Coupon Convertible Subordinated Notes (the "convertible notes") due July 15, 2023 on July 14, 2003 and on July 31, 2003, respectively, in private offerings. The convertible notes are general unsecured obligations of the Company

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**Table of Contents****14. Zero Coupon Convertible Subordinated Notes (Cont'd)**

and are subordinated to any existing or future senior indebtedness of the Company. The convertible notes do not pay any interest except in limited circumstances, have a zero yield to maturity and are convertible into the Company's ordinary shares at a conversion price of US\$0.4815 per ordinary share, subject to adjustments and upon the occurrence of certain other events. Holders of the convertible notes may require the Company to repurchase all or a portion of their notes for cash on July 15, 2006, July 15, 2007, July 15, 2008, July 15, 2013 and July 15, 2018, at a price equal to 100% of the principal amount of the notes, together with accrued and unpaid interest, if any, subject to certain conditions. On or after July 15, 2008, the Company may redeem for cash for all or part of the notes at a price equal to 100% of the principal amount, together with accrued and unpaid interest, if any, subject to certain conditions.

**(a) The conversion option**

The convertible notes are financial instruments that consist of an underlying debt and a conversion option. SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities ("SFAS 133") requires that derivative instruments be bifurcated, unless the scope exception in paragraph 11(a) of SFAS 133 applies ("scope exception"). The scope exception states that a contract is not a derivative, if it is issued by an entity that is both (a) indexed to its own stock and (b) would be classified in stockholders' equity if it were a freestanding financial instrument. Management has concluded that the conversion option is "indexed to the Company's own stock" as that term is defined by EITF Issue No. 01-6, "The Meaning of Indexed to a Company's Own Stock" and EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock". Accordingly, the conversion option was not bifurcated and the Company has reported its convertible notes at unamortized cost under long-term payable in its consolidated balance sheets since issuance.

The convertible notes are denominated in U.S. dollars. While the Group's functional currency is RMB, its equity shares are listed in the U.S. stock market and can only be transacted in the same currency as that of its convertible notes. The EITF is considering comments on the Draft Abstract of Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock" ("EITF 07-5") issued in April 2008, where it concluded that the convertible notes issued by the Company would be considered dual-indexed and does not meet the scope exception. Therefore, the conversion option would be considered a derivative for purposes of SFAS 133 and would have to be bifurcated from the underlying debt. The transition guidance indicates that this conclusion would be applied if the Company's convertible debt was outstanding as of the beginning of the fiscal year in which EITF 07-5 is initially applied and any adjustment would be reflected as a cumulative catch up adjustment in opening retained earnings.

**(b) Classification**

On May 17, 2007, the Company entered into a revolving loan facility with a Hong Kong commercial bank, which provides refinancing to its convertible notes upon redemption requests by noteholders. The facility was a committed facility in the amount of US\$100 million expiring on July 31, 2008 with an interest rate of 0.10% per annum over the London Inter Bank Offering Rate upon drawdown. Under the committed facility, the lender created a general lien and reserved the right to combine and consolidate all or any of the accounts the Company maintains with the bank in an amount of US\$100 million. In light of the committed facility, the Company classified the callable obligations of the convertible notes as long-term payable as of December 31, 2006 in accordance with SFAS No. 6, "Classification of Short-Term Obligations Expected to Be Refinanced". This classification was consistent with ARB No. 43 and SFAS No. 78, "Classification of Obligations that are Callable by the Creditor".

In December 2007, the Company cancelled the above-mentioned revolving loan facility with the bank prior to its expiration. As a result of the termination of the loan facility, the related restriction on the Company's cash balance was removed on December 31, 2007, and the outstanding convertible notes as of December 31, 2007 were classified as current liabilities as holders of the notes have the right to require the Company to repurchase all or a portion of the notes for cash on July 15, 2008.

[Table of Contents](#)**14. Zero Coupon Convertible Subordinated Notes (Cont'd)****(c) Summary of conversion and redemption**

The following table presents a summary of conversion and redemption activities related to the convertible notes during 2006 and 2007:

|      | <u>Balance at<br/>January 1</u> | <u>Conversion<br/>to Ordinary<br/>Shares</u> | <u>Redemption<br/>for Cash</u> | <u>Balance at<br/>December 31</u> | <u>Balance at<br/>December 31</u> |
|------|---------------------------------|--|--------------------------------|-----------------------------------|-----------------------------------|
|      | US\$                            | US\$   | US\$                           | US\$                              | RMB                               |
| 2006 | 99,980,000                      | —  | —                              | 99,980,000                        | 780,253,918                       |
| 2007 | 99,980,000                      | (12,000,000)                                 | —                              | 87,980,000                        | 641,778,908                       |

The fair value of the Company's zero-coupon convertible subordinated notes was approximately RMB1.2 billion and RMB1.0 billion as of December 31, 2006 and 2007, respectively.

**15. Capital Structure**

The holders of ordinary shares in the Company are entitled to one vote per share and to receive ratably such dividends, if any, as may be declared by the board of directors of the Company. In the event of liquidation, the holders of ordinary shares are entitled to share ratably in all assets remaining after payment of liabilities. The ordinary shares have no preemptive, conversion, or other subscription rights.

**16. Stock-based Compensation****(a) Stock-based compensation expense**

Since the adoption of SFAS 123R effective January 1, 2006, there have been no changes to the Company's stock option plans or modifications to outstanding stock-based awards. As the stock-based compensation cost recognized on the consolidated statements of operations and comprehensive income is based on awards ultimately expected to vest, such amount has been reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on the Company's historical experience over the last five years. Previously, under SFAS 123, the Company recorded forfeitures as they occurred.

The table below presents a summary of the Company's stock-based compensation cost for the years ended December 31, 2006 and 2007:

|                            | <u>For the year ended December 31,</u> |                   |
|----------------------------|--|-------------------|
|                            | <u>2006</u>                            | <u>2007</u>       |
|                            | RMB                                    | RMB               |
| Cost of revenues           | 16,614,309                             | 14,890,378        |
| Sales and marketing        | 21,147,343                             | 14,357,336        |
| General and administrative | 37,360,433                             | 33,887,323        |
| Research and development   | 26,164,591                             | 32,293,138        |
| Effect on net income       | <u>101,286,676</u>                     | <u>95,428,175</u> |

The above stock-based compensation cost included approximately RMB0.1 million associated with the Company's other equity interest awards made to four key employees of Yodao Information and Yodao Computer (see Note 16 (f)).

As of December 31, 2007, total unrecognized compensation cost related to unvested awards not yet recognized related to the stock option plan, adjusted for estimated forfeitures, was US\$20.3 million (RMB148.0 million) and is expected to be recognized through the remaining vesting period of each grant. As of December 31, 2007, the weighted average remaining vesting period was 1.34 years.

[Table of Contents](#)**16. Stock-based Compensation (Cont'd)****(b) Stock-based compensation cost for period prior to the adoption of SFAS 123R**

Prior to the adoption of SFAS 123R, the Company used the intrinsic value-based method as prescribed in APB 25, to account for all stock-based compensation plans, and the Company had adopted the disclosure-only alternative of SFAS 123 as amended by SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure. The pro forma information for the year ended December 31, 2005 would have been as follows:

|  | <u>For the year ended<br/>December 31, 2005</u><br>RMB |
|--|--|
| Net profit:  |  |
| As reported  | 931,990,169  |
| Add: Stock-based employee compensation expense included in the determination of net income as reported, net of tax | 13,835   |
| Less: Stock-based employee compensation expense determined under the fair value-based method, net of tax           | <u>(108,217,212)</u>                                   |
| Pro forma  | <u>823,786,792</u>                                     |
| Basic net earnings per ordinary share:   |  |
| As reported  | <u>0.29</u>  |
| Pro forma  | <u>0.26</u>  |
| Diluted net earnings per ordinary share:   |  |
| As reported  | <u>0.26</u>  |
| Pro forma  | <u>0.24</u>  |

**(c) Valuation assumptions**

The Company uses the Black-Scholes option pricing model to determine the fair value of stock options consistent with the provisions of SFAS 123R and SEC SAB 107. The estimated fair value of each stock option grant was estimated on the date of grant using the Black-Scholes option pricing method with the following assumptions:

|  | <u>For the year ended December 31,</u> |             |             |
|--|--|-------------|-------------|
|  | <u>2005</u>                            | <u>2006</u> | <u>2007</u> |
| Risk free interest rate  | 3.66%                                  | *           | 4.47%       |
| Expected life (in years)   | 2.85                                   | *           | 2.76        |
| Expected dividend yield  | 0%                                     | *           | 0%          |
| Volatility   | 0.92                                   | *           | 0.48        |
| Weighted average fair value of the underlying shares on the date of option grants (US\$) | 0.486                                  | *           | 0.728       |
| Weighted average grant-date fair value of options (US\$)                                 | 0.284                                  | *           | 0.257       |

\* Not applicable as the Company did not grant any stock options during 2006.

[Table of Contents](#)**16. Stock-based Compensation (Cont'd)****(d) Stock options award activity**

The following table presents a summary of the Company's stock options award activities for the years ended December 31, 2005, 2006 and 2007:

|   | <u>Employees</u>   | <u>Senior<br/>Management</u> | <u>Director<br/>and<br/>consultants</u> | <u>Total</u>       | <u>Weighted<br/>average<br/>exercise price<br/>US\$</u> |
|---|--------------------|------------------------------|---|--------------------|---|
| Number of ordinary shares issuable upon exercise of stock options |                    |                              |   |                    |   |
| Outstanding at January 1, 2005                                    | 173,180,500        | 102,500,000                  | 1,837,500                               | 277,518,000        | 0.226   |
| Granted during the year   | 50,430,000         | 22,060,000                   | —                                       | 72,490,000         | 0.486   |
| Exercised during the year   | (46,275,300)       | (32,650,000)                 | (392,500)                               | (79,317,800)       | 0.164   |
| Cancelled during the year   | (29,170,500)       | (32,500,000)                 | (700,000)                               | (62,370,500)       | 0.264   |
| Outstanding at December 31, 2005                                  | <u>148,164,700</u> | <u>59,410,000</u>            | <u>745,000</u>                          | <u>208,319,700</u> | <u>0.329</u>  |
| Outstanding at January 1, 2006                                    | 148,164,700        | 59,410,000                   | 745,000                                 | 208,319,700        | 0.329   |
| Granted during the year   | —                  | —                            | —                                       | —                  | —   |
| Exercised during the year   | (37,924,600)       | (21,235,000)                 | (332,500)                               | (59,492,100)       | 0.280   |
| Cancelled during the year   | (10,272,000)       | (3,775,000)                  | —                                       | (14,047,000)       | 0.314   |
| Outstanding at December 31, 2006                                  | <u>99,968,100</u>  | <u>34,400,000</u>            | <u>412,500</u>                          | <u>134,780,600</u> | <u>0.353</u>  |
| Outstanding at January 1, 2007                                    | 99,968,100         | 34,400,000                   | 412,500                                 | 134,780,600        | 0.353   |
| Granted during the year   | 57,340,000         | 5,875,000                    | —                                       | 63,215,000         | 0.728   |
| Exercised during the year   | (36,535,350)       | (13,975,000)                 | (4,025,000)                             | (54,535,350)       | 0.299   |
| Cancelled during the year   | (15,012,500)       | (1,755,000)                  | —                                       | (16,767,500)       | 0.447   |
| Reclassification due to position change                           | (6,100,000)        | (3,900,000)                  | 10,000,000                              | —                  | —   |
| Outstanding at December 31, 2007                                  | <u>99,660,250</u>  | <u>20,645,000</u>            | <u>6,387,500</u>                        | <u>126,692,750</u> | <u>0.551</u>  |

For the year ended December 31, 2007, the numbers of stock options expired and forfeited totaled 80,000 and 16,687,500, respectively.

The total intrinsic value of options exercised for the years ended 2005, 2006 and 2007 was US\$36.2 million, US\$28.8 million and US\$22.2 million, respectively. The total fair value of share options vested was US\$11.9 million, US\$13.2 million and US\$11.5 million for the years ended 2005, 2006 and 2007, respectively.



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**16. Stock-based Compensation (Cont'd)**  
**(d) Stock options award activity (Cont'd)**

The following table presents the weighted average remaining contractual life and exercise price for the options outstanding and exercisable as of December 31, 2007:

| <u>Exercise Price</u> | <u>Number<br/>Outstanding</u> | <u>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Life<br/>Years</u> | <u>Weighted<br/>Average<br/>Exercise<br/>Price<br/>US\$</u> | <u>Number<br/>Exercisable</u> | <u>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Life<br/>Years</u> | <u>Weighted<br/>Average<br/>Exercise<br/>Price<br/>US\$</u> |
|-----------------------|-------------------------------|--|---|-------------------------------|--|---|
| US\$0.110-US\$0.110   | 848,500                       | 0.17   | 0.110   | 848,500                       | 0.17   | 0.110   |
| US\$0.300-US\$0.320   | 33,521,750                    | 1.62   | 0.301   | 9,776,250                     | 1.63   | 0.301   |
| US\$0.486-US\$0.679   | 31,772,500                    | 2.35   | 0.489   | 7,052,500                     | 2.29   | 0.497   |
| US\$0.728             | 60,550,000                    | 4.21   | 0.728   | —                             | —  | —   |
|                       | <u>126,692,750</u>            | <u>3.03</u>  | <u>0.551</u>  | <u>17,677,250</u>             | <u>1.82</u>  | <u>0.370</u>  |

The aggregate intrinsic value of options outstanding, adjusted for forfeiture and fully vested share options as of December 31, 2007 was US\$24.9 million and US\$6.9 million, respectively. The intrinsic value is calculated as the difference between the Company's closing stock price of US\$18.96 per ADS, or US\$0.7584 per share as of December 31, 2007 and the exercise price of the underlying options as of that date.

As of December 31, 2007, 29,393,124 ordinary shares were available for future grant under the Company's stock option plans. It is the Company's policy to issue new shares upon share option exercise.

**(e) Description of stock option plan**

In December 1999, the Company adopted an incentive and non-statutory stock option plan for the Company's directors, senior management, employees and consultants (the 1999 Stock Option Plan). The Company had reserved 345,675,000 ordinary shares for issuance under the plan. According to a resolution of the board of directors of the Company in 2000, the 1999 Stock Option Plan was replaced by the 2000 Stock Option Plan.

According to resolutions of the board of directors and the shareholders of the Company in 2001, the 2000 stock option plan was amended and restated. Under the amended plan, the number of ordinary shares available for issuance was increased from 223,715,000 under the prior plan to 323,715,000. The amended plan also included a mechanism for the automatic increase in the number of ordinary shares available for future issuance. This mechanism, which is known as "Evergreen Provision", provided for a periodic increase so that the number of ordinary shares available under the plan would automatically increase by 3% each year up to a maximum at any given time of 17.5% of the Company's total outstanding ordinary shares, on a fully-diluted basis. These increases would occur on June 1 of 2001 and January 1 of each year thereafter. The "Evergreen Provision" has been suspended pursuant to a resolution of the board of directors dated March 25, 2002.

**(f) Other equity interest awards**

For the year ended 2007, the Company granted equity interest awards in Yodao Computer and Yodao Information to the four key employees over a four to five year period, beginning from December 1, 2007 and December 13, 2007, respectively, and ending on the respective anniversary dates of initial employment dates of the four key employees concerned. The percentage of equity interest awards ranged from 0.5% to 1.0%, and amounted to a total of 3.5% each in Yodao Computer and Yodao Information, respectively. The exercise price for each vesting period is to be determined based on the equity interest percentage awarded multiplied by the registered share capital of Yodao Computer and Yodao Information at the time of exercise. In accordance with the terms and conditions of the granting of such equity interest awards, awards granted will be forfeited upon grantee's termination of employment, either voluntarily or involuntarily. If the employees do not exercise any of the vested equity interest awards, such awards will expire twelve months after the last vesting date.

[Table of Contents](#)**17. Earnings Per Share**

The following table sets forth the computation of basic and diluted net earnings per share for the years ended December 31, 2005, 2006 and 2007:

|  | For the year ended December 31, |               |               |
|--|---------------------------------|---------------|---------------|
|  | 2005                            | 2006          | 2007          |
| Numerator (RMB):   |                                 |               |               |
| Net profit attributable to ordinary shareholders                   | 931,990,169                     | 1,242,777,584 | 1,264,086,122 |
| Effect of dilutive securities:                                     |                                 |               |               |
| Amortization of offering cost of the zero coupon convertible notes | 7,755,531                       | 4,331,016     | —             |
| Interest for zero coupon convertible notes                         | 344,859                         | —             | —             |
| Net profit adjusted for dilutive securities                        | 940,090,559                     | 1,247,108,600 | 1,264,086,122 |
| Denominator (No. of shares):                                       |                                 |               |               |
| Weighted average number of ordinary shares outstanding, basic      | 3,225,684,510                   | 3,231,832,008 | 3,086,451,412 |
| Dilutive effect of employee stock options and convertible notes    | 339,727,509                     | 266,573,102   | 221,086,967   |
| Weighted average number of ordinary shares outstanding, diluted    | 3,565,412,019                   | 3,498,405,110 | 3,307,538,379 |
| Net earnings per share, basic (RMB)                                | 0.29                            | 0.38          | 0.41          |
| Net earnings per share, diluted (RMB)                              | 0.26                            | 0.36          | 0.38          |

**18. Commitments and Contingencies****(a) Commitments**

As of December 31, 2007, future minimum lease and capital commitments were as follows:

|      | Rental<br>Commitments | Server custody<br>fee<br>commitments | Capital<br>Commitments | Total      |
|------|-----------------------|--------------------------------------|------------------------|------------|
|      | RMB                   | RMB                                  | RMB                    | RMB        |
| 2008 | 12,317,616            | 49,925,982                           | 23,310,962             | 85,554,560 |
| 2009 | 4,178,491             | 6,368,574                            | 2,131,000              | 12,678,065 |
| 2010 | 412,810               | —                                    | —                      | 412,810    |
|      | 16,908,917            | 56,294,556                           | 25,441,962             | 98,645,435 |

For the years ended December 31, 2005, 2006 and 2007, the Company incurred rental expenses in the amounts of approximately RMB10.6 million, RMB19.6 million and RMB25.9 million, respectively. The rental expenses for the years ended December 31, 2006 and 2007 included the imputed rent (based on the prevailing market rental) in the amount of approximately RMB3.7 million and RMB9.4 million, respectively related to the Company's use of Guangzhou office building even though it has no legal obligation to pay such rent (see Note 6).

**(b) Litigation**

From time to time, the Company is involved in claims and legal proceedings that arise in the ordinary course of business. Based on currently available information, management does not believe that the ultimate outcome of these unresolved matters, individually and in the aggregate, is likely to have a material adverse effect on the Company's financial position or results of operations. However, litigation is subject to inherent uncertainties and the Company's view of these matters may change in the future. Were an unfavorable outcome to occur, there exists the possibility of a material adverse impact on the Company's financial position and results of operations for the period in which the unfavorable outcome occurs, and potentially in future periods.

[Table of Contents](#)**19. Share Repurchase Programs**

The Company's Board has approved four share repurchase programs since 2006 authorizing management to repurchase shares of the Company's ordinary shares to enhance shareholder value. The timing and actual number of shares subject to repurchase are at the discretion of the Company's management and are contingent on a number of factors and limitations, including the price of the Company's stock, corporate and regulatory requirements, alternative investment opportunities and other market conditions. The stock repurchase programs specify a maximum number of shares subject to repurchase and have an expiration date and may be limited or terminated at any time without prior notice.

The following is a summary of the Company's share repurchase programs authorized by the Company's Board for the years ended 2006 and 2007:

| <u>Date of authorization</u>                             | <u>Amount Authorized</u><br>(US\$ in millions) |
|--|--|
| <i>For the year ended December 31, 2006</i>              |  |
| May 18, 2006 (for approximately one month)               | 50   |
| August 28, 2006 (for a period not to exceed six months)  | 100  |
| Total  | 150  |
| <i>For the year ended December 31, 2007</i>              |  |
| March 13, 2007 (for a period not to exceed three months) | 100  |
| July 2, 2007 (for one year ending July 1, 2008)          | 120  |
| Total  | 220  |

The following is a summary of the Company's repurchase activities for the years ended December 31, 2006 and 2007:

| <u>Share repurchase program</u> | <u>Total number of</u><br><u>ADS repurchased</u> | <u>Cost</u><br>US\$ | <u>Average price</u><br><u>paid per ADS</u><br>US\$ |
|---------------------------------|--|---------------------|---|
| <i>Authorized in 2006</i>       |  |                     |   |
| May 18                          | 2,369,600  | 50,082,901          | 21.1356   |
| August 28                       | 3,615,587  | 60,075,553          | 16.6157   |
|                                 | 5,985,187  | 110,158,454         | 18.4052   |
| <i>Authorized in 2007</i>       |  |                     |   |
| March 13                        | 5,314,544  | 95,747,517          | 18.0161   |
| July 2                          | 2,154,169  | 35,678,494          | 16.5625   |
|                                 | 7,468,713  | 131,426,011         | 17.5969   |

The Company accounts for repurchased ordinary shares under the cost method and include such treasury stock as a component of the common shareholders' equity. Retirement of treasury stock is recorded as a reduction of ordinary shares, additional paid-in-capital and retained earnings, as applicable. An excess of purchase price over par value is allocated to additional paid-in-capital firstly, any remaining excess is charged entirely to retained earnings.

As of December 31, 2006, the Company had 36.6 million repurchased shares pending cancellation. The repurchased shares pending cancellation were reported at cost (including transaction costs) of RMB188.8 million determined using the specific identification method. As of December 31, 2007, the Company did not have any repurchased shares pending cancellation.

As of December 31, 2007, approximately US\$84.3 million was available to be used under the Board authorized share repurchase program approved on July 2, 2007.

[Table of Contents](#)**20. Segment Information****(a) Description of segments**

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker (“CODM”), or decision making group, in deciding how to allocate resources and in assessing performance. The Company’s CODM is the Chief Executive Officer.

The Company’s organizational structure is based on a number of factors that the CODM uses to evaluate, view and run its business operations which include, but are not limited to, customer base, homogeneity of products and technology. The Company’s operating segments are based on this organizational structure and information reviewed by the Company’s CODM to evaluate the operating segment results. The Company has determined that its operations are organized into three reportable segments: 1) Online Game Services; 2) Advertising Services; and 3) Wireless Value-added Services and Others. Future changes to this organizational structure may result in changes to the business segments disclosed.

**(b) Segment data**

The table below provides a summary of the Group’s operating segment results for the years ended December 31, 2005, 2006 and 2007. The Group does not allocate any operating costs or assets to its business segments as the Company’s CODM does not use this information to measure the performance of the operating segments. There was no transaction between reportable segments for the years ended December 31, 2005, 2006 and 2007.

|  | For the year ended December 31, |                      |                      |
|--|---------------------------------|----------------------|----------------------|
|  | 2005                            | 2006                 | 2007                 |
|  | RMB                             | RMB                  | RMB                  |
| Total revenues:                          |                                 |                      |                      |
| Online game services                     | 1,379,475,803                   | 1,856,062,971        | 1,932,634,947        |
| Advertising services                     | 241,200,444                     | 285,772,653          | 305,057,556          |
| Wireless value-added services and others | 73,742,136                      | 75,406,121           | 68,018,461           |
| Total revenues                           | <u>1,694,418,383</u>            | <u>2,217,241,745</u> | <u>2,305,710,964</u> |
| Business tax (Note 10(b)):               |                                 |                      |                      |
| Online game services                     | (58,851,439)                    | (25,769,359)         | (63,776,953)         |
| Advertising services                     | (20,502,038)                    | (24,290,676)         | (25,929,892)         |
| Wireless value-added services and others | (2,701,425)                     | (2,822,240)          | (2,717,355)          |
| Total business taxes                     | <u>(82,054,902)</u>             | <u>(52,882,275)</u>  | <u>(92,424,200)</u>  |
| Net revenues:                            |                                 |                      |                      |
| Online game services                     | 1,320,624,364                   | 1,830,293,612        | 1,868,857,994        |
| Advertising services                     | 220,698,406                     | 261,481,977          | 279,127,664          |
| Wireless value-added services and others | 71,040,711                      | 72,583,881           | 65,301,106           |
| Total net revenues                       | <u>1,612,363,481</u>            | <u>2,164,359,470</u> | <u>2,213,286,764</u> |
| Cost of revenues:                        |                                 |                      |                      |
| Online game services                     | (137,301,493)                   | (178,676,915)        | (187,411,229)        |
| Advertising services                     | (78,589,395)                    | (125,183,293)        | (143,676,057)        |
| Wireless value-added services and others | (59,346,085)                    | (77,437,973)         | (84,365,760)         |
| Total cost of revenues                   | <u>(275,236,973)</u>            | <u>(381,298,181)</u> | <u>(415,453,046)</u> |
| Gross profit (loss):                     |                                 |                      |                      |
| Online game services                     | 1,183,322,871                   | 1,651,616,697        | 1,681,446,765        |
| Advertising services                     | 142,109,011                     | 136,298,684          | 135,451,607          |
| Wireless value-added services and others | 11,694,626                      | (4,854,092)          | (19,064,654)         |
| Total gross profit                       | <u>1,337,126,508</u>            | <u>1,783,061,289</u> | <u>1,797,833,718</u> |

All revenues of the Company’s reportable segments are derived from China based on the geographical locations where services are provided to customers.

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[Table of Contents](#)**21. Subsequent Event**

On June 13, 2008, the Company announced that it has called for redemption of the convertible notes (see Note 14) due July 15, 2023. The redemption date will be July 15, 2008. The convertible notes may be converted at any time before the close of business on July 11, 2008 at the conversion price of US\$0.4815 per ordinary share. If all of the currently outstanding convertible notes as of December 31, 2007 are redeemed without any conversion of the convertible notes into the Company's ordinary shares prior to July 11, 2008, the aggregate redemption amount will be approximately US\$87.98 million. The Company will use its available working capital to fund the redemption of the convertible notes.

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**FINANCIAL STATEMENTS SCHDULE I**  
**CONDENSED FINANCIAL INFORMATION OF NETEASE.COM, INC.**
**Condensed Balance Sheets**

|  | December 31,<br>2006<br>RMB | December 31,<br>2007<br>RMB | December 31,<br>2007<br>US\$ |
|--|-----------------------------|-----------------------------|------------------------------|
| <b>Assets</b>  |                             |                             |                              |
| Current assets:  |                             |                             |                              |
| Cash   | 358,331,284                 | 1,911,873,077               | 262,094,299                  |
| Prepayments and other current assets                                 | 1,197,470                   | 847,835                     | 116,228                      |
| Total current assets   | 359,528,754                 | 1,912,720,912               | 262,210,527                  |
| Non-current assets:  |                             |                             |                              |
| Investment in subsidiaries   | 3,364,164,029               | 2,137,244,913               | 292,990,008                  |
| Other long-term assets   | 7,804,100                   | 8,626,900                   | 1,182,642                    |
| Total non-current assets   | 3,371,968,129               | 2,145,871,813               | 294,172,650                  |
| Total assets   | 3,731,496,883               | 4,058,592,725               | 556,383,177                  |
| <b>Liabilities and Shareholders' Equity</b>                          |                             |                             |                              |
| Current liabilities:   |                             |                             |                              |
| Zero Coupon Convertible Subordinated Notes due July 15, 2023         | —                           | 641,778,908                 | 87,980,000                   |
| Accounts payable and other liabilities                               | 22,877,663                  | 4,163,666                   | 570,787                      |
| Salary and welfare payable   | 2,546,244                   | 4,312,776                   | 591,229                      |
| Taxes payable  | 1,286,970                   | 2,311,909                   | 316,934                      |
| Accrued liabilities  | 18,863,907                  | 7,599,835                   | 1,041,844                    |
| Total current liabilities  | 45,574,784                  | 660,167,094                 | 90,500,794                   |
| Long-term payable:   |                             |                             |                              |
| Zero Coupon Convertible Subordinated Notes due July 15, 2023         | 780,253,918                 | —                           | —                            |
| Total long-term liabilities  | 780,253,918                 | —                           | —                            |
| Total liabilities  | 825,828,702                 | 660,167,094                 | 90,500,794                   |
| Shareholders' equity:  |                             |                             |                              |
| Ordinary shares, US\$0.0001 par value:                               |                             |                             |                              |
| 1,000,300,000,000 shares authorized, 3,195,024,725 shares issued and |                             |                             |                              |
| 3,158,385,050 outstanding as of December 31, 2006 and 3,036,270,590  |                             |                             |                              |
| shares issued and outstanding as of December 31, 2007                | 2,645,941                   | 2,525,952                   | 346,277                      |
| Additional paid-in capital   | 590,597,648                 | —                           | —                            |
| Treasury stock   | (188,802,099)               | —                           | —                            |
| Accumulated other comprehensive income                               | —                           | 1,332,300                   | 182,642                      |
| Retained earnings  | 2,501,226,691               | 3,394,567,379               | 465,353,464                  |
| Total shareholders' equity   | 2,905,668,181               | 3,398,425,631               | 465,882,383                  |
| Total liabilities and shareholders' equity                           | 3,731,496,883               | 4,058,592,725               | 556,383,177                  |

[Table of Contents](#)**Condensed Statements of Operations & Comprehensive Income**

|   | For the year ended December 31, |               |               |              |
|---|---------------------------------|---------------|---------------|--------------|
|   | 2005<br>RMB                     | 2006<br>RMB   | 2007<br>RMB   | 2007<br>US\$ |
| Net revenues                                  | —                               | —             | —             | —            |
| Cost of revenues                              | —                               | —             | —             | —            |
| Gross profit                                  | —                               | —             | —             | —            |
| Operating expenses:                           |                                 |               |               |              |
| Selling, general and administrative expenses  | (33,890,348)                    | (75,714,017)  | (67,474,691)  | (9,249,951)  |
| Research and development expenses             | (11,871)                        | (20,884)      | —             | —            |
| Total operating expenses                      | (33,902,219)                    | (75,734,901)  | (67,474,691)  | (9,249,951)  |
| Operating loss                                | (33,902,219)                    | (75,734,901)  | (67,474,691)  | (9,249,951)  |
| Equity in profit of subsidiary companies, net | 940,450,634                     | 1,275,572,947 | 1,314,434,085 | 180,192,757  |
| Other income:                                 |                                 |               |               |              |
| Investment income                             | 1,301,975                       | 340,721       | 380,686       | 52,187       |
| Interest income                               | 31,917,167                      | 42,269,080    | 52,809,770    | 7,239,568    |
| Exchange gains (losses)                       | (7,865,476)                     | 539,341       | (41,784,221)  | (5,728,103)  |
| Other, net                                    | 88,088                          | (209,604)     | 5,720,493     | 784,209      |
| Profit before tax                             | 931,990,169                     | 1,242,777,584 | 1,264,086,122 | 173,290,667  |
| Income tax expense                            | —                               | —             | —             | —            |
| Net profit                                    | 931,990,169                     | 1,242,777,584 | 1,264,086,122 | 173,290,667  |
| Unrealized gains on investments               | —                               | —             | 1,332,300     | 182,642      |
| Comprehensive Income                          | 931,990,169                     | 1,242,777,584 | 1,265,418,422 | 173,473,309  |

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[Table of Contents](#)**Condensed Statements of Cash Flows**

|  | For the year ended December 31, |                      |                      |                      |
|--|---------------------------------|----------------------|----------------------|----------------------|
|  | 2005<br>RMB                     | 2006<br>RMB          | 2007<br>RMB          | 2007<br>US\$         |
| <b>Net cash (used in)/provided by operating activities</b>                   | (45,958,942)                    | 18,528,338           | 2,596,910,403        | 356,004,497          |
| <b>Cash flows from investing activities</b>                                  |                                 |                      |                      |                      |
| Decrease in held-to-maturity investments                                     | 165,532,000                     | —                    | —                    | —                    |
| Increase in other long-term assets   | —                               | (8,077,341)          | —                    | —                    |
| <b>Net cash (used in)/provided by investing activities</b>                   | <b>165,532,000</b>              | <b>(8,077,341)</b>   | <b>—</b>             | <b>—</b>             |
| <b>Cash flows from financing activities:</b>                                 |                                 |                      |                      |                      |
| Proceeds from employees exercising stock options                             | 105,692,433                     | 44,127,417           | 43,232,921           | 5,926,702            |
| Repurchase of company shares   | —                               | (873,406,019)        | (1,003,747,328)      | (137,601,421)        |
| <b>Net cash used in/(provided by) financing activities</b>                   | <b>105,692,433</b>              | <b>(829,278,602)</b> | <b>(960,514,407)</b> | <b>(131,674,719)</b> |
| <b>Effect of exchange rate changes on cash</b>                               | <b>(29,684,897)</b>             | <b>(27,866,616)</b>  | <b>(82,854,203)</b>  | <b>(11,358,293)</b>  |
| <b>Net increase/(decrease) in cash</b>                                       | <b>195,580,594</b>              | <b>(846,694,221)</b> | <b>1,553,541,793</b> | <b>212,971,485</b>   |
| <b>Cash, beginning of the year</b>   | <b>1,009,444,911</b>            | <b>1,205,025,505</b> | <b>358,331,284</b>   | <b>49,122,814</b>    |
| <b>Cash, end of the year</b>   | <b>1,205,025,505</b>            | <b>358,331,284</b>   | <b>1,911,873,077</b> | <b>262,094,299</b>   |
| <b>Supplemental schedule of non-cash investing and financing activities:</b> |                                 |                      |                      |                      |
| Treasury stock cancellation  | —                               | 684,603,920          | 1,192,549,427        | 163,483,868          |
| Conversion of convertible notes to ordinary shares                           | 161,438                         | —                    | 92,424,750           | 12,670,297           |

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**Table of Contents****Notes to the Condensed Financial Statements**

(Amounts expressed in Renminbi (“RMB”), unless otherwise stated)

The condensed financial statements of NetEase.com, Inc. (the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States of America except for accounting of the Company’s subsidiaries and certain footnote disclosures as described below.

The Company records its investment in its subsidiaries under the equity method of accounting as prescribed in APB Opinion No. 18, “The Equity Method of Accounting for Investments in Common Stock”. Such investment is presented on the balance sheet as Investment in subsidiaries and equity share of the profit or loss of the subsidiaries is presented as equity in profit (loss) of subsidiary companies on the statement of operations and comprehensive income.

The Company received cash dividend of RMB nil, RMB nil and RMB2.6 billion from its consolidated subsidiaries for the years ended December 31, 2005, 2006 and 2007, respectively.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. The footnote disclosures contain supplemental information relating to the operations of the Company and, as such, these statements should be read in conjunction with the notes to the consolidated financial statements of the Company.

The Company did not have any significant commitment as of December 31, 2006 and 2007.

The United States dollar (“US\$”) amounts disclosed in the financial statements are presented solely for the convenience of the readers. Translations of amounts from RMB into United States dollars for the convenience of the reader were calculated at the noon buying rate of US\$1.00 = RMB7.2946 on December 31, 2007 in The City of New York for the cable transfers of RMB as certified for customs purposes by the Federal Reserve Bank of New York. No representation is made that the RMB amounts could have been, or could be, converted into US\$ at that rate on December 31, 2007, or at any other certain date.

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