



# Annual Report 2011

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## Corporate Profile



We are one of the leading providers of digital entertainment services for consumers in the PRC. We operate three main business units, namely WVAS, mobile games and Internet games. We are one of the leading providers of WVAS to mobile phone users and have been in cooperation with all major telecommunications operators in the PRC since 2002. In 2005, we began providing feature-phone mobile games on the networks of China Mobile with the acquisition of Tianjin Mammoth, a feature phone mobile games developer. To further expand our mobile games development capabilities, we acquired Noumena in 2012 in order to develop smartphone mobile games on smartphone mobile operating systems, such as iOS and Android. We commenced our Internet games business in 2010 through our acquisition of Dacheng, a developer and operator of Internet games in the PRC. In addition to developing and operating our self-developed Internet games, such as Loong, Demon Code and Kung Fu Hero, we are the exclusive operator of the popular World of Tanks game for the PRC Internet games market. In May 2012, KONG entered into a strategic partnership with Wargaming.net's granting KONG exclusive rights to all of Wargaming.net's future games in mainland China, including but not limited to World of Tanks, World of Warplanes and World of Warships. In addition, KONG is the also the exclusive China partner for Guild Wars 2 from ArenaNet, Offensive Combat from U4iA Games and Hawken from Meteor Entertainment.



**Chairman and Chief Executive  
Officer's Letter**

### Dear Shareholders:



On behalf of the Board of Directors and the management team, we are pleased to present you with our 2011 annual report.

During the course of 2011, we continued to make significant steps to transform KongZhong into a diversified digital entertainment company. Against a more stable WVAS environment, we believe our growth strategy of partnering with world class overseas Internet game developers supplemented with our self-developed Internet games has begun to show progress and our recent pivot to smartphone mobile games will provide us with a new growth opportunity in the coming years.

- Our total revenues increased by 7.0% to US\$160.0 million in 2011 from US\$149.6 million in 2010. This increase was driven largely by the growth of our Internet games business, led by growth in revenues generated from World of Tanks, a massive multiplayer online game that we commercially launched in March 2011. This increase in total revenues was partially offset by a decrease in revenues generated from our WVAS and mobile games businesses.
- Full year net income (excluding non-cash items) was stable – Net loss in 2011 was US\$ 7.65 mn, which includes a US\$ 20.26 mn non-cash impairment loss on goodwill and intangible assets. Excluding this impairment loss, net income in 2011 was US\$ 12.60 mn, compared to 2010 net income of US\$ 11.92 mn.
- Full year Non-GAAP net income increased – Non-GAAP net income was US\$ 25.23 mn, a 10% increase compared to 2010 full year Non-GAAP net income of US\$ 22.85 mn.

### Internet Games

Our Internet games revenues increased to US\$38.9 million in 2011 from US\$17.1 million in 2010. This increase was driven largely by revenues generated from the operation of our massive multiplayer online game, World of Tanks, in the China. Due to our strong performance with World of Tanks, in May 2012, we announced a strategic partnership with Wargaming.net for all of Wargaming.net's existing and future games in the mainland China market, including but not limited to World of Tanks, World of Warplanes and World of Warships.

In addition to our partnership with Wargaming.net, in 2012, we also announced exclusive licensing deals to bring Guild Wars 2 from ArenaNet, Hawken from Meteor Entertainment and Offensive Combat from U4iA Games to the mainland China online game market.

These licensing deals highlight our strategy of partnering with world-class Internet game developers in the mainland China online game market, while maintaining our self-development of high-quality 3D online games for the China market, like Kung Fu Hero.

We believe our portfolio of Internet games provides the Company with a truly differentiated Internet game offering compared to our competitors in the market and expect our Internet games business to see continued growth in the coming years.

### Smartphone Mobile Games

Our mobile games revenues decreased by 16.9% to US\$40.9 million in 2011 from US\$49.2 million in 2010. This decrease was mainly due to our mobile operator partners decision to de-emphasize its subscription-based feature phone mobile games download services.

However in early 2012, we completed our acquisition of Noumena and began our pivot away from featurephone mobile games to smartphone mobile games on iOS and Android smartphone platforms. Although we are still early in the development of our smartphone game business, we believe we have a number of advantages to potentially become a leading player in the China in the smartphone game market.

- Through our acquisition Noumena and their mobile game engine, Handymo, we are able to cost efficiently produce high-quality games, that allow us to address both the global iOS and China Android markets with limited porting costs.
- In addition, we now have over 100 development staff from both our mobile game and Internet game teams developing games on the Noumena/Handymo game platform with a focus on high-end smartphone mobile games.
- Moreover, we have begun to develop marketing channels for the China Android market by leveraging our WVAS team and resources to take advantage of the estimated 150 mn Android smartphones in the market in China today.

## WVAS

Our WVAS revenues decreased by 3.6% to US\$80.3 million in 2011 from US\$83.3 million in 2010. Although we expect the WVAS business environment to remain difficult, we still view our WVAS business as a stable source of cashflow for the Company and more importantly, due to the WVAS division's strong relationships with Chinese mobile operators, partnerships with various mobile handset manufacturers and other distribution partners, WVAS provides KONG with a strong platform to support the more rapid development of smartphone mobile games and future 3G applications, such as mobile literature.

## Transformation into a diversified digital entertainment company

I believe the foundation KONG has established in our games business, in particular our overseas licensed games and smartphone mobile games, provides strong growth opportunities for the Company in the coming years.

I would like to thank all of our shareholders, business partners and employees for their continued support and confidence.

Sincerely,



Leilei Wang  
Chairman and Chief Executive Officer



## Key Financial Information

Our audited consolidated financial statements have been prepared and presented in accordance with the generally accepted accounting principles in the United States, or U.S. GAAP.

For the year ended December 31,						
Consolidated statements of operations data	2007	2008	2009	2010	2011	
(in thousands of U.S. dollars, except shares and per share data)						
Revenues	US\$ 74,016.9	US\$ 96,689.7	US\$ 131,298.2	US\$ 149,583.4	US\$ 160,008.4	
WVAS (1)	71,181.0	88,946.4	104,001.6	83,280.3	80,265.9	
Mobile games	2,835.9	7,743.3	27,296.6	49,171.5	40,850.5	
Internet games	—	—	—	17,131.6	38,892.0	
Sales tax (2)	(2,229.6)	(2,839.6)	(2,885.1)	(3,209.0)	(3,827.8)	
WVAS	(2,207.7)	(2,583.0)	(2,273.6)	(1,584.4)	(1,390.9)	
Mobile games	(21.9)	(256.6)	(611.5)	(925.1)	(621.1)	
Internet games	—	—	—	(699.5)	(1,815.8)	
Net revenues	71,787.3	93,850.1	128,413.1	146,374.4	156,180.6	
WVAS	68,973.3	86,363.4	101,728.0	81,695.9	78,875.0	
Mobile games	2,814.0	7,486.7	26,685.1	48,246.4	40,229.4	
Internet games	—	—	—	16,432.1	37,076.2	
Cost of revenues	(36,495.6)	(51,612.5)	(65,946.8)	(80,238.6)	(91,930.2)	
WVAS	(35,119.7)	(48,132.7)	(54,258.5)	(48,329.5)	(50,758.6)	
Mobile games	(1,375.9)	(3,479.8)	(11,688.3)	(29,570.8)	(25,248.0)	
Internet games	—	—	—	(2,338.3)	(15,923.6)	
Gross profit	35,291.7	42,237.6	62,466.3	66,135.8	64,250.4	
WVAS	33,853.6	38,230.7	47,469.5	33,366.5	28,116.4	
Mobile games	1,438.1	4,006.9	14,996.8	18,675.4	14,981.4	
Internet games	—	—	—	14,093.9	21,152.6	
Operating expenses:						
Product development	(12,535.2)	(15,180.8)	(18,272.0)	(23,964.7)	(15,416.9)	
Selling and marketing	(18,094.2)	(21,338.9)	(17,821.2)	(18,975.6)	(20,891.6)	
General and administrative	(4,991.4)	(8,800.4)	(10,186.9)	(10,481.8)	(11,582.2)	
Impairment loss on goodwill	—	—	—	(2,998.3)	(20,255.3)	
Impairment loss on intangible assets	—	(21,623.3)	—	(5,730.6)	(3.9)	
Total operating expenses	(35,620.8)	(66,943.4)	(46,280.1)	(62,151.0)	(68,149.9)	
Change in fair value of contingent consideration for business acquisition	—	—	—	10,894.5	(3,729.5)	
Government subsidies	—	—	—	337.7	319.2	
Income (loss) from operations	(329.1)	(24,705.8)	16,186.2	15,217.0	(7,309.8)	
Interest income	3,810.0	4,897.4	3,114.3	2,342.8	3,569.2	
Interest income from loans to third party	—	—	—	—	1,193.2	
Interest expense for convertible senior note	—	—	(725.9)	(1,059.9)	(487.7)	
Impairment loss on cost method investment	—	—	(1,500.0)	(1,509.9)	—	
Loss on extinguishment of debt upon prepayment of convertible senior note	—	—	—	—	(1,567.5)	
Investment income	207.6	—	206.9	883.2	85.6	
Net income (loss) before income taxes	3,688.5	(19,808.4)	17,281.5	15,873.2	(4,517.0)	
Income taxes expense	(856.8)	(851.9)	(4,698.1)	(3,950.0)	(3,137.9)	
Net income (loss)	US\$ 2,831.7	(20,660.3)	12,583.4	11,923.2	(7,654.9)	
Net income (loss) per share:						
Basic	US\$ 0.00	(0.01)	0.01	0.01	(0.00)	
Diluted	US\$ 0.00	(0.01)	0.01	0.01	(0.00)	
Weighted average shares used in calculating net income (loss) per share:						
Basic	1,423,156,120	1,424,581,293	1,385,201,479	1,466,947,693	1,607,110,119	
Diluted (3)	1,430,910,421	1,424,581,293	1,537,771,051	1,547,870,678	1,607,110,119	

(1) We combined our wireless Internet services, or WIS, business into our WVAS business in 2010. The segment reporting information of the WIS business has been combined into that of WVAS for all prior periods presented.

(2) Prior to October 1, 2009, we presented sales tax on a gross basis (included in revenues and general and administrative expenses). Since October 1, 2009, we have presented sales tax on a net basis (excluded from net revenues) in order to provide better comparability of our financial statements to those of our peer companies. We have applied this change in accounting principles retrospectively to all prior periods presented.

(3) As of December 31, 2007, 2008, 2009, 2010 and 2011, we had 82 million, 137 million, 76 million, 76 million and 210 million ordinary share equivalents, respectively, outstanding that could potentially dilute income per share in the future, but that were excluded in the computation of diluted income per share in the periods as their effect would have been anti-dilutive.

As of December 31,					
Consolidated balance sheet data	2007	2008	2009	2010	2011
Cash and cash equivalents	US\$ 122,342.7	US\$ 136,054.3	US\$ 139,289.5	US\$ 157,170.8	US\$ 129,511.5
Held-to-maturity securities	—	—	—	—	17,299.1
Trading Securities	—	—	100.6	20.3	7,754.6
Loans to third party	—	—	—	—	22,187.3
Accounts receivable, net	14,992.9	16,196.0	25,276.8	21,794.0	19,903.0
Property and equipment, net	4,498.1	3,369.3	3,116.0	3,738.6	3,620.3
Acquired intangible assets, net	1,266.3	673.4	2,284.9	4,452.7	2,347.9
Long-term investment	—	2,963.0	1,464.5	—	—
Goodwill	34,918.7	15,683.1	23,042.3	87,705.7	72,967.1
<b>Total assets</b>	<b>181,891.9</b>	<b>178,852.4</b>	<b>200,078.6</b>	<b>281,445.3</b>	<b>280,248.0</b>
Total current liabilities	11,293.1	18,108.7	23,565.3	63,474.7	32,526.0
Convertible note payable	—	—	3,001.0	3,552.7	1,272.6
Total shareholders' equity	170,475.8	160,688.2	173,040.7	213,940.4	246,177.7
Total liabilities and shareholders' equity	181,891.9	178,852.4	200,078.6	281,445.3	280,248.0

For the year ended December 31					
Consolidated cash flow data	2007	2008	2009	2010	2011
(in thousands of U.S. dollars)					
Net cash (used in) provided by:					
Operating activities	US\$ 3,315.3	US\$ 12,521.5	US\$ 15,289.1	US\$ 26,013.6	US\$ 33,433.8
Investing activities	(18,720.1)	(4,811.9)	(8,282.6)	(10,314.9)	(40,284.8)
Financing activities	152.2	(759.3)	(3,865.7)	(776.5)	(26,335.0)



## Business Overview

## History and Development of the Company

We were incorporated on May 6, 2002 under the laws of the Cayman Islands as Communication Over The Air Inc., an exempted limited liability company. In March 2004, we changed our name to KongZhong Corporation. We are headquartered in Beijing, the PRC, and provide WVAS, mobile games and wireless Internet sites to mobile phone users throughout the PRC. Since our acquisition of Dacheng in January 2010, we have also offered Internet games to Internet users throughout the PRC. In January 2007, we established a wholly-owned subsidiary, Monkey King Search Corporation, or Monkey King, under the laws of the Cayman Islands in an effort to develop our wireless search business. Monkey King in turn established its own wholly-owned subsidiary, Wukong Shentong, under the laws of the PRC. After developing our wireless search business through Monkey King and Wukong Shentong for a period of time, in September 2008, we decided to terminate our project of developing wireless search business and liquidate Monkey King and Wukong Shentong, which did not have significant business activities at the time. We completed the liquidation of Wukong Shentong in July 2010. As part of the winding-up of the businesses of Monkey King and Wukong Shentong, we sold certain assets of these companies to Nick Yang, the former Vice Chairman of our Board of Directors. In July 2008, we liquidated Beijing Shuziyuansu Advertising Co., Ltd., a company formerly owned by two of our operating companies, Beijing Boya Wuji and Beijing WINT, because it had not had any operating activity since its incorporation in September 2005. In July 2008, BJXR, one of our operating companies, established its own subsidiary, Beijing Shiyuan Leya, which operates certain types of our WVAS business. We completed the liquidation of Anjian Xingye Technology (Beijing) Co., Ltd., or Anjian Xingye, our wholly foreign owned enterprise in the PRC, in May 2010.

We conduct substantially all of our business in the PRC through our wholly-owned subsidiaries in the PRC, KongZhong Beijing, KongZhong China and Simlife Beijing. In order to meet domestic ownership requirements under PRC laws, which restrict us and our PRC subsidiaries, as either foreign or foreign-invested companies, from operating certain value-added telecommunications, Internet services and Internet games businesses. We operate WVAS, mobile games, wireless Internet sites and Internet games through Beijing AirInbox, Beijing WINT, Beijing Chengxitong, BJXR, Mailifang, Xinreli and Dacheng, all of which are based in the PRC and are wholly-owned by PRC citizens. We do not have any equity interests in Beijing AirInbox, Beijing WINT, Beijing Chengxitong, BJXR, Mailifang, Xinreli or Dacheng, but enjoy the economic benefits of these companies through a series of contractual arrangements as described below.

Our principal executive office is located at 35th Floor, Tengda Plaza, No. 168, Xizhimenwai Street, Beijing, 100044, the PRC. Our telephone number is (8610) 8857-6000. The address of our primary website is [www.KongZhong.com](http://www.KongZhong.com) and the address of our primary wireless Internet site is [Kong.net](http://Kong.net). Information contained on our website or our wireless Internet site does not constitute a part of this annual report.

In July 2004, we completed the initial public offering of our ADSs representing our ordinary shares and listed the ADSs on the NASDAQ Global Market, or NASDAQ. Effective January 1, 2008, our ADSs are listed on the NASDAQ Global Select Market.

## Our Online Games Business

In January 2010, we acquired Dacheng and with it our business unit, Internet games. We launched our self-developed 3D MMORPGs, Loong, EMoFaZe, XiaKeXing and ShengMoZhiXue from December 2009 to October 2010.

In 2010, we licensed the World of Tanks game from WarGaming.net LLP. World of Tanks is a “freemium” 3D team-based massive multiplayer online game, featuring historic fighting vehicles from the 1930s to the 1950s. Since its launch, the World of Tanks game has become one of the most popular games we offer. As of December 31, 2011, the World of Tanks game had been downloaded over 4.7 million times, with over 5 million registered users. As a result of the successful launching of the game, revenues generated from in-game items purchased by game players who play the World of Tanks game represented over 69% of our Internet games revenues in 2011.

In addition to licensed games, we also develop Internet games internally based mainly on our proprietary technologies, which include our proprietary game engine (Dazzler 3D), game development platforms and online game billing system, all developed by our internal team. In particular, our Dazzler 3D game engine enables us to create high-quality 3D graphics and visual effects, and provides the technical foundation for creating innovative features in our games. Furthermore, our game development platforms give us the capacity to develop Internet games within approximately six to 24 months and to update our Internet games frequently in response to players’ preferences. Based on these platforms, we made publicly available our newest self-developed game, Kung Fu Hero, a Chinese martial arts-themed 3D MMORPG, in March 2012 for open beta testing.

We use an item-based revenue model for our games, whether internally developed or licensed, under which players can play our games on the Internet free of charge, but have to pay for purchases of in-game virtual items, such as in-game currencies,



performance-enhancing clothing, weapons, accessories and pets. We distribute our electronic prepaid game cards and game points, which can be used to purchase in-game virtual items, to players through multiple payment channels. Although we expect a substantial portion of our Internet games revenues to be generated in the PRC, we have licensed our games to leading game operators outside the PRC and plan to license them in additional countries and regions.

### Our Mobile Games Business

We are a leading developer and publisher of mobile games for mobile phone users in the PRC. Our internal development team develops mobile games based primarily on the Java™ technology, but more recently we have broadened our development of mobile games to include smartphone mobile operation systems, such as iOS and Android. The mobile games we develop include action, role-playing and leisure games.

We established a dedicated mobile games product development team, and acquired Tianjin Mammoth, a mobile games developer, in 2005. In 2009, we acquired Simlife, a leading mobile games developer in the PRC. In 2012, we acquired Noumena, a developer of cross-platform smartphone mobile game engines. We believe the integration of the Noumena team into our existing mobile game development team will enable us to create new smartphone mobile games that can take advantage of the Handymo game engine technologies developed by Noumena. We believe these new smartphone mobile games will enable us to leverage our existing mobile game distribution channels in China and capture market share in the nascent PRC smartphone mobile games market.

### Our WVAS Business

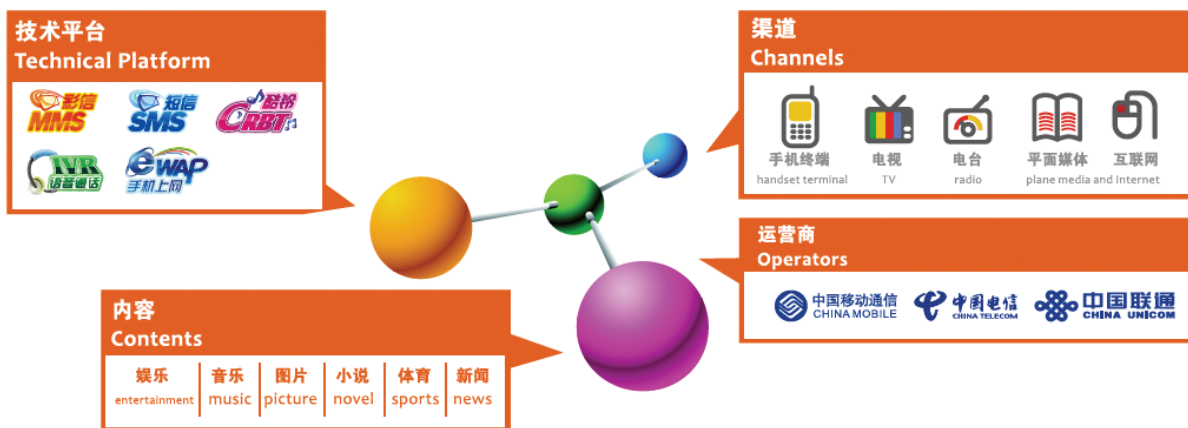
We provide interactive entertainment, media and other interactive services to mobile phone users in China through various second generation standard, or 2G, technology platforms, including SMS, IVR and CRBT, and through various “second and a half” generation standard, or 2.5G, technology



and operating platforms, including WAP and MMS, which offer higher quality graphics, richer content and more interactivity than 2G wireless services. Our WVAS are tailored to the technical or other requirements of our telecommunications operator partners, through whom we deliver most of our WVAS, and to various billing systems for WVAS. Our WVAS are also delivered and marketed through various media partners, including handset manufacturers, television stations, radio stations, print media and Internet sites. Our WVAS revenues accounted for 79.2%, 55.7% and 50.2% of our total revenues in 2009, 2010 and 2011, respectively.

We offer a variety of WVAS, such as mobile games, pictures, karaoke, electronic books, mobile phone personalization features, and entertainment news, chat and message boards. Customers can access these services directly from their mobile phones: (i) by using our access code or by choosing a feature pre-loaded in select models of handsets; (ii) from a telecommunications operator’s portal or website; and (iii) from our wireless Internet websites, including Kong.net. Substantially all of our services are ordered or accessed by users directly through their mobile phones, and all services are delivered through mobile phones.

We provide our services mainly pursuant to our cooperation arrangements with the telecommunications operators and their provincial subsidiaries, the terms of which are generally for one year or less. We do not directly bill our users, and depend on the billing systems and records of the telecommunications operators to bill and collect all fees. We generally do not have the ability to independently verify the accuracy of the billing systems of the telecommunications operators. As the telecommunications operators do not provide us with a detailed revenue breakdown on a service-by-service basis, we depend on our internal data management system to monitor revenues derived from each of our services. We make our business decisions based on our internal data, taking into account our historical experience in reconciling our internal data to our actual results of operations and other factors, including strategic considerations. Our dependence on the substance and timing of the billing systems of the telecommunications operators and their subsidiaries may require us to estimate portions of our reported revenues and cost of revenues for WVAS and mobile games. As a result, subsequent adjustments may have to be made to our financial statements.”



Our WVAS business also includes what had previously been our WIS business, which consists of the operation of a variety of mobile Internet sites, such as: (i) Kong.net, our integrated mobile portal; (ii) ct.cn, our mobile Chinese literature site; and (iii) ko.cn, our internally-developed mobile games community site. These sites had previously been operated as a separate business segment, but we consolidated the majority of the WIS business segment, including our operation of Kong.net and ct.cn, into our WVAS business segment in 2010 to reflect certain changes in our WIS business, further streamline our WIS operations and take advantage of the synergies between our operation of Kong.net and ct.cn and our WVAS business. We expected a key factor in the future revenue growth for our WIS business to be our partnership with China Mobile’s mobile literature and WAP platforms. The future growth of our WIS business, particularly our operation of Kong.net and ct.cn, was expected to be more dependent on our WVAS business and the partnership with China Mobile. Due to this anticipated synergy between our WVAS and WIS businesses, we believed it was more appropriate to combine our WIS business into our overall WVAS business.



**Operation and Financial  
Review and Prospects**

## Overview

We are one of the leading providers of digital entertainment services for consumers in the PRC. We operate three main business units, namely WVAS, mobile games and Internet games. We are one of the leading providers of WVAS to mobile phone users and have been in cooperation with all major telecommunications operators in the PRC since 2002. In 2005, we began providing feature-phone mobile games on the networks of China Mobile with the acquisition of Tianjin Mammoth, a mobile games developer. To further expand our mobile games development capabilities, we acquired Noumena in 2012 in order to develop smartphone mobile games on smartphone mobile operating systems, such as iOS and Android. We commenced our Internet games business in 2010 through our acquisition of Dacheng, a developer and operator of Internet games in the PRC. In addition to developing and operating our self-developed Internet games, such as Loong, Demon Code and Kung Fu Hero, we are the exclusive operator of the popular World of Tanks game for the PRC Internet games market.

## Revenues

The following table sets forth the revenues attributable to services derived from the WVAS, mobile games and Internet games segments in terms of amount and as a percentage of our total revenues for the periods indicated:

	For the year ended December 31,					
	2009		2010		2011	
	Amount	Percentage of revenues	Amount	Percentage of revenues	Amount	Percentage of revenues
	(in thousands of U.S. dollars, except percentages)					
WVAS	US\$ 104,001.6	79.2%	US\$ 83,280.3	55.7%	US\$ 80,265.9	50.2%
Mobile games	27,296.6	20.8	49,171.5	32.8	40,850.5	25.5
Internet games	–	–	17,131.6	11.5	38,892.0	24.3
Total	US\$ 131,298.2	100.0%	US\$ 149,583.4	100.0%	US\$ 160,008.4	100.0%

The following table sets forth the revenues attributable to services derived from each of our 2G and 2.5G technology platforms in terms of amount and as a percentage of our total revenues for the periods indicated:

	For the year ended December 31,					
	2009		2010		2011	
	Amount	Percentage of revenues	Amount	Percentage of revenues	Amount	Percentage of revenues
	(in thousands of U.S. dollars, except percentages)					
2G services SMS	US\$ 44,484.6	33.9%	US\$ 34,485.6	23.1%	US\$ 37,096.5	23.2%
IVR	19,512.7	14.9	17,706.8	11.8	12,661.9	7.9
CRBT and others	18,694.5	14.2	21,057.4	14.1	21,578.9	13.5
Subtotal	82,691.8	63.0	73,249.8	49.0	71,337.3	44.6
2.5G services WAP	US\$ 13,106.2	10.0	US\$ 4,485.8	3.0	US\$ 2,355.4	1.5
MMS	8,203.6	6.2	5,544.7	3.7	6,573.2	4.1
Subtotal	21,309.8	16.2	10,030.5	6.7	8,928.6	5.6
Total WVAS revenues	104,001.6	79.2%	83,280.3	55.7%	80,265.9	50.2%

## ***WVAS Revenues***

Prior to 2004, we generated all of our WVAS revenues from fees paid by mobile phone users who use our services through China Mobile's network. Starting from 2004, we began cooperating with China Unicom, China Netcom and China Telecom and received revenues from services provided on their networks. In order to reduce our dependence on China Mobile for our WVAS business, we acquired Sharp Edge in January 2006, which derived most of its revenues from China Unicom, China Netcom and China Telecom. However, our dependence on China Mobile increased in 2011, as China Unicom and China Telecom continued to de-emphasize their WVAS businesses relative to China Mobile. Our WVAS business through China Mobile as a percentage of our total WVAS revenues grew as a result. As a percentage of our total WVAS revenues, WVAS revenues generated from China Mobile represented approximately 71% and 73% in 2010 and 2011, respectively. However, due to our dependence on China Mobile for a substantial portion of our WVAS revenues, our working relationship with China Mobile is critical to the financial condition and results of operations of our WVAS business.

We allocate our WVAS resources based on the geographic concentration of our customers. Due to our customer base being primarily concentrated in the coastal regions of the PRC, we generally allocate more of our WVAS resources to these regions, including maintaining sales offices in most of the coastal regions of the PRC.

We recognize revenues derived from our services before deducting the service fees and the net transmission charges that we pay to the telecommunications operators. Fees for our services are charged on either a single-transaction or monthly subscription basis and vary according to the type of services delivered.

## ***Mobile Games Revenues***

We generate substantially all of our mobile games revenues by distributing mobile games through the networks of China Mobile. In 2011, we derived 93.2% of our mobile games revenues from the monthly subscription fees paid by our customers. As a percentage of our total mobile games revenues, mobile games revenues received through China Mobile accounted for 98.5%, 98.4% and 97.1% in 2009, 2010 and 2011, respectively. Due to our dependence on China Mobile for substantially all of our mobile games revenues, our working relationship with China Mobile is critical to the operation of our mobile games business. We expect to supplement these streams of revenues in 2012 with revenues that we expect to generate from sales of our internally-developed smartphone mobile games, which we plan to distribute through digital distribution platforms, such as app stores developed by smartphone handset manufacturers.

Our mobile games revenues increased to US\$49.2 million in 2010 from US\$27.3 million in 2009, principally as a result of our efforts in developing our mobile games business, decreases in 2.5G data tariffs and the increased penetration of higher-end feature-phones capable of playing mobile games. In 2011, our revenues generated from mobile games decreased to US\$40.9 million, which was primarily due to the adoption by China Mobile of measures similar to those that have affected our WVAS business, as described above, and China Mobile's decision to de-emphasize its subscription-based mobile games download services. The decrease in 2011 was also attributable to impact created by the overall market shift in the tastes and preferences of consumers in China from traditional feature-phone mobile games, which are mainly Java-based, to mobile games that are developed for smartphone mobile operating systems, such as iOS and Android mobile games. We believe this shift in tastes and preferences of consumers in China will continue in 2012.

## ***Internet Games Revenues***

The Internet games revenues are primarily derived from Internet games operation revenues and licensing revenues. We earn Internet games operation revenues through the provision of Internet games services to players under an item-based revenue model. Under such a model, the basic functions of a game are free of charge, and, instead, players are charged for purchases of in-game items, which can enhance the game-playing experience. In 2011, we derived a majority of our Internet games revenues from revenues generated through the operation of our licensed Internet games, especially the World of Tanks game, which generated over 69% of our Internet games revenues from the in-game items purchased for the World of Tanks game for 2011. We expect revenues generated from the World of Tanks game to continue to be a major driver for growing our Internet games revenues in 2012. Due to our dependence on the World of Tanks game for a majority of our Internet games revenues, our business relationship with WarGaming.net LLP is critical to the continued operation of the World of Tanks game. As a result, any factors that could have an adverse impact on the development, marketing and distribution of these Internet games, or on our business relationships with the licensors of these Internet games, could material reduce our Internet games revenues, and have a material adverse effect on our business, financial condition, results of operations and prospects.

Revenues from the sales of in-game items are recognized when items are consumed by customers or over the estimated lives of the items. The average period that players typically play the game and other player behavior patterns, which are affected by various factors such as acceptance and popularity of expansion packs, promotional events and market conditions, are utilized to arrive at the best estimates for lives of these in-game items. We assess the estimated lives of in-game items for all of our games on a quarterly basis. If there are indications of any significant changes to the estimated lives of the in-game items, such changes would be applied in the period of change prospectively.

Under the item-based revenue model, proceeds received from sales of game points, which can be used to purchase in-game



items, to players are recorded as deferred revenues, while proceeds received from sales of game points to third parties other than players and sales of prepaid game cards, which can also be used to purchase in-game items, are initially recorded as advances from customers. As we do not have control and generally do not know the ultimate selling price of the prepaid game cards or game points sold by the distributors, net proceeds from distributors are recorded as advances from customers. Upon activation of the game cards or the game points, these advances from customers are immediately transferred to deferred revenues.

In addition, we entered into licensing arrangements with various licensees to operate our games in the PRC and in other countries and regions. These licensing agreements provide for two revenue streams: the initial fees and the usage-based royalty fees. In certain licensing arrangements, we provide free upgrades, maintenance support and training, which are our post-sale customer support, or PCS, for the first year. The licensees have the option to purchase PCS in subsequent years at specified renewal rates. In these arrangements, we allocate the initial fee into two parts. The first part represents the license of the game and is recognized as license revenue immediately upon the launch of the games in foreign countries or regions. The second part represents fees for the PCS and is recognized ratably over the contractual period of the PCS. In other licensing arrangements, we provide PCS over the full licensing period for no additional charge. In such cases, the total amount of the initial fee is recognized ratably over the full contractual licensing period.

According to our license agreements, we are also entitled to ongoing usage-based royalties determined based on the amount of fees charged to the players' accounts or services payable by players in a given country or region. The usage-based royalties are recognized when they are earned, provided that the collection is probable.

Our Internet games revenues were US\$38.9 million in 2011, of which 94.0% was generated from game operations and 6.0% was generated from licensing our Internet games to third party licensees.

## Cost of Revenues

Our cost of revenues includes WVAS cost of revenues, mobile games cost of revenues and Internet games cost of revenues.

### WVAS Cost of Revenues

Our WVAS cost of revenues includes the following:

- Service fees payable by us to the telecommunications operators. In the case of China Mobile and its subsidiaries, service fees are generally 15% to 60% of the revenues, while in the case of China Unicom and China Telecom, service fees are in the range of 15% to 52%, varying according to the service platform. We are not obligated to pay the service fees to the telecommunications operators if the customers cannot be billed or do not pay the telecommunications operators;
- Net transmission charges payable by us to the telecommunications operators, calculated as the number of messages we send to customers in any given month, minus the number of messages we receive from customers regarding our services in that month, multiplied by a per-message transmission fee. We are obligated to pay the telecommunications operators the net transmission charges even if the customers cannot be billed or do not pay the telecommunications operators;
- Payments to content providers for the use of their content, and to mobile handset manufacturers and other industry partners with whom we have cooperation arrangements, in the form of a fixed fee or a percentage of our aggregate net revenues received from the telecommunications operators with respect to services provided through the cooperation arrangements;
- Bandwidth leasing charges and depreciation and facility costs relating to equipment used to provide WVAS;
- Depreciation and facility maintenance.

Our total WVAS cost of revenues in 2009, 2010 and 2011 was US\$54.3 million, US\$48.3 million and US\$50.8 million, respectively. As a percentage of our WVAS revenues, our WVAS cost of revenues in 2009, 2010 and 2011 was 52.2%, 58.0% and 63.2%, respectively. In 2011, as a percentage of our WVAS cost of revenues, service fees to the telecommunications operators represented approximately 39.1%, payments to handset manufacturers represented approximately 19.5%, net transmission charges to the telecommunications operators represented approximately 27.5%, payments to content providers represented approximately 6.8%, payment to other cooperation partners represented approximately 0.5% and bandwidth leasing charges, depreciation and other facility costs represented approximately 6.6%.

Our WVAS cost of revenues increased in 2011 primarily as a result of increases in the content fees we paid to our content providers in 2011. As our overall WVAS revenues decreased, the amount that we paid to telecommunications operators in service fees and net transmission charges also decreased. The service fees that we paid to other business partners, including mobile handset manufacturers and media partners, also decreased as we sought to diversify our non-operator distribution channels.

As part of our business strategy, we expect to continue to pursue more cooperation arrangements with business partners, such as handset manufacturers, because these arrangements make it easier for customers to access our products and services and are a cost-effective way to increase our market share as compared to traditional advertising. However, as we generally pay higher rates of service fees, in terms of percentages of revenues generated from cooperation arrangements, to such business partners than those paid to telecommunications operators, this strategy may result in a decrease in our gross profit margin.

### Mobile Games Cost of Revenues

Our mobile games cost of revenues consists mainly of service fees and net transmission charges to the telecommunications operators, payments to content providers for the use of their content and bandwidth leasing charges.

Total mobile games cost of revenues in 2009, 2010 and 2011 was US\$11.7 million, US\$29.6 million and US\$25.2 million, respectively. The decrease in mobile games cost of revenues in 2011 resulted largely from a decrease in our overall mobile games business and associated service fees paid to telecommunications operators. In 2010, we began offering subscription-based mobile games download services through our partnership with China Mobile. Based on our agreement with China Mobile, we share approximately 50% of our subscription-based revenues with China Mobile, compared to approximately 15% for single-download games. Largely as a result of the adoption by China Mobile of similar measures that have affected our WVAS business and China Mobile's de-emphasizing of its feature-phone mobile games services, our mobile games cost of revenues in 2011 has decreased by 14.6% from 2010. We expect our mobile games cost of revenues to remain stable in 2012. We further expect our mobile games cost of revenues to correspondingly increase as a result of higher sales of our internally-developed smartphone mobile games, which we plan to distribute through digital distribution platforms, such as app stores developed by smartphone handset manufacturers. However, we expect such increase to be offset by continued decreases in the costs of distributing our mobile games through China Mobile as China Mobile continues to de-emphasize feature-phone mobile games.

We intend to develop internally the majority of our mobile games, which generally have lower cost of revenues. However, in order to expand our mobile games business and increase our market share, we also plan to actively identify quality mobile games to be acquired or licensed from third parties, which generally have higher cost of revenues.

### Internet Games Cost of Revenues

Our Internet games cost of revenues consists mainly of revenue sharing paid to third party Internet game licensors, labor cost, bandwidth leasing charges, depreciation and facility costs relating to equipment used to provide Internet games services. Total Internet games cost of revenues in 2010 and 2011 was US\$2.3 million and US\$15.9 million, respectively. As a percentage of our Internet games cost of revenues, revenue sharing paid to third party Internet game licensors accounted for nil and 68.8% in 2010 and 2011, respectively. The increase in Internet games cost of revenues in 2011 was primarily due to increases in our overall Internet games business and associated revenue sharing paid to third party Internet game licensors. We began acquiring licenses to operate Internet games from other Internet games developers in 2011, as part of our plan to grow our portfolio of licensed Internet games that complement our internally developed games. We expect our Internet games cost of revenues to increase in 2012 as we expect revenues generated from the World of Tanks game to continue to be a major driver for growing our Internet games revenues in 2012. To a lesser extent, we expect our Internet games cost of revenues to increase in 2012 as a result of a new stream of revenues derived from the operation of one of our internally-developed Internet games, which we plan to launch in the first quarter of 2012.

## Operating Expenses

Our operating expenses include product development, sales and marketing and general and administrative expenses. The following table sets forth operating expenses data in terms of amount and as a percentage of our revenues for the periods indicated:

	For the year ended December 31,					
	2009		2010		2011	
	Amount	Percentage of revenues	Amount	Percentage of revenues	Amount	Percentage of revenues
(in thousands of U.S. dollars, except percentages)						
Product development	US\$ 18,272.0	13.9%	US\$ 23,964.7	16.0%	US\$ 15,416.9	9.6%
Selling and marketing	17,821.2	13.6	18,975.6	12.7	20,891.6	13.1
General and administrative	10,186.9	7.8	10,481.8	7.0	11,582.2	7.2
Goodwill and intangible assets impairment loss	—	—	8,728.9	5.8	20,259.2	12.7
<b>Total</b>	<b>US\$ 46,280.1</b>	<b>35.3%</b>	<b>US\$ 62,151.0</b>	<b>41.5%</b>	<b>US\$ 68,149.9</b>	<b>42.6%</b>

### ***Product Development Expenses***

Our product development expenses consist primarily of compensation and benefits for our product and development team. Our product development expenses in 2009, 2010 and 2011 were US\$18.3 million, US\$24.0 million and US\$15.4 million, respectively. We expect our product development expenses to increase in 2012 as we continue to expand our offerings in mobile games and Internet games.

### ***Sales and Marketing Expenses***

Our sales and marketing expenses consist mainly of expenses associated with sponsoring promotional events and compensation and benefits for our sales, marketing and customer service teams. Our sales and marketing expenses in 2009, 2010 and 2011 were US\$17.8 million, US\$19.0 million, and US\$20.9 million, respectively. We expect our sales and marketing expenses to increase in 2012, as we plan to continue to promote our Internet and mobile games and to launch Kungfu Hero, one of our internally-developed Internet games, in 2012.

### ***General and Administrative Expense***

Our general and administrative expenses consist primarily of compensation and benefits for general management, finance and administrative personnel, professional fees and other office expenses. Our general and administrative expenses in 2009, 2010 and 2011 were US\$10.2 million, US\$10.5 million, and US\$11.6 million, respectively. We expect our general and administrative expenses to increase if our business grows in future periods as we may also incur more expenses relating to employee compensation and other administrative and professional fees.

### ***Impairment of Goodwill and Intangibles***

In the annual goodwill impairment test conducted in December 2009, the fair value of each reporting unit substantially exceeded its carrying value. Consequently, no goodwill impairment was recorded in 2009. In 2010, as certain of our Internet games performed significantly below our expectations, the goodwill and intangible assets impairment test performed in December 2010 found that the goodwill and intangible assets in the Internet games unit were impaired, resulting in a total impairment charge of US\$8.7 million.

In 2011, we experienced significant fluctuations in the prices of our ADSs, which resulted in our market capitalization falling below our book value during certain periods of the year and made it necessary for us to perform an impairment review of our business units. In the third quarter of 2011, we performed a goodwill impairment test and found that the goodwill and our intangible assets of our WVAS unit were impaired, resulting in a total impairment charge of US\$20.3 million and US\$4.0 thousand, respectively. However, based on the impairment test, our mobile games and Internet games units were not impaired.

## Results of Operations

The following table sets forth certain data from our consolidated results of operations for the periods indicated. This information should be read in conjunction with the consolidated financial statements and related notes included elsewhere in this annual report.

	For the year ended December 31,					
	2009		2010		2011	
	Amount	Percentage of revenues	Amount	Percentage of revenues	Amount	Percentage of revenues
(in thousands of U.S. dollars, except percentages)						
<b>Revenues</b>						
WVAS	\$104,001.6	79.2%	\$83,280.3	55.7%	\$80,265.9	50.2%
Mobile games	27,296.6	20.8	49,171.5	32.8	40,850.5	25.5
Internet games	—	—	17,131.6	11.5	38,892.0	24.3
Total revenues	131,298.2	100.0%	149,583.4	100.0%	160,008.4	100.0%
<b>Sales tax</b>						
WVAS	(2,273.6)	(1.7)%	(1,584.4)	(1.1)%	(1,390.9)	(0.9)%
Mobile games	(611.5)	(0.5)	(925.1)	(0.5)	(621.1)	(0.4)
Internet games	—	—	(699.5)	(0.5)	(1,815.8)	(1.1)
Total sales tax	(2,885.1)	(2.2)%	(3,209.0)	(2.1)%	(3,827.8)	(2.4)%
<b>Net revenues</b>						
WVAS	101,728.0	77.5%	81,695.9	54.6%	78,875.0	49.3%
Mobile games	26,685.1	20.3	48,246.4	32.3	40,229.4	25.1
Internet games	—	—	16,432.1	11.0	37,076.2	23.2
Total net revenues	128,413.1	97.8%	146,374.4	97.9%	156,180.6	97.6%
<b>Cost of revenues</b>						
WVAS	(54,258.5)	(41.3)%	(48,329.5)	(32.3)%	(50,758.6)	(31.7)%
Mobile games	(11,688.3)	(8.9)	(29,570.8)	(19.7)	(25,248.0)	(15.8)
Internet games	—	—	(2,338.3)	(1.6)	(15,923.6)	(10.0)
Total cost of revenues	(65,946.8)	(50.2)%	(80,238.6)	(53.6)%	(91,930.2)	(57.5)%
<b>Gross profit</b>						
WVAS	47,469.5	36.2%	33,366.4	22.3%	28,116.4	17.6%
Mobile games	14,996.8	11.4	18,675.6	12.5	14,981.4	9.4
Internet games	—	—	14,093.8	9.4	21,152.6	13.2
Total gross profit	62,466.3	47.6%	66,135.8	44.2%	64,250.4	40.2%
<b>Operating expenses:</b>						
Product development	(18,272.0)	(13.9)%	(23,964.7)	(16.0)%	(15,416.9)	(9.6)%
Selling and marketing	(17,821.2)	(13.6)	(18,975.6)	(12.7)	(20,891.6)	(13.1)
General and administrative	(10,186.9)	(7.8)	(10,481.8)	(7.0)	(11,582.2)	(7.2)
Impairment loss on goodwill	—	—	(2,998.3)	(2.0)	(20,255.3)	(12.7)
Impairment loss on intangible assets	—	—	(5,730.6)	(3.8)	(3.9)	—
Total operating expenses	(46,280.1)	(35.3)%	(62,151.0)	(41.5)%	(68,149.9)	(42.6)%
Change in fair value of contingent consideration for business acquisition	—	—	10,894.5	7.3	(3,729.5)	(2.3)
Government subsidies	—	—	337.7	0.2	319.2	0.2
Income (loss) from operations	16,186.2	12.3%	15,217.0	10.2%	(7,309.8)	(4.6)%
Interest income	\$3,114.3	2.4	\$2,342.8	1.5	\$3,569.2	2.2
Interest income from loans to third party	—	—	—	—	1,193.2	0.7
Interest expense for convertible senior note	(725.9)	(0.6)	(1,059.9)	(0.7)	(487.7)	(0.3)
Impairment loss on cost method investment	(1,500.0)	(1.1)	(1,509.9)	(1.0)	—	—
Loss on extinguishment of debt upon prepayment of convertible senior note	—	—	—	—	(1,567.5)	(1.0)
Investment income	206.9	0.2	883.2	0.6	85.6	0.1
Net income (loss) before income taxes	17,281.5	13.2%	15,873.2	10.6%	(4,517.0)	(2.8)%
<b>taxes</b>						
Income taxes expense	(4,698.1)	(3.6)	(3,950.0)	(2.6)	(3,137.9)	(2.0)
Net (loss) income	\$12,583.4	9.6%	\$11,923.2	8.0%	\$(7,654.9)	(4.8)%

Year ended December 31, 2011 compared to year ended December 31, 2010

**Revenues.** Our total revenues increased by 7.0% to US\$160.0 million in 2011 from US\$149.6 million in 2010. This increase was driven largely by the growth of our Internet games business, led by growth in revenues generated from the World of Tanks game, a massive multiplayer online game that we commercially launched in the PRC on March 15, 2011. This increase in total revenues was partially offset by a decrease in revenues generated from our WVAS and mobile games businesses.

Our WVAS revenues decreased by 3.6% to US\$80.3 million in 2011 from US\$83.3 million in 2010. Revenues from our 2G services decreased by 2.6% to US\$71.3 million in 2011 from US\$73.2 million in 2010. Revenues from our 2.5G services decreased by 11.0% to US\$8.9 million in 2011 from US\$10.0 million in 2010. These decreases were mainly due to policies implemented by the PRC telecommunications operators since late 2009, including those policies which resulted in the suspension of billing on WAP and G+ mobile games by China Mobile and other PRC telecommunications operators on behalf of third party service providers of such services. To a lesser extent, the decreases were also due to a decrease in emphasis placed on WVAS by China Unicom, China Netcom and China Telecom, the three principal telecommunications operators in the PRC through which we collectively derived approximately 25% and 29% of our WVAS revenues in 2011 and 2010, respectively.

Our mobile games revenues decreased by 16.9% to US\$40.9 million in 2011 from US\$49.2 million in 2010. This decrease was mainly due to the adoption by China Mobile of measures similar to those that have affected our WVAS business, as described above, and China Mobile's decision to de-emphasize its subscription-based mobile games download services. In addition, the decrease in our mobile games revenues was also attributable to an overall shift in the tastes and preferences of consumers in China from traditional feature-phone mobile games, which are mainly Java-based, to mobile games that are developed for smartphone platforms, such as iOS and Android mobile games.

Our Internet games revenues increased to US\$38.9 million in 2011 from US\$17.1 million in 2010. This increase was driven largely by significant growth in revenues generated from the operation of our massive multiplayer online game, the World of Tanks game, in the PRC, which saw an increase in sales of in-game items purchased by the World of Tanks game players. We commercially launched the World of Tanks game on March 15, 2011. The increase in our Internet games revenues was partially offset by a decrease in our Internet games licensing revenues, which decreased by 3.7% from US\$2.4 million in 2010 to US\$2.3 million in 2011. Revenues generated within the PRC increased to US\$33.3 million in 2011 from US\$12.5 million in 2010, representing approximately 86% and 73% of our total Internet games revenues in 2011 and 2010, respectively. This increase was primarily attributable to increases in transaction volumes from sales of in-game items of the World of Tanks game. The portion of our Internet games revenues derived outside the PRC includes both license fees and revenue share generated from the operation of our self-developed games by third party publishing partners. Revenues generated outside the PRC increased by 20.0% to US\$5.6 million in 2011 from US\$4.6 million in 2010, representing approximately 14% and 27% of our Internet games revenues in 2011 and 2010, respectively. This increase was largely attributable to increases in licensing fees and revenue share generated from our self-developed games, such as Loong and Sheng Mo Zhi Xue, in overseas markets, such as Taiwan, Korea and South East Asia.

**Sales Tax.** Our total sales tax increased by 19.3% to US\$3.8 million in 2011 from US\$3.2 million in 2010.

Our WVAS sales tax decreased by 12.2% to US\$1.4 million in 2011 from US\$1.6 million in 2010. The decrease was mainly due to a decrease in the volume of our WVAS business.

Our mobile games sales tax decreased by 32.9% to US\$0.6 million in 2011 from US\$0.9 million in 2010, primarily due to a decrease in the volume of our mobile games business.

Our Internet games sales tax increased by 159.6% to US\$1.8 million in 2011 from US\$0.7 million in 2010, largely due to an increase in the volume of our internet games business.

**Cost of Revenues.** Our total cost of revenues increased by 14.6% to US\$91.9 million in 2011 from US\$80.2 million in 2010, representing 57.5% and 53.6% of our total revenues in 2011 and 2010, respectively. This increase was largely due to increases in revenue sharing paid to third party Internet games licensors and other costs associated with our Internet games business, as a result of increases in the volume of our Internet games business.

Our WVAS cost of revenues increased by 5.0% to US\$50.8 million in 2011 from US\$48.3 million in 2010, representing 63.2% and 58.0% of our WVAS revenues in 2011 and 2010, respectively. Despite a decrease in our WVAS revenues, WVAS cost of revenues increased in 2011 as a result of higher costs incurred by us to support additional compliance costs related to the changes in our WVAS business as required by the policies implemented since 2009 by the PRC telecommunications

operators to improve consumer experience. In addition, the increase in our WVAS cost of revenues was also due to increases in the cost of distribution channels for our WVAS services, which was principally attributable to the stricter operating environment as a result of the policies implemented by the PRC telecommunications operators described above.

Our mobile games cost of revenues decreased by 14.6% to US\$25.2 million in 2011 from US\$29.6 million in 2010, representing 61.8% and 60.1% of our mobile games revenues in 2011 and 2010, respectively. The decrease in our mobile games cost of revenues was primarily due to decreases in service fees and net transmission charges paid to the telecommunications operators, as a result of decreases in our overall mobile games business.

Our Internet games cost of revenues increased to US\$15.9 million in 2011 from US\$2.3 million in 2010, representing 40.9% and 13.7% of our Internet games revenues in 2011 and 2010, respectively. The significant increase in our Internet games revenues was primarily due to the significant increase in revenue sharing paid to third party Internet games licensors, as a result of significant increases in the volume of our Internet games business. In particular, the increase in revenue share paid to third party Internet games licensors was primarily due to increases in revenue sharing relating to the World of Tanks game.

**Gross Profit and Gross Margin.** Our total gross profit decreased by 2.9% to US\$64.3 million in 2011 from US\$66.1 million in 2010, primarily due to the decreased in the volume of our WVAS and mobile games business, which was partially offset by increases in the volume of our Internet games business. Our gross margin decreased slightly to 40.2% in 2011 from 44.2% in 2010.

Our WVAS gross profit decreased by 15.7% to US\$28.1 million in 2011 from US\$33.4 million in 2010, due to the decrease in our WVAS revenues relative to the increase in our WVAS cost of revenues, attributable primarily to a more strict operating environment as a result of the policies implemented by the PRC telecommunications operators described above. As a result of the foregoing, our WVAS gross profit margin decreased to 35.0% in 2011 from 40.1% in 2010.

Our mobile games gross profit decreased by 19.8% to US\$15.0 million in 2011 from US\$18.7 million in 2010, largely due to decreases in the volume of our mobile games business, as a result of the adoption by China Mobile of measures similar to those that have affected our WVAS business, as described above, and China Mobile's decision to de-emphasize its subscription-based mobile games download services. Our mobile games gross margin decreased to 36.7% in 2011 from 38.0% in 2010, as the de-emphasis by China Mobile of its subscription-based mobile games download services resulted in higher subscriber turnover, which increased the costs necessary to support a lower level of revenues generated from our mobile games segment.

Our Internet games gross profit increased by 50.1% to US\$21.2 million in 2011 from US\$14.1 million in 2010, largely due to increases in the volume of our Internet games business, driven primarily by increases in sales from in-game item purchases made by the World of Tanks game players and our successful operation of the World of Tanks game. Our internet games gross margin decreased to 54.4% in 2011 from 82.3% in 2010, principally as a result of increases in revenue sharing relating to the World of Tanks game.

**Operating Expenses.** Our operating expenses increased by 9.7% to US\$68.1 million in 2011 from US\$62.2 million in 2010, representing 42.6% and 41.5% of our total revenues in 2011 and 2010, respectively. The increase in our operating expenses primarily reflected the impact of an impairment loss of US\$20.3 million on goodwill and intangible assets for our WVAS segment, which was partially offset by a decrease in our product and development expenses. To a lesser extent, the increase in our operating expenses also reflected increases in our sales and marketing expenses, as a result of the increase in sales and marketing activity associated with our Internet games business.

Our product development expenses decreased by 35.7% to US\$15.4 million in 2011 from US\$24.0 million in 2010, representing 9.6% and 16.0% of our total revenues in 2011 and 2010, respectively. The decrease in our product and development expenses was primarily due to decreases in intangible assets amortization of our Internet games business and decreases in the number of our product development employees, which decreased to 660 as of December 31, 2011 from 773 as of December 31, 2010.

Our sales and marketing expenses increased by 10.1% to US\$20.9 million in 2011 from US\$19.0 million in 2010, representing 13.1% and 12.7% of our total revenues in 2011 and 2010, respectively. The increase in our sales and marketing expenses was primarily due to increase in sales and marketing activity associated with our Internet games business and increases in the number of our sales and marketing employees, which increased to 142 employees as of December 31, 2011 from 117 employees as of December 31, 2010, and, to a lesser extent, an increase in our customer service employees, which

was increased to 97 employees as of December 31, 2011 from 93 employees as of December 31, 2010.

Our general and administrative expenses increased by 10.5% to US\$11.6 million in 2011 from US\$10.5 million in 2010, representing 7.2% and 7.0% of our total revenues in 2011 and 2010, respectively.

**Change in Fair Value of Contingent Consideration for Business Acquisition.** On March 23, 2011, we completed the last payment due to Dacheng's shareholders. This final payment included US\$14.6 million in cash and 123.5 million of our ordinary shares, which is equivalent to 3.1 million ADSs. The fair value of this payment was US\$44.6 million, which resulted in a US\$3.7 million change in fair value of the contingent consideration.

**Loss on Extinguishment of Debt upon Prepayment of Convertible Senior Note.** On February 25, 2011, we prepaid 70% of the aggregate principal amount of a 5-year convertible senior note issued to NGP in March 2009 for US\$9.31 million in cash, plus any accrued but unpaid interest on the note. We recorded a US\$1.6 million non-cash charge to our net income as a result of the premium paid to the underlying conversion price of the convertible senior note.

**Income Tax.** Our income tax decreased by 20.6% to US\$3.1 million in 2011 from US\$4.0 million in 2010, primarily reflecting the decrease in our taxable income.

**Net income.** As a result of the foregoing, we had a net loss of US\$7.7 million in 2011 compared to net income US\$11.9 million in 2010.

## Liquidity and Capital Resources

### Cash Flows and Working Capital

The following table sets forth our cash flows with respect to operating, investing and financing activities for the periods indicated.

For the year ended December 31,			
	2009	2010	2011
(in thousands of U.S. dollars)			
Net cash provided by operating activities	US\$15,289.1	US\$26,013.6	US\$33,433.8
Net cash used in investing activities	8,282.6	10,314.9	40,284.8
Net cash used in financing activities	3,865.7	776.5	26,335.0
Effect of exchange rate changes	94.4	2,959.1	5,526.7
Net (decrease) increase in cash and cash equivalents	3,235.2	17,881.3	(27,659.3)
Cash and cash equivalents, beginning of year	136,054.3	139,289.5	157,170.8
Cash and cash equivalents, end of year	US\$139,289.5	US\$157,170.8	US\$129,511.5

Since the completion of our initial public offering, our primary sources of liquidity have been cash flow from operating activities and the proceeds of our initial public offering. We used a portion of the proceeds of our public offering to expand our business through acquisitions, and as of December 31, 2011, we had used the entire net proceeds from the initial public offering. As of December 31, 2010 and December 31, 2011, our cash and cash equivalents were US\$157.2 million and US\$129.5 million, respectively.

We do not bill or collect payment from users of our WVAS and mobile games directly, but instead depend on the billing systems and records of China Mobile and other PRC telecommunications operators to record the volume of such services provided, charge our customers, collect payments and remit payments to us less transmission fees and service fees. If China Mobile or any other PRC telecommunications operator ceases to continue cooperating with us, we would have to explore further cooperation with other telecommunications service providers and/or explore alternative billing systems to collect bills from customers.

Net cash provided by operating activities increased to US\$33.4 million in 2011 from US\$26.0 million in 2010 and US\$15.3 million in 2009. These increases were primarily due to cash provided by our Internet games business and a decrease in the turnover days of our accounts receivable.

Net cash used in investing activities increased to US\$40.3 million in 2011 from US\$10.3 million in 2010. This increase was mainly due to loans of RMB139.8 million, or US\$22.19 million, at an interest rate of 6.39% per annum, made to Chengdu Jinhua Tianchuang Investment Co., Ltd in 2011, with China Mingsheng Banking Co., Ltd. as the arranger of the loans. Net cash used in investing activities increased to US\$10.3 million in 2010 from US\$8.3 million in 2009. This increase

was primarily due to our increased acquisition activities, including our acquisitions of Sigma, Mailifang, Simlife, Success Blueprint, Zhulang, Dacheng and Shenzhen Zhida.

Net cash used in financing activities was US\$26.3 million in 2011, compared to US\$0.8 million in 2010. The change was primarily due to the payment of the deferred consideration of US\$14.6 million for the acquisition of Dacheng in March 2011, prepayment of convertible senior note of US\$9.3 million in February 2011 and share repurchase of US\$2.7 million during 2011. Net cash used in financing activities was US\$0.8 million in 2010, compared to US\$3.9 million used in financing activities in 2009. The change was primarily due to the termination of our share repurchase plan, the cash we received from our employees when they exercised their share options in 2010 and the payment of the deferred consideration of US\$1.25 million for the acquisition of Simlife in June 2010.

We believe that our current cash and cash equivalents and cash flow from operations will be sufficient to meet our anticipated cash needs, including for working capital purposes, capital expenditures and various contractual obligations, for at least the next 12 months. We may, however, require additional cash resources due to changed business conditions or other future developments, including any investments or acquisitions we may decide to pursue. If these sources are insufficient to satisfy our cash requirements, we may seek to sell additional debt securities or equity or to obtain a credit facility. The sale of additional convertible debt securities or equity securities could result in additional dilution to holders of our ordinary shares and ADSs. The incurrence of indebtedness would result in incurring debt service obligations, which could result in operating and financial covenants that would restrict our operations. We currently do not have any lines of credit or loans with any commercial banks. As a result, we are unlikely to rely on any bank loans to meet our liquidity needs. We cannot assure you that financing will be available in amounts or on terms acceptable to us, if at all.

We are a holding company with no operations of our own. Our operations are conducted through Beijing AirInbox, Beijing WINT, BJXR, Beijing Chengxitong, Mailifang, Xinreli and Dacheng and our subsidiaries in the PRC. As a result, our ability to pay dividends and to finance any debt that we may incur is dependent upon license and service fees paid by Beijing AirInbox, Beijing WINT, BJXR, Beijing Chengxitong, Mailifang, Xinreli and Dacheng and dividends and other distributions paid by our subsidiaries. If our subsidiaries incur debt on their own behalf in the future, the instruments governing the debt may restrict their ability to pay dividends to us. In addition, PRC legal restrictions permit payment of dividends to us by our subsidiaries only out of the net income from our subsidiaries, if any, determined in accordance with PRC accounting standards and regulations. Under PRC law, our subsidiaries are required to set aside no less than 10% of their respective after-tax net income each year as reserve funds unless such reserve funds, after making up losses of preceding years, have reached 50% of their respective registered capital, and these reserve funds are not distributable as cash dividends.

### *Capital Expenditures*

Our total capital expenditures in 2009, 2010 and 2011 were US\$1.6 million, US\$1.7 million and US\$1.9 million, respectively. We did not have any material commitment for capital expenditures as of December 31, 2011. We currently do not have any material capital expenditures in progress.

Our capital expenditures are spent primarily on servers, computers, office equipment, leasehold improvement and vehicles. In general, there is a positive correlation between our revenues and the amount of traffic that passes through our servers and transmission equipment. From time to time we need to purchase additional servers and transmission equipment as a result of increased business traffic. Our purchase of personal computers is primarily driven by headcount increases.

As the telecommunications operators do not provide us with detailed revenue breakdown on a service-by-service basis, we depend on our internal database system to monitor revenues derived from each of our services that are delivered through the telecommunications operators. We make our business decisions based on our internal data, taking into account other factors including strategic considerations.



**Management Team**

## Directors and Senior Officers

**Leilei Wang**, has served as the Chairman of the Board of Directors of our company and our Chief Executive Officer since October 2008. His current term expires in 2013. Mr. Wang was the chief executive officer of TOM Online from September 2003 to September 2008. Between 1999, when Mr. Wang joined TOM Group Limited, or TOM Group, TOM Online's parent company, and 2003, Mr. Wang held various management positions within TOM Group. Mr. Wang graduated in 1996 from the Electronic Engineering Department of Tsinghua University with a bachelor's degree in Electronic Technology and Information.

**Jay Chang**, has served as the Chief Financial Officer of our company since February 2009 and has been a Director of our company since July 2010. His current term expires in 2014. Before joining our company, Mr. Chang was the president and chief financial officer of 56.com, a leading online video provider in the PRC. Before that, he was the chief financial officer of TOM Online for over two years. Prior to TOM Online, for nearly six years, Mr. Chang was the director of equity research at Credit Suisse, responsible for covering the Internet and telecommunications sectors in the PRC. Mr. Chang graduated in 1994 from University of Washington with a bachelor's degree in Electrical Engineering.

**Xiaoxin Chen**, has been an Independent Director of our company since September 2008. His current term expires in 2012. Mr. Chen has been a managing partner of Zeniphs China Capital, a private equity fund, since late 2007. Before joining the fund, Mr. Chen was the chief financial officer of Oak Pacific Interactive, or OPI, a leading next generation Internet platform provider that offers web 2.0 communities, content creation and distribution, gaming and integrated communication in the PRC. Before joining OPI, Mr. Chen was an investment banker at Citigroup Hong Kong. Mr. Chen was an independent director of Abax Global Capital (Hong Kong) Ltd. before August 2011. Mr. Chen is also the independent director of Prosten Technology Holdings Ltd., a Hong Kong Stock Exchange Growth Enterprise Market-listed company. Mr. Chen received his bachelor's degree in Operations Research and Industrial Engineering (summa cum laude) from Cornell University and his MBA degree from Stanford Graduate School of Business and was a recipient of the 2000 Arjay Miller Scholar Award upon graduation.

**Hope Ni**, has been an Independent Director of our company since January 2007. Her current term expires in 2012. Ms. Ni has been the chairman of the board of directors of Inspire Capital, an investment and consulting company, since May 2008, which changed its name from Rising Year Group Limited in 2011. Until January 2008, Ms. Ni served as the chief financial officer and director for Cogo Group, Inc., a NASDAQ-listed company and a technology service provider in the PRC, which she joined in August 2004. Prior to joining Cogo, Ms. Ni spent six years as a practicing attorney at Skadden, Arps, Slate, Meagher & Flom LLP in New York and Hong Kong, specializing in corporate finance, during which she was actively involved in the initial public offerings and New York Stock Exchange/NASDAQ listings of a number of major global PRC-based companies. Prior to that, Ms. Ni worked at Merrill Lynch's investment banking division in New York. Ms. Ni is also an independent director at Digital China Holdings Ltd., a Hong Kong-listed company; JA Solar Holdings Co., Ltd., a NASDAQ-listed company; and ATA Inc., a NASDAQ-listed company. Ms. Ni received her J.D. degree from the University of Pennsylvania Law School and her bachelor's degree in Applied Economics and Business Management from Cornell University.

**Charles Xue**, has been an Independent Director of our company since July 2009. His current term expires in 2014. Mr. Xue was the original founder and is the chairman of the board of directors of ChinaEdu Corporation, a leading NASDAQ-listed educational service provider in China. Before that, Mr. Xue was the original founder of UT Starcom, a global leader and a NASDAQ-listed company in the manufacture, integration and support of Internet protocol-based, end-to-end networking and telecommunications solutions, and served as its chairman and vice chairman from 1991 to 2001. Mr. Xue received his postgraduate degree in East Asia History Specialty from the University of California, Berkeley in 1983.

**Tai Fan**, has served as the Chief Investment Officer of our company since March 2009. Since August 2002, Mr. Fan has served as the vice president of the department of finance at Beijing Super Channel, a subsidiary of TOM Online, and as an executive vice president of TOM Online. Prior to joining TOM Online, Mr. Fan served as the financial controller of Xin De Telecom and was an auditor at KPMG. Mr. Fan graduated in 2003 from the State University of New Jersey, Rutgers with an EMBA and in 1994 from Beijing College of Economics with a bachelor's degree in Accounting.

**Zhen Yang**, has served as the President of our Company since January 2010, pursuant to the definitive share purchase agreement we entered into with Dacheng on December 15, 2009. Mr. Yang previously served as the chief executive officer and chairman of Dacheng. Since December 2002, Mr. Yang has served as the executive vice president of NC-Sina, a joint venture of Sina.com and NCsoft Corporation, and as a vice president of Sina.com. Prior to joining Sina.com, Mr. Yang

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served as the vice president of NetEase from January 2002 to November 2002, the vice president of UBISOFT China from September 1996 to October 2001, general manager of Topdisk Multimedia (Hangzhou) Ltd. from February 1994 to October 1996 and was a lecturer in Zhejiang University and Nanjing Communications Engineering College. Mr. Yang graduated in 1989 from Zhejiang University with a master's degree in Communication System and in 1984 from South China University of Science and Technology with a bachelor's degree in Radio Engineering.



**Report of Independent  
Registered Public Accounting Firm**



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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE BOARD OF DIRECTORS AND SHAREHOLDERS OF  
KONGZHONG CORPORATION

We have audited the accompanying consolidated balance sheets of KongZhong Corporation and its subsidiaries and variable interest entities (collectively, the "Company") as of December 31, 2010 and 2011 and the related consolidated statements of operations, changes in shareholders' equity and comprehensive income, and cash flows for each of the three years in the period ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of KongZhong Corporation and its subsidiaries and variable interest entities as of December 31, 2010 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2011, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2011, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated April 16, 2012 expressed an unqualified opinion on the Company's internal control over financial reporting.

Deloitte Touche Tohmatsu CPA Ltd.  
Beijing, The People's Republic of China  
April 16, 2012

**CONSOLIDATED STATEMENTS OF OPERATIONS  
(In US dollars)**

For the years ended December 31,			
	2009	2010	2011
Revenues	\$ 131,298,223	\$ 149,583,364	\$ 160,008,435
Sales tax	(2,885,127)	(3,208,933)	(3,827,823)
Net revenues	128,413,096	146,374,431	156,180,612
Cost of revenues	(65,946,821)	(80,238,617)	(91,930,241)
Gross profit	62,466,275	66,135,814	64,250,371
Operating expenses			
Product development (including share-based compensation expense of \$1,503,758, \$1,038,275 and \$614,780 for 2009, 2010 and 2011, respectively)	(18,272,008)	(23,964,697)	(15,416,944)
Selling and marketing (including share-based compensation expense of \$178,291, \$131,396 and \$121,623 for 2009, 2010 and 2011, respectively)	(17,821,260)	(18,975,617)	(20,891,615)
General and administrative (including share-based compensation expense of \$2,529,481, \$3,830,585 and \$3,843,119 for 2009, 2010 and 2011, respectively)	(10,186,853)	(10,481,827)	(11,582,200)
Impairment loss on goodwill	-	(2,998,317)	(20,255,242)
Impairment loss on intangible assets	-	(5,730,579)	(3,927)
Total operating expenses	(46,280,121)	(62,151,037)	(68,149,928)
Change in fair value of contingent consideration for business acquisition	-	10,894,533	(3,729,513)
Government subsidies	-	337,663	319,319
Income (loss) from operations	16,186,154	15,216,973	(7,309,751)
Interest income	3,114,306	2,342,761	3,569,175
Interest income from loans to third party	-	-	1,193,226
Interest expense for convertible senior note	(725,910)	(1,059,905)	(487,763)
Impairment loss on cost method investment	(1,500,000)	(1,509,912)	-
Loss on extinguishment of debt upon prepayment of convertible senior note	-	-	(1,567,472)
Income taxes expense	206,945	883,285	85,561
Net income (loss) before income taxes	17,281,495	15,873,202	(4,517,024)
Income taxes expense	(4,698,114)	(3,950,003)	(3,137,838)
Net income (loss)	\$ 12,583,381	\$ 11,923,199	\$ (7,654,862)
Net income (loss) per share, basic	\$ 0.01	\$ 0.01	\$ (0.00)
Net income (loss) per share, diluted	\$ 0.01	\$ 0.01	\$ (0.00)
Weighted average shares used in calculating basic net income (loss) per share	1,385,201,479	1,466,947,693	1,607,110,119
Weighted average shares used in calculating diluted net income (loss) per share	1,537,771,051	1,547,870,678	1,607,110,119

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

## CONSOLIDATED BALANCE SHEETS (In US dollars)

As of December 31		
	2010	2011
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$ 157,170,761	\$ 129,511,530
Held-to-maturity securities	-	17,299,116
Trading securities	20,276	7,754,630
Loans to third party	-	22,187,307
Accounts receivables, net of allowance of \$nil and \$222,007 as of December 31, 2010 and 2011	21,793,956	19,902,975
Prepaid expenses and other current assets	5,979,068	4,146,025
<b>Total current assets</b>	<b>184,964,061</b>	<b>200,801,583</b>
Rental deposits	584,292	511,152
Property and equipment, net	3,738,598	3,620,279
Goodwill	87,705,675	72,967,109
Acquired intangible assets, net	4,452,688	2,347,891
<b>Total assets</b>	<b>\$ 281,445,314</b>	<b>\$ 280,248,014</b>
<b>Liabilities and shareholders' equity</b>		
Current liabilities		
Accounts payable (including account payable of the consolidated variable interest entities ("VIEs") without recourse to the Company of \$9,870,853 and \$15,343,859 as of December 31, 2010 and 2011, respectively)	\$9,909,704	\$15,347,033
Accrued expenses and other current liabilities (including accrued expenses and other current liabilities of the consolidated VIEs without recourse to the Company of \$6,925,533 and \$7,852,121 as of December 31, 2010 and 2011, respectively)	48,084,857	9,489,794
Deferred revenue (including deferred revenue of the consolidated VIEs without recourse to the Company of \$564,812 and \$2,796,228 as of December 31, 2010 and 2011, respectively)	2,549,820	4,043,619
Income tax payable (including income tax payable of the consolidated VIEs without recourse to the Company of \$1,056,443 and \$nil as of December 31, 2010 and 2011, respectively)	2,930,337	3,645,583
<b>Total current liabilities</b>	<b>\$ 63,474,718</b>	<b>\$ 32,526,029</b>
Commitments and contingencies (Note 21)		
Convertible senior note, net of discount due to beneficial conversion feature	3,552,716	1,272,619
Non-current deferred tax liability (including non-current deferred tax liability of the consolidated VIEs without recourse to the Company of \$477,457 and \$271,622 as of December 31, 2010 and 2011, respectively)	477,457	271,622
<b>Total liabilities</b>	<b>\$ 67,504,891</b>	<b>\$ 34,070,270</b>
Ordinary shares (\$0.0000005 par value; 1,000,000,000,000 shares authorized, 1,510,906,573 and 1,661,939,143 shares issued and outstanding as of December 31, 2010 and 2011, respectively)	755	829
Additional paid-in capital	105,120,495	131,140,682
Warrant	677,332	677,332
Accumulated other comprehensive income	32,314,355	46,186,277
Statutory reserve	9,392,790	10,341,491
Retained earnings	66,434,696	57,831,133
<b>Total shareholders' equity</b>	<b>213,940,423</b>	<b>246,177,744</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 281,445,314</b>	<b>\$ 280,248,014</b>

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

## CONSOLIDATED CASH FLOW STATEMENTS (In US dollars)

For the years ended December 31,			
	2009	2010	2011
<b>Operating activities</b>			
Net income (loss)	\$ 12,583,381	\$ 11,923,199	\$ (7,654,862)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	2,941,175	7,691,043	4,443,449
Loss on disposal of property and equipment	72,188	5,037	(37,099)
Provision of bad debt	266,252	45,857	222,007
Impairment loss on cost method investment	1,500,000	1,509,912	-
Impairment loss on goodwill	-	2,998,317	20,255,242
Impairment loss on intangible assets	-	5,730,579	3,927
Change in fair value of contingent consideration for business acquisition	-	(10,894,533)	3,729,513
Share-based compensation	4,211,530	5,000,256	4,579,522
Loss on extinguishment of debt upon prepayment of convertible senior note	-	-	1,567,472
Amortization of the debt discount	299,813	585,627	294,543
Changes in operating assets and liabilities			
Accounts receivable	(8,960,860)	4,855,600	2,902,691
Prepaid expenses and other current assets	(1,422,058)	(337,872)	3,748,469
Rental deposits	(71,903)	78,309	98,928
Trading securities	(100,617)	81,617	(8,339,291)
Accounts payable	2,469,397	(3,850,530)	4,780,428
Deferred revenue	-	2,529,804	1,347,963
Accrued expenses and other liabilities	878,723	(5,498,911)	760,161
Income tax payable	622,111	3,560,300	730,690
Net cash provided by operating activities	15,289,132	26,013,611	33,433,753
<b>Investing activities</b>			
Purchases of subsidiaries, net of cash acquired \$419,215 and \$2,145,792 in 2009 and 2010, respectively	(6,686,930)	(8,603,609)	-
Loans to third party	-	-	(21,227,812)
Held-to-maturity securities	-	-	(17,203,826)
Purchase of property and equipment	(1,599,477)	(1,717,930)	(1,890,271)
Proceeds from disposal of property and equipment	3,804	6,676	37,099
Net cash used in investing activities	(8,282,603)	(10,314,863)	(40,284,810)
<b>Financing activities</b>			
Payment of contingent consideration for acquisition of business	-	(1,163,064)	(14,578,427)
Repurchase of ordinary shares	(11,108,039)	-	(2,748,579)
Proceeds from exercise of employee stock options	466,890	386,524	302,075
Proceeds from issuance of convertible senior note	6,775,400	-	-
Prepayment of convertible senior note	-	-	(9,310,000)
Net cash used in financing activities	(3,865,749)	(776,540)	(26,334,931)
Effect of foreign exchange rate changes	94,471	2,959,028	5,526,757
Net increase (decrease) in cash and cash equivalents	3,235,251	17,881,236	(27,659,231)
Cash and cash equivalents, beginning of year	136,054,274	139,289,525	157,170,761
Cash and cash equivalents, end of year	\$ 139,289,525	\$ 157,170,761	\$ 129,511,530
<b>Supplemental disclosures of cash flow information</b>			
Income taxes paid	\$ 5,180,013	\$ 3,053,601	\$ 2,561,368
Interest paid	155,081	508,155	358,632
<b>Non-cash investing and financing activities:</b>			
Acquisition consideration payable	1,250,000	-	-
Contingent consideration in connection with business acquisition	-	40,155,908	-
Ordinary shares to be issued for business acquisitions	1,325,917	-	-
Ordinary shares issued for business acquisitions	373,001	14,545,600	29,220,543

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



**Note to the Consolidated Financial Statements**

## 1. ORGANIZATION AND PRINCIPAL ACTIVITIES

KongZhong Corporation ("KongZhong") was incorporated under the laws of the Cayman Islands on May 6, 2002. KongZhong and its consolidated entities (collectively, the "Company") provide wireless interactive entertainment, media and community services to mobile phone users, and internet games.

As of December 31, 2011, details of the Company's significant majority-owned subsidiaries and VIEs are as follows:

Name	Incorporation or acquisition date/place	Shareholder/ nominee owner	Legal ownership %	Principal activities
<b>Subsidiaries:</b>				
KongZhong Information Technologies (Beijing) Co., Ltd. ("KongZhong Beijing")	July 2002 People's Republic of China ("PRC")	KongZhong	100	Providing consulting and technology services
KongZhong China Co., Ltd. ("KongZhong China")	June 2005 the PRC	KongZhong	100	Providing consulting and technology services
Simlife (Beijing) Science Co., Ltd. ("Simlife Beijing")	June 2009 the PRC	Simlife International Inc.	100	Providing consulting and technology services
Success Blueprint Limited ("Success Blueprint")	October 2009 British Virgin Islands	KongZhong	100	Providing novel license to overseas
Dacheng Holdings Limited ("Dacheng Holdings")	January 2010 Cayman Islands	KongZhong	100	Providing internet games services
Dacheng Investment (Hong Kong) Limited ("Dacheng Hong Kong")	January 2010 Hong Kong	KongZhong	100	Providing internet games services
<b>VIEs:</b>				
Beijing AirInbox Information Technologies Co., Ltd. ("Beijing AirInbox")	April 2002 the PRC	Linguang Wu Songlin Yang Guijun Wang Zhen Huang	45 42 10 3	Providing wireless value-added services to mobile phone users
Beijing Wireless Interactive Network Technologies Co., Ltd. ("Beijing WINT")	February, 2005 the PRC	Yang Yang Jingye Sun Li Ai	40 30 30	Providing wireless value-added services to mobile phone users
Beijing Chengxitong Information Technology Co., Ltd. ("Beijing Chengxitong")	November, 2005 the PRC	Yang Li Xuelei Wu	90 10	Providing wireless value-added services to mobile phone users
Beijing Xinrui Network Technology Co., Ltd. ("Beijing Xinrui")	January, 2006 the PRC	Guijun Wang Yang Li	51 49	Providing wireless value-added services to mobile phone users
Shanghai Mailifang Communication Co., Ltd. ("Shanghai Mailifang")	March, 2009 the PRC	Xu Guo Yang Yang	90 10	Providing wireless value-added services to mobile phone users
Xiamen Xinreli Technology Co., Ltd. ("Xiamen Simlife")	June 2009 the PRC	Tao Jia Junhong Chen	80 20	Providing wireless value-added services to mobile phone users
Shanghai Dacheng Network Technology Co., Ltd. ("Shanghai Dacheng")	January 2010 the PRC	Leilei Wang Zhen Yang	59 41	Providing internet games services
<b>Subsidiaries of VIE:</b>				
Beijing Boya Wuji Technologies Co., Ltd. ("Beijing Boya Wuji")	March 2004 the PRC	Beijing AirInbox	100	Providing wireless value-added services to mobile phone users
Tianjin Mammoth Technologies Co., Ltd. ("Tianjin Mammoth")	May, 2005 the PRC	Beijing AirInbox Beijing WINT	95 5	Mobile games developing services
Beijing Shiyuan Leya Culture Communication Co., Ltd. ("Beijing Shiyuan Leya")	July 2008 the PRC	Beijing Xinrui	100	Providing wireless value-added services to mobile phone users
Nanjing Net Book Culture Co., Ltd., ("Nanjing Zhulang")	October 2009 the PRC	Beijing Chengxitong	100	Providing internet novel services
Wuxi Dacheng Network Technology Co., Ltd. ("Wuxi Dacheng")	January 2010 the PRC	Shanghai Dacheng	100	Providing internet game services
Shenzhen Zhida Network Technology Co., Ltd. ("Shenzhen Zhida")	February 2010 the PRC	Beijing WINT	100	Providing technology services to mobile phone manufactures

**The VIE arrangements**

PRC regulations prohibit direct foreign ownership of business entities providing value-added telecommunications services in the PRC where certain licenses are required for the provision of such services. To comply with these regulations, the Company conducts the majority of its activities through its VIEs and their subsidiaries.

To provide the Company effective control over and the ability to receive substantially all of the economic benefits of its VIEs and their subsidiaries, KongZhong Beijing, or KongZhong China, or Simlife Beijing (collectively, the "Foreign Owned Subsidiaries") has entered into a series of contractual arrangements with Beijing AirInbox, Beijing WINT, Beijing Chengxitong, Shanghai Mailifang, Xiamen Simlife, Beijing Xinrui and Shanghai Dacheng (collectively the "VIE Companies"), respectively, as summarized below:

<u>Name of Foreign Owned Subsidiaries</u>	<u>Name of VIE Companies</u>
KongZhong Beijing.....	Beijing Airinbox
KongZhong Beijing.....	Beijing WINT
KongZhong Beijing.....	Beijing Chengxitong
KongZhong Beijing.....	Shanghai Mailifang
Simlife Beijing.....	Xiamen Simlife
KongZhong China.....	Beijing Xinrui
KongZhong China.....	Shanghai Dacheng

•Agreements that provide the Foreign Owned Subsidiaries effective control over the VIE Companies

Business operation agreement. The Foreign Owned Subsidiaries have entered into business operation agreements with the VIE Companies and their respective shareholders, respectively. Pursuant to these agreements, the VIE companies and their respective shareholders agreed to appoint individuals designated by the Foreign Owned Subsidiaries to the management team of the VIE Companies and to refrain from taking certain actions that may materially affect these VIE Companies' operations.

Under their original terms, the business operation agreements of Beijing AirInbox and Xiamen Simlife will expire in 2016 and 2019, respectively. The business operation agreement of Beijing AirInbox will be automatically extended for another ten years unless KongZhong Beijing writes to terminate the agreement three months before the expiration of the agreement. The business operation agreement of Xiamen Simlife could be extended upon the requirements of Simlife Beijing. The business operation agreements of the remaining VIEs do not contain any expiration provision.

The VIEs have no authority to terminate the business operation agreements.

Power of attorney. Each of the shareholders of the VIE Companies has also executed an irrevocable power of attorney in favor of individuals designated by the Foreign Owned Subsidiaries. Pursuant to these powers of attorney, those designated individuals have full power and authority to exercise all of such shareholders' rights with respect to their equity interests in the VIE Companies.

•Agreements that transfer economic benefits to the Foreign Owned Subsidiaries

Exclusive technical and consulting services agreement. The Foreign Owned Subsidiaries have entered into exclusive technical and consulting services agreements with the VIE Companies, respectively. Pursuant to these technical and consulting services agreements, the Foreign Owned Subsidiaries provide certain technical and consulting services to the VIE Companies in exchange for service fees.

Under their original terms, the exclusive technical and consulting services agreements of Beijing AirInbox, Shanghai Mailifang, Beijing Xinrui and Shanghai Dacheng will expire in 2014, 2019, 2019 and 2020, respectively. The exclusive technical and consulting services agreements of these VIEs will be automatically extended for another ten years unless the relevant Foreign Owned Subsidiaries write to terminate the agreements three months before the expiration of the agreements. The technical and consulting services agreements of the remaining VIEs do not contain any expiration provision.

The VIEs have no authority to terminate the exclusive technical and consulting services agreements.

Equity pledge agreement. Each of the shareholders of the VIE Companies has also entered into an equity pledge agreement with the respective Foreign Owned Subsidiary, pursuant to which these shareholders pledged their respective interests in the



VIE Companies to guarantee the performance of such VIE Companies' payment obligations under the respective exclusive technical and consulting services agreements.

•Agreements that provide the Foreign Owned Subsidiaries the option to purchase the equity interest in the VIE Companies

Exclusive option agreement. Each of the VIE Companies and their respective shareholders have also entered into an exclusive share option agreement with the respective Foreign Owned Subsidiary. Pursuant to these agreements, each of the shareholders of the VIE Companies has granted an exclusive option to the Foreign Owned Subsidiaries or their designees to purchase all or part of such shareholder's equity interest in the VIE Companies, at a purchase price equal to the respective capital of the VIE companies or a price required under PRC laws at the time of such purchase.

Risks in relation to the VIE structure

The Company believes that the Foreign Owned Subsidiaries' contractual arrangements with the VIE Companies are in compliance with PRC law and are legally enforceable. However, uncertainties in the PRC legal system could limit the Company's ability to enforce these contractual arrangements and the interests of the shareholders of the VIE Companies may diverge from that of the Company and that may potentially increase the risk that they would seek to act contrary to the contractual terms, for example by influencing the VIE Companies not to pay the service fees when required to do so.

The Company's ability to control the VIE Companies also depends on the power of attorney the Foreign Owned Subsidiaries have to vote on all matters requiring shareholder approval in the VIE Companies. As noted above, the Company believes this power of attorney is legally enforceable but may not be as effective as direct equity ownership.

In addition, if the legal structure and contractual arrangements were found to be in violation of any existing PRC laws and regulations, the Company may be subject to fines or other actions. The Company does not believe such actions would result in the liquidation or dissolution of the Company, the Foreign Owned Subsidiaries or the VIE Companies.

The Company, through its subsidiaries and through the contractual arrangements, has (1) the power to direct the activities of the VIEs that most significantly affect the entity's economic performance and (2) the right to receive benefits from the VIEs. Accordingly, the Company is the primary beneficiary of the VIE Companies and has consolidated the financial results of the VIE Companies.

The following financial statement amounts and balances of KongZhong's VIEs were included in the accompanying consolidated financial statements:

Years ended December 31,		
	2010 \$	2011 \$
Total current assets	105,809,341	139,333,143
Total assets	109,930,914	143,283,271
Total current liabilities	18,417,641	25,767,750
Total liabilities	18,895,098	26,039,372

Years ended December 31,			
	2009 \$	2010 \$	2011 \$
Gross revenues	129,526,292	145,516,670	154,828,573
Net income	22,383,613	21,053,062	22,628,312

Years ended December 31,			
	2009 \$	2010 \$	2011 \$
Net cash provided by operating activities	17,750,530	23,547,374	29,159,789
Net cash used in investing activities	1,653,372	2,471,765	16,777,374

There are no consolidated VIE's assets that are collateral for the VIE's obligations and which can only be used to settle the VIE's obligations.



## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Basis of presentation

The consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America ("US GAAP").

### Basis of consolidation

The consolidated financial statements include the financial statements of the Company, its wholly-owned subsidiaries, and its VIEs. All inter-company transactions and balances have been eliminated upon consolidation.

### Cash and cash equivalents

Cash and cash equivalents consist of cash on hand and accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty.

### Fair value

Fair value is the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be recorded at fair value, the Group considers the principal or most advantageous market in which it would transact and it considers assumptions that market participants would use when pricing the asset or liability.

Authoritative literature provides a fair value hierarchy which prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The level in the hierarchy within which the fair value measurement in its entirety falls is based upon the lowest level of input that is significant to the fair value measurement as follows:

#### *Level 1*

Level 1 applies to assets or liabilities for which there are quoted prices in active markets for identical assets or liabilities.

#### *Level 2*

Level 2 applies to assets or liabilities for which there are inputs other than quoted prices included within Level 1 that are observable for the asset or liability such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical assets or liabilities in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which significant inputs are observable or can be derived principally from, or corroborated by, observable market data.

#### *Level 3*

Level 3 applies to assets or liabilities for which there are unobservable inputs to the valuation methodology that are significant to the measurement of the fair value of the assets or liabilities.

The Group's financial instruments include cash and cash equivalents, held-to-maturity securities, trading securities, accounts receivables, loans to third party, accounts payable and convertible senior notes.

The carrying values of cash and cash equivalents, trading securities, accounts receivable, loans to third party and accounts payable approximate their fair values due to short-term maturities.

The carrying amount of convertible senior note is measured at amortized cost using the effective interest rate method.

Fair value of acquired assets and contingent consideration is discussed in Note 3.

Fair value of trading securities is discussed in Note 5.

Short-term investments

Short-term investments comprise debt and equity securities, which are classified as held-to-maturity securities or trading securities. Short-term investments are classified as held-to-maturity securities when the Company has the positive intent and ability to hold the securities to maturity. All of the Company's held-to-maturity securities are classified as current assets on the consolidated balance sheets based on their contractual maturity dates which are less than one year and are stated at their amortized costs. Trading securities are carried at their fair values and the unrealized gains or losses from the changes in fair values are included in net earnings.

The Company reviews its short-term investments for other-than-temporary impairment based on the specific identification method. The Company considers available quantitative and qualitative evidence in evaluating potential impairment of its short-term investments. If the cost of an investment exceeds the investment's fair value, the Company considers, among other factors, general market conditions, government economic plans, the duration and the extent to which the fair value of the investment is less than the cost, and the Company's intent and ability to hold the investment, in determining if impairment is needed.

Use of estimates

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 revenues and expenses in the financial statements and accompanying notes. Significant accounting estimates reflected in the Company's financial statements include impairment of goodwill and other intangible assets, purchase price allocation in business combinations, accruals for revenues, valuation allowance for deferred tax assets, valuation of contingent consideration for business acquisition, and share-based compensation expense. Actual results could differ from those estimates.

Property and equipment, net

Property and equipment are carried at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the following estimated useful lives:

Computer and transmission equipment	3 years
Furniture and office equipment	3 years
Motor vehicles	3 years
Leasehold improvements	Over the shorter of the lease term or useful lives
Communication equipment	1 year
Office building	20 years

Acquired intangible assets (other than indefinite lived intangible assets), net

Acquired intangible assets, other than indefinite lived intangible assets, are carried at cost less accumulated amortization and impairment. The amortization of such acquired intangible assets is recognized over the expected useful lives of the assets.

Impairment of long-lived assets

Long-lived assets and certain identifiable intangible assets to be held and used are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may no longer be recoverable. When these events occur, the Company measures impairment by comparing the carrying value of the long-lived assets to the estimated undiscounted future cash flows expected to result from the use of the assets and their eventual disposition. If the sum of the expected undiscounted cash flows is less than the carrying amount of the assets, the Company would recognize an impairment loss based on the fair value of the assets.

No impairment loss was recorded for the year ended December 31, 2009. In the year of 2010 and 2011, the Company recognized an impairment loss of \$5,730,579 and \$3,927, respectively, relating to acquired intangible assets.

Business Combinations

Business combinations are recorded using the purchase method of accounting. On January 1, 2009, the Company adopted a new accounting pronouncement with prospective application which made certain changes to the previous authoritative

literature on business combinations. From January 1, 2009, the assets acquired, the liabilities assumed, and any noncontrolling interest of the acquiree at the acquisition date, if any, are measured at their fair values as of that date. Goodwill is recognized and measured as the excess of the total consideration transferred plus the fair value of any noncontrolling interest of the acquiree, if any, at the acquisition date over the fair values of the identifiable net assets acquired. Previously, any non-controlling interest was reflected at historical cost. Common forms of the consideration made in acquisitions include cash and common equity instruments. Consideration transferred in a business acquisition is measured at the fair value as at the date of acquisition. For shares issued in a business combination, the Company has estimated the fair value as of the date of acquisition.

Where the consideration in an acquisition includes contingent consideration the payment of which depends on the achievement of certain specified conditions post-acquisition, from January 1, 2009 the contingent consideration is recognized and measured at its fair value at the acquisition date and if recorded as a liability it is subsequently carried at fair value with changes in fair value reflected in earnings. For periods prior to January 1, 2009 contingent consideration was not recorded until the contingency was resolved.

#### Goodwill and indefinite-lived intangible assets

The excess of the purchase price over the fair value of net assets acquired is recorded on the consolidated balance sheet as goodwill. Goodwill is not amortized but is evaluated by the Company at least annually (at December 31) for impairment following a two-step process.

The first step compares the fair value of each reporting unit (operating segment or one level below an operating segment) to its carrying amount, including goodwill. As of December 31, 2010 and 2011, there were three reporting units, wireless value-added services ("WVAS"), mobile games and internet games. If the fair value of each reporting unit exceeds its carrying amount, goodwill is not considered to be impaired and the second step will not be required. If the carrying amount of a reporting unit exceeds its fair value, the second step compares the implied fair value of the affected reporting unit's goodwill to the carrying value of that goodwill. The implied fair value of goodwill is determined in a manner similar to accounting for a business combination with the allocation of the assessed fair value determined in the first step to the assets and liabilities of the reporting unit. The excess of the fair value of the reporting unit over the amounts assigned to the assets and liabilities is the implied fair value of goodwill. This allocation process is only performed for purposes of evaluating goodwill impairment and does not result in an entry to adjust the value of any assets or liabilities. An impairment loss is recognized for any excess in the carrying value of goodwill over the implied fair value of goodwill. The impairment losses of \$ nil, \$3.0 million and \$20.3 million were recorded for the years ended December 31, 2009, 2010 and 2011, respectively (see Note 11).

The Company has determined that the Company's trade names do not have determinable useful lives. Consequently, the carrying amounts of trade names are not amortized but are tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. Such impairment test consists of a comparison of the fair values of the trade names with their carrying amounts and an impairment loss is recognized if and when the carrying amounts of the trade names exceed their fair values. The estimates of fair values of intangible assets not subject to amortization are determined using various discounted cash flow valuation methodologies. Significant assumptions are inherent in this process, including estimates of discount rates. Discount rate assumptions are based on an assessment of the risk inherent in the respective intangible assets. No impairment of intangible assets with indefinite life was recorded during the years ended December 31, 2009, 2010 and 2011.

#### Long-term investments

For investments in investees over which the Company does not have significant influence, the Company carries the investments at cost. The Company reviews the long-term investments for impairment whenever events or circumstances indicate that an other-than-temporary decline has occurred. An impairment loss is recognized in earnings equal to the amount of the investment's carrying amount in excess of its fair value at the assessment date. The fair value of the investment would then become the new cost basis of the investment. Impairment losses of \$1.5 million, \$1.5 million and \$nil were recorded for the years ended December 31, 2009, 2010 and 2011, respectively (see Note 10).

#### Revenue recognition and cost of revenues

The Company's revenues are primarily derived from WVAS, mobile games service and internet games services.

## (i) WVAS

WVAS revenues are derived from providing personalized interactive entertainment, media and community services primarily to mobile phone customers of China Mobile Communication Corporation ("China Mobile"), China United Telecommunications Corporation ("China Unicom"), and China Telecommunications Corporation ("China Telecom") (collectively, the "Mobile Operator").

The Company contracts with the Mobile Operator for the transmission of WVAS as well as for billing and collection services. The Mobile Operator provides the Company with monthly statements that represent the principal evidence that service has been delivered and triggers revenue recognition for a substantial portion of the Company's revenues. In certain instances, when a statement is not received within a reasonable period of time, the Company makes an estimate of the revenues and cost of revenues for the period covered by the statement based on internally generated information, historical experience, verbal communication with Mobile Operator, and/or other assumptions that are believed to be reasonable under the circumstances.

The Mobile Operator remits to the Company only amounts net of the following items: (1) allowance that Mobile Operator has made for the doubtful debts in respect of the amounts due to the Company from its customers, (2) the Mobile Operator's fees for the services provided to the Company, including billing and collection services, and (3) the Mobile Operator's transmission charges. China Unicom and China Telecom do not provide an itemized analysis of their remittances and the Company is therefore unable to determine what allowance, if any, for doubtful or bad debts should be recorded with respect to services delivered through them. China Mobile occasionally specifies the allowance it makes for doubtful debts. As a result, the Company's revenue recognition is based upon the amounts reported on the Mobile Operator's monthly statements, which are net of doubtful debts and represent the amounts the Company reasonably believes will be collected.

The Company records the following fees paid to the Mobile Operator as cost of revenues:

- Service fees paid to the Mobile Operator which are charged to the Company as a percentage, ranging from 15% to 70%, of gross revenues less bad debts.
- Fixed transmission fees that are charged on a basis of each transmission (regardless whether the customers can be billed or pay the Mobile Operator).

In addition, cost of revenues includes amounts paid to content providers and certain payments to handset manufacturers with whom the Company has cooperation agreements.

## (ii) Mobile games

The Company recognizes revenues from providing mobile games services. Mobile phone users download the mobile games in the same manner as the WVAS and the Company recognizes revenues from such mobile games services in the same way as the WVAS revenues are recognized.

## (iii) Internet games

The internet games revenues are primarily derived from internet games operation revenues and licensing revenues.

Online game operation revenues

The Company adopts the item-based revenue model. The basic game play functions are free of charge, and players are charged for purchases of in-game items. Revenues from the sales of in-game items are recognized when the items are consumed by the customers or over the estimated lives of the items.

Cash received but not converted into in-game money is initially recorded as advances from customers, which are transferred as deferred revenue upon conversion into in-game money.

Revenues from licensing arrangement

The Company enters into licensing arrangements with various licensees who provide the internet games services in PRC and overseas. A licensing arrangement usually includes license of the games and support and maintenance services

after the commercial launch of the games, which include bug fixes, technical support via telephone and site visit, and unspecified upgrades on a when-and-if-available basis for certain period. The licensees pay non-refundable upfront fee for the license and support and maintenance services.

For the licensing arrangements, the vendor specific objective evidence ("VSOE") of fair value of the support and maintenance services, which is the last element to be delivered, has been established based on renewal prices. Therefore, under the residual method, the amount of consideration allocated to the license of games equals the total arrangement consideration less the fair value of the support and maintenance services, which is fully recognized as revenue from license of games upon the commercial launch of the games by the licensee. The arrangement consideration allocated to the support and maintenance services is recognized as revenue from support and maintenance services ratably over the service period, which is usually one year.

For the licensing arrangements entered prior to the establishment of the VSOE of fair value of the support and maintenance services, the entire licensing arrangement is accounted for as one accounting unit resulting in the upfront fee being recognized on a straight line basis over the support and maintenance services period beginning the commercial launch of the games by the licensee.

According to certain licensing arrangements, the Group is also entitled to ongoing usage-based royalties determined based on the amount charged to the players' accounts or services payable by players in a given country or region. The usage-based royalties are recognized when they are earned, provided that the collection is probable.

#### Allowance for credit losses

The allowance for credit losses related to accounts receivable is maintained at a level considered by management to be adequate to absorb an estimate of probable future losses existing at the balance sheet date. In estimating probable losses, the Company reviews accounts that are past due or in bankruptcy and accounts that may have higher credit risk using information available about the customer. The Company arrives at an estimated loss for specific doubtful accounts. This process is based on estimates, and ultimate losses may differ from those estimates. Receivable balance is written off when the Company determines that the balance is uncollectible. Subsequent recoveries, if any, are credited to the allowance when received. The Company considers an accounts receivable balance past due when payment has not been received within the stated terms. The charges related to allowance for credit losses for the years ended December 31, 2009, 2010 and 2011 were \$266,252, \$45,857 and \$222,007, respectively. The accounts receivable relating to the doubtful debt provision for the year ended December 31, 2010 were written off in the same year.

The allowance for credit losses arising from end users in WVAS and mobile games services has been net off with account receivables in the monthly statements provided by the Mobile Operator. The Company has not experienced any significant credit losses related to the net receivables in monthly statements provided by Mobile Operator.

#### Operating leases

Leases where substantially all the rewards and risks of ownership of assets remain with the leasing company are accounted for as operating leases. Payments made under operating leases are charged to the consolidated statements of operations on a straight-line basis over the lease period.

#### Government subsidies

The Company receives subsidies from the local government authorities as incentives for local area development and technology development, which amounted \$nil, \$337,663 and \$319,319 for the years ended December 31, 2009, 2010 and 2011, respectively. The Company records the government subsidies, that are receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the Company with no future related costs, as income in the period in which such subsidies are receivable.

#### Foreign currency translation

The functional and reporting currency of KongZhong is US dollar. The functional currency of the Company's subsidiaries and VIEs in the PRC is Renminbi ("RMB").



Assets and liabilities are translated from each entity's functional currency to the reporting currency at the exchange rate on the balance sheet date. Equity amounts are translated at historical exchange rates, and revenues, expenses, gains and losses are translated using the average rate for the year. Translation adjustments are reported as cumulative translation adjustments and are shown as a separate component of other comprehensive income in the consolidated statements of shareholders' equity and comprehensive income.

Monetary assets and liabilities denominated in currencies other than the applicable functional currencies are translated into the functional currencies at the prevailing rates of exchange at the balance sheet date. Nonmonetary assets and liabilities are remeasured into the applicable functional currencies at historical exchange rates. Transactions in currencies other than the applicable functional currencies during the year are converted into the functional currencies at the applicable rates of exchange prevailing at the transaction dates. Transaction gains and losses are recognized in the consolidated statements of operations.

#### Product development expenses

Product development expenses which consist primarily of the compensation and related costs for employees associated with the development and programming of mobile data content and internet games content are expensed as incurred.

#### Income taxes

Current income taxes are provided for in accordance with the laws of the relevant tax authorities.

Deferred income taxes are recognized when temporary differences exist between the tax bases of assets and liabilities and their reported amounts in the financial statements. Net operating loss carry forwards and credits are applied using enacted statutory tax rates applicable to future years. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more-likely-than-not that a portion of or all of the deferred tax assets will not be realized. The components of the deferred tax assets and liabilities are individually classified as current and non-current based on their characteristics.

The impact of an uncertain income tax position on the income tax return is recognized at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant tax authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Interest and penalties on income taxes will be classified as a component of the provisions for income taxes.

#### Comprehensive income

Comprehensive income includes net income and foreign currency translation adjustments. Comprehensive income is reported in the statements of shareholders' equity.

#### Advertising costs

The Company expenses advertising costs as incurred. Total advertising expenses were \$385,583, \$1,097,040 and \$1,465,272 for the years ended December 31, 2009, 2010 and 2011, respectively, and have been included as part of selling and marketing expenses.

#### Share-based compensation

Share-based compensation with employees is measured based on the grant date fair value of the equity instrument. The Company recognizes the compensation costs net of a forfeiture rate on a straight-line basis over the requisite service period of the award, with the amount of compensation expenses recognized in any period not less than the portion of the grant date fair value of the options vested during that period, which is generally the vesting period of the award. The estimate of forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized through a cumulative catch-up adjustment in the period of change.

#### Net income (loss) per share

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of ordinary shares outstanding during the year. Diluted net income (loss) per ordinary share reflects the potential dilution that could occur if securities or other contracts to issue ordinary shares were exercised or converted into ordinary shares. The dilutive effect of the stock options, nonvested shares and warrant is computed using treasury stock method. The dilutive effect of the convertible senior notes is computed using as-if converted method.

#### Recently issued accounting standards

In May 2011, the FASB issued an authoritative pronouncement on fair value measurement. The guidance is the result of joint efforts by the FASB and International Accounting Standards Board to develop a single, converged fair value framework. The guidance is largely consistent with existing fair value measurement principles in US GAAP. The guidance expands the existing disclosure requirements for fair value measurements and makes other amendments, mainly including:

- Highest-and-best-use and valuation-premise concepts for nonfinancial assets-the guidance indicates that the highest-and-best-use and valuation-premise concepts only apply to measuring the fair value of nonfinancial assets.
- Application to financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk - the guidance permits an exception to fair value measurement principles for financial assets and financial liabilities (and derivatives) with offsetting positions in market risks or counterparty credit risk when several criteria are met. When the criteria are met, an entity can measure the fair value of the net risk position.
- Premiums or discounts in fair value measure - the guidance states that "premiums or discounts that reflect size as a characteristic of the reporting entity's holding (specifically, a blockage factor that adjusts the quoted price of an asset or a liability because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity) rather than as a characteristic of the asset or liability (for example, a control premium when measuring the fair value of a controlling interest) are not permitted in a fair value measurement."
- Fair value of an instrument classified in a reporting entity's shareholders' equity - the guidance prescribes a model for measuring the fair value of an instrument classified in shareholders' equity; this model is consistent with the guidance on measuring the fair value of liabilities.
- Disclosures about fair value measurements - the guidance expands disclosure requirements, particularly for Level 3 inputs. Required disclosures include:
  - o For fair value measurements categorized in level 3 of the fair value hierarchy: (1) a quantitative disclosure of the unobservable inputs and assumptions used in the measurement, (2) a description of the valuation process in place (e.g., how the entity decides its valuation policies and procedures, as well as changes in its analyses of fair value measurements, from period to period), and (3) a narrative description of the sensitivity of the fair value to changes in unobservable inputs and interrelationships between those inputs.
  - o The level in the fair value hierarchy of items that are not measured at fair value in the statement of financial position but whose fair value must be disclosed.

The guidance is to be applied prospective and effective for interim and annual periods beginning after December 15, 2011, for public entities. Early application by public entities is not permitted. The Company will adopt this pronouncement effective January 1, 2012, which will not have a significant impact on its financial condition or results of operations.

In June 2011, the FASB issued an authoritative pronouncement to allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. The guidance eliminates the option to present the components of other comprehensive income as part of the statement of changes in shareholders' equity. These amendments do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The guidance should be applied retrospectively. For public entities, the amendments are effective for fiscal years and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted. The Company will adopt this pronouncement effective January 1, 2012, which will not have a significant impact on its financial condition or results of operations.

In September 2011, the FASB has issued an authoritative pronouncement related to testing goodwill for impairment. The guidance is intended to simplify how entities, both public and nonpublic, test goodwill for impairment. The pronouncement permits an entity to first assess qualitative factors to determine whether it is "more likely than not" that the fair value of

a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. The guidance is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity's financial statements for the most recent annual or interim period have not yet been issued or, for nonpublic entities, have not yet been made available for issuance. The Company will adopt this pronouncement effective January 1, 2012, which will not have a significant impact on its financial condition or results of operations.

In December 2011, the FASB issued an authoritative pronouncement related to Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update. This guidance allows the FASB to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before the pronouncement issued in June 2011. The Company does not expect the adoption of this guidance will have a significant impact on its financial condition or results of operations.

In December 2011, the FASB has issued an authoritative pronouncement related to Disclosures about Offsetting Assets and Liabilities. The guidance requires an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The Company will adopt this pronouncement effective January 1, 2013, and is in the process of evaluating the effect of adoption of this pronouncement on its consolidated financial statements.

### 3. ACQUISITIONS

#### (a) Sigma

In February 2009, the Company acquired 100% equity interest of Sigma Interactive Inc. ("Sigma"), a company incorporated in the British Virgin Islands, for a total consideration of RMB7 million (approximately \$1.02 million) in cash. Sigma is engaged in the business of developing technology solutions for mobile Internet, including the development of its on-device portal platform. Through this acquisition, the Company has strengthened its technical competence in the area of mobile device software development. This acquisition was recorded using the purchase method of accounting and, accordingly, the acquired assets and liabilities were recorded at fair value at the date of acquisition. The acquisition-related cost of \$12,459 was recorded as general and administrative expenses as incurred in 2009. The revenues and net loss of Sigma in the amounts of \$0 and \$2,238 respectively were included in the Company's consolidated statement of the operation for the year ended December 31, 2009. The purchase price was allocated as follows:

Tangible assets acquired (including cash of \$2,136)	\$ 13,009
Acquired intangible assets:	
Operating platforms	138,121
Liabilities assumed	-
Deferred tax liability	-
Goodwill	873,070
<b>Total</b>	<b>\$ 1,024,200</b>

The goodwill arising from the acquisition of Sigma was allocated to and included in the WVAS segment as of December 31, 2010 and 2011.

#### (b) Shanghai Mailifang

In March 2009, the Company acquired 100% equity interest of Shanghai Mailifang. Shanghai Mailifang is engaged in the business of developing and publishing mobile games in Mainland China. This acquisition has strengthened the Company's technical competence in mobile games development and broadened the Company's distribution channels for mobile games in Mainland China. The purchase price of RMB5,047,696 (equivalent to \$738,864) was fully paid in cash during the second quarter of 2009. This acquisition was recorded using the purchase method of accounting and, accordingly, the acquired assets

and liabilities were recorded at fair value at the date of acquisition. The revenues and net income of Shanghai Mailifang in the amounts of \$1,687,898 and \$166,395 respectively were included in the Company's consolidated statement of operations for the year ended December 31, 2009. The purchase price was allocated as follows:

Tangible assets acquired (including cash of \$268,014)	\$ 333,236
Acquired intangible assets:	
Product technologies	27,480
Agreements with Mobile Operator	703
Licenses of service providers	10,759
Liabilities assumed	(33,501)
Deferred tax liability	(9,736)
Goodwill	409,923
<b>Total</b>	<b>\$ 738,864</b>

The goodwill arising from the acquisition of Shanghai Mailifang was allocated to and included in the mobile games segment as of December 31, 2010 and 2011.

(c) Simlife and Xiamen Simlife

In June 2009, the Company acquired 100% equity interest in Simlife, a company incorporated in the Cayman Islands which provides consulting and technology services through its wholly owned subsidiary, Simlife Beijing. Simlife Beijing entered into a series of contractual arrangements with Xiamen Simlife, pursuant to which, Xiamen Simlife became the Company's variable interest entity. Xiamen Simlife is engaged in development of mobile games, in particular, high-quality 3D mobile games. Xiamen Simlife's development capabilities, including its self-developed 3D mobile games engine, have helped consolidate and extend the Company's leadership in the Chinese mobile games market.

The aggregate acquisition consideration consisted of (i) an initial consideration of \$3 million in cash, which was paid in June 2009; and (ii) a contingent consideration of \$1,250,000 in cash and 6,000,000 ordinary shares of KongZhong (equivalent to 150,000 American Depositary Shares ("ADSs")) subject to the completion of a commercial version of certain games on or prior to December 31, 2009. The fair value of the contingent consideration was determined to be \$2,488,981 as of the acquisition date based on an assessment of the achievement of the development goal, of which, \$1,163,064 of the fair value of the contingent consideration in cash was recorded as a liability and \$1,325,917 of the fair value of the contingent consideration in ordinary shares, based on the closing market price of the Company's ADSs at the acquisition date, was recorded in equity in the consolidated balance sheet. This acquisition was recorded using the purchase method of accounting and, accordingly, the acquired assets and liabilities were recorded at fair value at the date of acquisition. The acquisition-related cost of \$17,602 was recorded as general and administrative expenses as incurred in 2009. The revenues and net income of Xiamen Simlife in the amounts of \$889,278 and \$225,609 respectively were included in the Company's consolidated statement of the operations for the year ended December 31, 2009. The purchase price was allocated as follows:

Total consideration estimated at acquisition date:

Cash paid	3,000,000
Fair value of contingent consideration:	
Cash consideration	1,163,064
Equity consideration	1,325,917
<b>Total</b>	<b>\$ 5,488,981</b>
Tangible assets acquired (including cash of \$59,640)	\$ 274,630
Acquired intangible assets:	
Product technologies	1,343,284
Licenses of service providers	11,706
Agreements with Mobile Operator	333,626
Liabilities assumed	(307,072)
Deferred tax liability	(422,302)
Goodwill	4,255,109
<b>Total</b>	<b>\$ 5,488,981</b>

The goodwill arising from the acquisition of Simlife and Xiamen Simlife was allocated to and included in the mobile games segment as of December 31, 2010 and 2011. The contingent consideration in cash and ordinary shares was fully settled in 2010.

## (d) Nanjing Zhulang and Success Blueprint

In October 2009, the Company acquired 100% equity interest of Nanjing Zhulang, an online Chinese-language novel company, and Success Blueprint, its affiliated entity, for an aggregate consideration of \$2.34 million in cash and 1,000,000 ordinary shares of KongZhong (equivalent to 25,000 ADSs), which was fully paid in 2009. Nanjing Zhulang is engaged in operating an internet literature site. Success Blueprint, a company incorporated in the British Virgin Islands, is engaged in the management of overseas Chinese novel copyright. The acquisition of Nanjing Zhulang and Success Blueprint has supported the development of the Company's mobile novel services. This acquisition was recorded using the purchase method of accounting and, accordingly, the acquired assets and liabilities were recorded at their fair market value at the date of acquisition. The acquisition-related cost of \$50,349 was recorded as general and administrative expenses as incurred in 2009. The revenues and net loss of Nanjing Zhulang and Success Blueprint in the amounts of \$270,776 and \$61,837 respectively were included in the Company's consolidated statement of operations for the year ended December 31, 2009. The purchase price was allocated as follows:

Total purchase consideration at acquisition date:

Cash paid	2,343,081
Fair value of ordinary shares issued (determined based on the closing market price of the Company's ADSs at the acquisition date)	373,001
<b>Total</b>	<b>\$ 2,716,082</b>
Tangible assets acquired (including cash of \$89,425)	\$ 312,359
Acquired intangible assets:	
Trademarks	260,361
Self-developed content	305,316
Agreements with Mobile Operator	193,586
Contracts with content providers	102,065
Subscriber list	14,204
Liabilities assumed	(95,458)
Deferred tax liability	(153,793)
Goodwill	1,777,442
<b>Total</b>	<b>\$ 2,716,082</b>

The goodwill arising from the acquisition of Nanjing Zhulang was allocated to and included in the WVAS segment as of December 31, 2010 and 2011.

## (e) Dacheng Holdings and Shanghai Dacheng

In January 2010, the Company obtained the control over Dacheng Holdings and Shanghai Dacheng (collectively, "Dacheng"), a developer of three-dimensional massively multi-player online role-playing games, through a series of contractual arrangements between KongZhong China and Dacheng and its shareholders. On January 14, 2010, \$24.1 million was paid to the selling shareholders of Dacheng, of which \$9.6 million was paid in cash and \$14.5 million was settled in 42.8 million ordinary shares of KongZhong (equivalent to 1.1 million ADSs) based upon the average closing price of the Company's ADSs over a 30-day period prior to December 15, 2009. The total consideration for the acquisition of Dacheng will be no greater than \$80 million and determined based on Dacheng's net profit after tax as calculated under US GAAP ("NPAT") for the year of 2010. If Dacheng's NPAT for 2010 equals or exceeds \$6.5 million, a multiple of 8 will be applied to Dacheng's NPAT for 2010 to arrive at the total consideration. If Dacheng's NPAT for 2010 is less than \$6.5 million, then a multiple of 5 will be applied to Dacheng's NPAT for 2010 to arrive at the total consideration. The additional contingent consideration was classified as a liability and subsequently re-measured at fair value with the change in fair value recorded in earnings. This acquisition was recorded using the purchase method of accounting and, accordingly, the acquired assets and liabilities were recorded at fair value at the date of acquisition. The acquisition-related cost of \$221,443 was recorded as general and administrative expenses as incurred in 2010. The revenues and net income of Dacheng in the amounts of \$15,313,630 and \$7,975,728 respectively were included in the Company's consolidated statement of the operations for the year ended December 31, 2010.

Total consideration estimated at acquisition date:

Cash paid	9,577,600
Fair value of ordinary shares issued (determined based on the market closing price of the Company's ADS at the acquisition date)	14,545,600
Fair value of contingent consideration	51,049,269
<b>Total</b>	<b>\$ 75,172,469</b>

The purchase price was allocated based on the estimated total consideration at the acquisition date as follows:

Tangible assets acquired (including cash of \$2,127,781)	\$ 4,258,638
Acquired intangible assets	
Core technologies	2,963,104
Product technologies	9,740,307
Liabilities assumed	(4,810,101)
Deferred tax liability	(529,317)
Goodwill	63,549,838
Total	\$ 75,172,469

The goodwill arising from the acquisition of Dacheng was allocated to and included in the internet games segment as of December 31, 2010 and 2011.

As of December 31, 2010, the contingent consideration payable was measured at the fair value of \$40.2 million and a gain arising from the change in fair value of \$10.9 million was recorded in the consolidated statement of operations in 2010. The contingency was finally resolved in March 2011 and the consideration payable was settled in the form of \$14.6 million in cash and 123.5 million ordinary shares. A loss arising from the change in fair value of \$3.7 million was recorded in the consolidated statement of operations in 2011.

(f) Shenzhen Zhida

In February 2010, Beijing WINT acquired 100% equity interest of Shenzhen Zhida, a technology developer for mobile device software platform, for a cash consideration of RMB8 million (equivalent to \$1.2 million). This acquisition was recorded using the purchase method of accounting and, accordingly, the acquired assets and liabilities were recorded at fair value at the date of acquisition. The acquisition-related cost was \$nil. The revenues and net loss of Shenzhen Zhida in the amounts of \$76,101 and \$76,332 respectively were included in the Company's consolidated statement of the operations for the year ended December 31, 2010. The purchase price was allocated as follows:

Tangible assets acquired (including cash of \$18,011)	\$ 21,939
Acquired intangible assets:	
Employment contract	351,540
Product technologies	66,866
Liabilities assumed	-
Deferred tax liability	(104,602)
Goodwill	836,058
Total	\$ 1,171,801

The goodwill arising from the acquisition of Shenzhen Zhida was allocated to and included in the WVAS segment as of December 31, 2010 and 2011.

Fair value of acquired assets and contingent consideration

The Company measured the fair value of the purchased intangible assets using the "cost," "income approach-excess earnings" and "with & without" valuation method. The Company measured the fair value of the contingent consideration considering, among other factors, forecasted financial performance of the acquired business, market performance, and the market potential of the acquired business in China. These purchased intangible assets and contingent consideration are considered Level 3 assets and liabilities because the Company used unobservable inputs, reflecting the Company's assessment of the assumptions market participants would use in valuing these assets and liabilities.

Pro forma

The following summarized unaudited pro forma results of operations for the year ended December 31, 2009 and 2010 assuming that all significant acquisitions during the two-year period ended December 31, 2010 occurred as of January 1, 2009 and all significant acquisitions during the year ended December 31, 2010 occurred as of January 1, 2010, respectively. These pro forma results have been prepared for comparative purposes only and do not purport to be indicative of the results of operations which actually would have resulted had the significant acquisitions occurred as of January 1, 2009 and 2010, nor is it indicative of future operating results.

For the years ended December 31,		
	2009 (unaudited)	2010 (unaudited)
Revenues	\$ 136,948,781	\$150,489,013
Net income	\$ 8,740,088	\$ 11,982,358
Income per share - basic	\$ 0.01	\$ 0.01
Income per share - diluted	\$ 0.01	\$ 0.01

#### 4. HELD-TO-MATURITY SECURITIES

The balance represents the Company's investments in debt securities provided by the banks with original maturities within one year.

#### 5. TRADING SECURITIES

The Company from time to time invests in publicly traded equity and debt securities in China's stock market, and accounts such investments as trading securities. The Company recognized gain related to trading securities of \$206,945, \$883,285 and \$85,561 in the statements of operations for the years ended December 31, 2009, 2010 and 2011, respectively. The fair value of trading securities is determined based on the quoted market price of the securities which is a Level 1 fair value measurement. The Company held trading securities in amounts of \$20,276 and \$7,754,630 as of December 31, 2010 and 2011, respectively.

#### 6. LOANS TO THIRD PARTY

The Company entered into three loan agreements with Chengdu Jinhua Tianchuang Investment Co., Ltd ("Chengdu Jinhua"), a third party, and China Mingsheng Banking Co., Ltd. whereby the Company loaned RMB99 million, RMB25.8 million and RMB15 million (a total of RMB139.8 million or US\$22.2 million) to Chengdu Jinhua for one year commencing January 24, January 24 and February 18, 2011, respectively, at an interest rate of 6.39% per annum. For the year ended December 31, 2011, the Company recorded interest income of US\$1,193,226. The terms of the loans were subsequently extended to March 31, 2012 at an interest rate of 7.93% per annum for the extended period. These loans were fully settled at the end of March 2012.

#### 7. PREPAID EXPENSES AND OTHER CURRENT ASSETS

Prepaid expenses and other current assets consist of the following:

As of December 31,		
	2010	2011
Prepayment to service providers	3,733,037	2,064,174
Staff advances	495,677	665,587
Rental and other deposits	1,084,706	1,143,509
Interest receivables	632,176	267,947
Other current assets	33,472	4,808
	\$ 5,979,068	\$ 4,146,025

#### 8. PROPERTY AND EQUIPMENT, NET

Property and equipment, net consists of the following:

As of December 31,		
	2010	2011
Computer and transmission equipment	\$ 8,211,532	\$10,246,858
Furniture and office equipment	747,805	812,019
Motor vehicles	664,968	747,186
Leasehold improvements	2,210,221	2,327,099
Communication equipment	335,594	348,602
Office building	649,867	683,077
	12,819,987	15,164,841
Less: accumulated depreciation	(9,081,389)	(11,544,562)
	\$ 3,738,598	\$ 3,620,279

Depreciation expenses for the years ended December 31, 2009, 2010 and 2011 are \$1,809,788, \$2,170,855 and \$2,165,883 respectively.

## 9. ACQUIRED INTANGIBLE ASSETS, NET

Acquired intangible assets, net consist of the following:

	December 31, 2010					December 31, 2011					Amortization period
	Gross carrying amount	Accumulated amortization difference	Exchange difference	Impairment	Net carrying amount	Gross carrying amount	Accumulated amortization difference	Exchange difference	Impairment	Net carrying amount	
Intangible assets not subject to amortization											
Trademarks with indefinite life	\$260,387	-	\$8,076	-	\$268,463	\$268,463	-	\$13,719	-	\$282,182	N/A
Intangible assets subject to amortization											
Agreements with Mobile Operator	\$2,962,358	\$(2,759,297)	\$9,653	-	\$212,714	\$3,113,746	\$(3,070,271)	\$6,782	-	\$50,257	3 years
Operating platforms	235,848	(152,044)	3,272	-	87,076	247,901	(191,348)	3,816	(3,927)	56,442	5 years
Licenses of service providers	54,296	(49,867)	-	-	4,429	57,071	(57,201)	130	-	-	3 years
Contracts with content providers	114,893	(70,396)	2,054	-	46,551	120,999	(122,678)	1,679	-	-	1 year
Non-compete agreement	369,627	(369,627)	-	-	-	388,516	(388,516)	-	-	-	2 years
Self-developed contents	360,657	(407,146)	46,516	-	27	379,089	(379,089)	-	-	-	2 years
Product technologies	10,500,573	(4,002,200)	201,643	(5,730,579)	969,437	4,966,102	(4,497,238)	39,769	-	508,633	3 years
Contracts with service providers	5,436	(5,436)	-	-	-	5,713	(5,713)	-	-	-	1 year
Subscriber list	15,898	(15,900)	2	-	-	16,710	(16,710)	-	-	-	1 year
Trademarks	35,081	(35,081)	-	-	-	36,874	(36,874)	-	-	-	1 year
Core technologies	4,432,801	(1,911,694)	91,232	-	2,612,339	4,667,587	(3,459,527)	104,770	-	1,312,830	3 years
Employment contract	362,379	(119,867)	9,140	-	251,652	380,898	(253,799)	10,448	-	137,547	3 years
<b>Total</b>	<b>\$19,710,234</b>	<b>\$(9,898,555)</b>	<b>\$371,588</b>	<b>\$(5,730,579)</b>	<b>\$4,452,688</b>	<b>\$14,649,669</b>	<b>\$(12,478,964)</b>	<b>\$181,113</b>	<b>\$(3,927)</b>	<b>\$2,347,891</b>	

The weighted average amortization period of the intangible assets subject to amortization was 3 and 3 years as of December 31, 2010 and 2011, respectively.

For purposes of recognition and measurement of an impairment loss, each intangible asset is considered the lowest level asset group that generates identifiable independent cash flows. Because the carrying amount of the product technology relating to certain games and mobile platform exceeded the sum of undiscounted future cash flows expected to generate from the use and eventual disposition of such technology, the Company recognized an impairment loss of \$5,730,579 in 2010, based on the fair value of the product technology. The impaired product technology was included in the internet games segment. The fair value of the product technology was measured using the excess earnings approach and the key assumptions included estimated life of the game, discount rate and income tax rate.

The Company recorded amortization expenses of \$1,131,387, \$5,520,188, and \$2,277,566 for the years ended December 31, 2009, 2010, and 2011, respectively. The amortization expenses for the years ending December 31, 2012, 2013, 2014 and 2015 and thereafter are expected to be \$1,968,170, \$97,539, \$0 and \$0.

## 10. LONG-TERM INVESTMENTS

In January 2008, the Company acquired 9.87% equity interest of HiU! Media, a company providing residential community advertising network and marketing solutions in China, for \$1.5 million of cash. As the Company had no significant influence over HiU! Media, this investment was accounted for using the cost method.

Since the completion of this investment, HiU! Media has been in a continuous loss-making position and has failed to create the type of profit-generating business that was contemplated at the time of the Company's investment. As a result, the Company recorded a full impairment loss in the year ended December 31, 2009 since it does not expect any positive cash flows from the investment in HiU! Media in the future and has no intention to hold this investment for recovery.

In July 2008, the Company acquired 19.9% equity interest in Xin Chuang Hang Yuan Technology Co. Ltd. ("XCHY"), a

company providing discount e-coupons on mobile phones and Internet in China, for \$1,464,118 of cash. As the Company had no significant influence on XCHY, this investment was accounted for using the cost method.

Since the completion of this investment, XCHY has been in a continuous loss-making position and the Company was unable to create any value-generating synergies with XCHY for its wireless internet services as expected at the time of the Company's investment. As a result, the Company recorded a full impairment loss in the year ended December 31, 2010 since it does not expect any positive cash flows from the investment in XCHY in the future and has no intention to hold this investment for recovery.

## 11. INCOME TAXES

The change in the carrying amounts of goodwill by reporting unit is as follows:

	2010				2011			
	WVAS	Mobile Game	Internet Game	Total	WVAS	Mobile Game	Internet Game	Total
Gross amount:								
Beginning balance	\$39,771,385	\$4,894,172	-	\$44,665,557	\$41,807,165	\$5,032,559	65,511,270	\$112,350,994
Goodwill recognized in acquisition	836,058	-	63,549,838	64,385,896	-	-	-	-
Exchange differences	1,199,722	138,387	1,961,432	3,299,541	2,116,019	235,104	3,319,991	5,671,114
Ending balance	41,807,165	5,032,559	65,511,270	112,350,994	43,923,184	5,267,663	68,831,261	118,022,108
Accumulated impairment loss:								
Beginning balance	(21,623,279)	-	-	(21,623,279)	(21,623,279)	-	(3,022,040)	(24,645,319)
Charge for the year	-	-	(2,998,317)	(2,998,317)	(20,255,242)	-	-	(20,255,242)
Exchange differences	-	-	(23,723)	(23,723)	-	-	(154,438)	(154,438)
Ending balance	(21,623,279)	-	(3,022,040)	(24,645,319)	(41,878,521)	-	(3,176,478)	(45,054,999)
Goodwill, net	\$20,183,886	\$5,032,559	\$62,489,230	\$87,705,675	\$2,044,663	\$5,267,663	\$65,654,783	\$72,967,109

The Company performs impairment test on goodwill at least annually at December 31.

As of December 31, 2010, the fair value of reporting units were estimated using a combination of income-based and market-based valuation methodologies. Under the income approach, forecasted cash flow of a reporting unit is discounted to a present value using a discount rate commensurate with the risks of those cash flows. The discounted cash flows for each reporting unit were based on discrete financial forecasts developed by management. Cash flows beyond the forecasted period and discrete forecast were estimated using a terminal value calculation, which incorporated historical and forecasted financial trends for each reporting unit and considered long-term earnings growth rates for publicly traded peer companies. Specifically, the income approach valuations included cash flow discount rates of 20.5%, 21% and 21.5%, and terminal value growth rates of 3%, 3% and 3% for WVAS, mobile games and internet games reporting units, respectively. Under the market approach, the fair value of a reporting unit is estimated based on the revenues and earnings multiples of a group of comparable public companies. Since internet game reporting unit had not met the revenue and earnings growth forecast, internet game reporting unit failed in the first step of the impairment test and recorded an impairment loss of \$2,998,317 based on the result of the second step of the impairment test.

During 2011, the Company determined that due to the significant decline in its stock price for a sustained period, there was an impairment indicator related to goodwill, and hence, the Company performed an impairment test on goodwill as of September 30, 2011. The Company estimated the fair values of the reporting units using the income approach valuation methodology. The market-based valuation methodology is not considered as appropriate because of volatility of the general market condition as well as the significant fluctuations in the multiples of the comparable companies. The income approach valuations included cash flow discount rates of 22.0%, 22.5% and 25.0%, and terminal value growth rates of 3%, 3% and 3% for WVAS, mobile games and internet games reporting units, respectively. Based on the performance and forecast of the WVAS reporting unit, WVAS reporting unit failed in the first step of the impairment test and the Company determined that there is an impairment loss of \$20,255,242 relating to the unit as of September 30, 2011 based on result of the second step of the impairment test. For the purpose of its annual goodwill impairment test, the Company performed another test as of December 31, 2011 using the same valuation methodology and assumptions on relevant discount rates and growth rates described above and concluded that no further impairment loss needs to be recognized as of December 31, 2011.

During the year ended December 31, 2009, 2010 and 2011, the Company recognized goodwill impairment losses of \$nil, \$2,998,317 and \$20,255,242, respectively.

## 12. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Accrued expenses and other current liabilities consist of the following:

As of December 31,		
	2010	2011
Accrued welfare benefits	\$ 573,500	\$ 507,458
Accrued payroll	560,838	981,537
Advance from customers	1,253,312	1,252,647
Accrued service fees	2,929,965	2,983,743
Other tax payables	2,375,812	3,138,414
Acquisition consideration payable (i)	40,155,908	-
Others	235,522	625,995
	\$48,084,857	\$ 9,489,794

(i) The balance of acquisition contingent consideration payable as of December 31, 2010 represented the contingent consideration in relation to the acquisition of Dacheng (see note 3(e)). The contingency was resolved and the consideration was settled in 2011.

## 13. INCOME TAXES

KongZhong and Dacheng Holdings are companies incorporated in the Cayman Islands. Under the current laws of the Cayman Islands, they are not subject to tax on either income or capital gain.

Success Blueprint is a company incorporated in the British Virgin Islands. Under the current laws of the British Virgin Islands, it is not subject to tax on either income or capital gain.

Under the current Hong Kong Inland Revenue Ordinance, Dacheng Hong Kong is subject to 16.5% income tax on its taxable income generated from operations in Hong Kong.

The Company's subsidiaries, VIEs and VIEs' subsidiaries established in the PRC are subject to income tax rate of 25%, except for the following, according to the PRC Enterprise Income Tax (the "New EIT Law"), which became effective from January 1, 2008 and adopted a unified income tax rate of 25% for most enterprises.

In 2008, KongZhong Beijing, Beijing AirInbox, Beijing Xinrui and Tianjin Mammoth obtained the "high and new technology enterprise" ("HNTE") status under the New EIT Law. In 2009, KongZhong China, Beijing Chengxitong and Beijing WINT also obtained the HNTE status under the new rules. Moreover, KongZhong China, Beijing WINT, Beijing Chengxitong and Beijing Xinrui enjoyed 50% tax relief in 2009. The HNTE status allows qualifying China-based enterprises to use a 15% tax rate for three years. At the conclusion of the three year period, the qualifying enterprises have the option to renew for additional three years through a simplified application process if their operations continue to qualify for HNTE status. KongZhong Beijing, Beijing AirInbox, Beijing Xinrui and Tianjin Mammoth renewed their HNTE status in 2011 for additional three years. After the first six years, enterprises will go through a new application process in order to renew their HNTE status. The Company believes it is highly likely that its qualifying entities will continue to obtain the renewal of the HNTE status in the future and has assumed so in calculating deferred tax assets and liabilities. If these qualifying entities failed to obtain such renewal, there would not be any significant impact on deferred tax balances as of December 31, 2011.

Xiamen Simlife and Shanghai Dacheng qualified for software enterprise for tax purposes. They were entitled to an exemption from income tax for two years commencing from the first year that presents accumulated earnings under the PRC tax law and entitled to a 50% relief from income tax for the following three years. The preferential tax treatment of Xiamen Simlife started in 2010 and Shanghai Dacheng started in 2011.

The principal components of the deferred income tax assets and liabilities are as follows:

As of December 31,		
	2010	2011
Current deferred tax assets		
Accrued expenses	\$ 284,491	\$335,946
Less: valuation allowance	(284,491)	(335,946)
Current deferred tax assets, net	\$ -	\$ -
Non-current deferred tax assets		
Net operating loss carry forwards	107,033	78,740
Less: valuation allowance	(107,033)	(78,740)
Non-current deferred tax assets, net	\$ -	\$ -
Deferred tax liabilities		
Amortization of intangible assets	\$ 477,457	\$271,622

The Company operates through multiple subsidiaries and VIEs and the valuation allowance is considered on each individual entity basis. A full valuation allowance has been established because the Company believes that either it is more likely than not that its deferred tax assets will not be realized as it does not expect to generate sufficient taxable income in the future, or the amount involved is not significant. The tax losses carried forward as of December 31, 2011 amounted to \$314,960 and will expire by 2016.

The income taxes expense consists of:

For the years ended December 31,			
	2009	2010	2011
Current	\$ 4,867,900	\$ 4,578,091	\$ 3,326,277
Deferred	(169,786)	(628,088)	(188,439)
Total	\$ 4,698,114	\$ 3,950,003	\$ 3,137,838

A reconciliation between the statutory PRC enterprise income tax rate and the Company's effective tax rate is as follows:

For the years ended December 31,			
	2009	2010	2011
Applicable rate for reconciliation purpose (note)	25%	25%	(25)%
Effect of tax holiday granted to PRC entities	(24.1)%	(26.7)%	(50.7)%
Effect on tax rates in different tax jurisdiction	-	(5.8)%	(23.7)%
Tax effect of expenses that are not deductible in determining taxable profit	25.8%	37.7%	29.4%
Change in valuation allowance	0.5%	(5.3)%	0.5%
Effective tax rate for the year	27.2%	24.9%	(69.5)%

Note: The domestic tax rate in the jurisdiction where the operation of the Company is substantially based is used. On January 1, 2008, the new PRC enterprise income tax law took effect and has applied a uniform statutory tax rate of 25% to domestic enterprises and foreign-invested enterprises.

If the tax holidays granted to the relevant subsidiaries and VIEs were not available, the impact on income tax provision and earnings per share amounts would be as follows:

For the years ended December 31,			
	2009	2010	2011
Increase in income tax expense	\$ 4,164,840	\$ 4,235,642	\$ 2,290,131
Impact on net income (loss) per ordinary share-basic	\$ 0.00	\$ 0.00	\$ 0.00
Impact on net income (loss) per ordinary share-diluted	\$ 0.00	\$ 0.00	\$ 0.00

The Company did not identify any significant unrecognized tax benefits or incur any interest or penalties related to potential underpaid income tax expenses for each of the three years ended December 31, 2011. The Company does not expect to have a significant increase or decrease on unrecognized tax benefits within 12 months from December 31, 2011.

Under New EIT Law, a "resident enterprise" which may include an enterprise established outside of the PRC with management located in the PRC, will be subject to the PRC income tax. If the PRC tax authorities subsequently determine that the Company and its subsidiaries registered outside the PRC should be deemed a resident enterprise, the Company and its

subsidiaries registered outside the PRC will be subject to the PRC income tax at a rate of 25%.

Aggregate undistributed earnings of the Company's VIEs and its VIEs' subsidiaries located in the PRC that are available for distribution to the Company of approximately \$119,199,035 at December 31, 2011 are considered to be indefinitely reinvested and accordingly, no provision has been made for the Chinese dividend withholding taxes that would be payable upon the distribution of those amounts to the Company. The Chinese tax authorities have also clarified that distribution made out of pre January 1, 2008 retained earnings will not be subject to the withholding tax.

Under applicable accounting principles, a deferred tax liability should be recorded for taxable temporary differences attributable to the excess of financial reporting over tax basis, including those differences attributable to a more than 50% interest in a domestic subsidiary. However, recognition is not required in situations where the tax law provides a means by which the reported amount of that investment can be recovered tax-free and the enterprise expects that it will ultimately use that means. The Company has not recorded any such deferred tax liability attributable to the undistributed earnings of its financial interest in VIE affiliates because the Company believes such excess earnings can be distributed in a manner that would not be subject to tax.

#### 14. CONVERTIBLE SENIOR NOTES

On March 18, 2009, the Company issued a convertible senior note to Nokia Growth Partners ("NGP"), which is due in 2014. This note in an aggregate principal amount of \$6,775,400 is convertible to ordinary shares of the Company at the conversion price of \$0.08915 per share. The conversion price is adjustable subject to standard anti-dilution provision i.e. stock splits, subdivisions, reclassifications or combinations, etc. The initial interest rate was 8% per annum for the period commencing and including March 18, 2009 and ending and including December 31, 2009, compounded annually on the outstanding portion of the principal amount and any accrued and unpaid interest that is overdue. The applicable interest rate was changed from 8% to 7% in 2010 according to certain earning/debt ratio. For the fiscal year commencing January 1, 2011 and each fiscal year thereafter, the applicable interest rate will be adjustable in a range of 6% to 8% according to certain earning/debt ratio. The interest was payable on July 15, 2009 and semi-annually on January 15 and July 15 afterwards. The Company was also entitled to a purchased call option to redeem the convertible senior note plus any accrued but unpaid interest following the third anniversary of the closing date. Furthermore, a share purchase warrant was issued to NGP to purchase 80,000,000 ordinary shares of KongZhong with a purchase price of \$0.125 per share, which is to be expired in five years after the issuance.

The conversion feature, interest rate reset feature and prepayment feature embedded in the convertible senior note are derivatives but not subject to bifurcation in accordance with the guidance of accounting for derivative instruments. The warrant issued with the convertible senior note was detachable and classified as equity. The total proceeds were allocated between the convertible senior note and the warrant based on their relative fair values. The amount of \$677,332 allocated to the warrant was recorded as equity. A beneficial conversion feature of \$3,667,931 was resulted as the effective conversion price was lower than the fair value of the ordinary shares on the closing date of March 18, 2009, which was recognized as additional paid in capital with a corresponding increase in debt discount. The debt discount totaling \$4,345,263 was amortized into interest expense over the term of convertible senior note using the effective interest rate method. During 2009, 2010 and 2011, the amortized discount of \$299,813, \$585,627 and \$294,543 were recorded as part of the interest expense respectively.

On February 25, 2011, the Company prepaid 70% of the aggregate principal amount of the convertible senior note for US\$9,310,000 in cash, plus any accrued but unpaid interest. The prepaid portion of the convertible senior note has rights to be converted into 1,330,000 ADSs, equivalent to 53,200,000 ordinary shares.

The carrying amount of the convertible senior note was as follows:

As of December 31,		
	2010	2011
Principal	6,775,400	2,032,620
Debt discount	(4,345,263)	(1,303,579)
Accumulated amortization of debt discount	885,440	471,852
Accrued interest	237,139	71,726
Carrying amount	3,552,716	1,272,619

Interest expense on the convertible senior note has been recorded at the effective rate of 31.85% after prepayment comparing to previous effective tax rate of 37.01%. Interest expense recognized related to the convertible senior note was as follows:

For the years ended December 31,			
	2009	2010	2011
Interest expense at coupon rate	426,097	474,278	193,220
Amortization of debt discount	299,813	585,627	294,543
Total interest expense recognized	725,910	1,059,905	487,763

## 15.SHAREHOLDER'S EQUITY

The Company's 2002 employee equity incentive plan ("2002 Plan") allows the Company to offer a variety of incentive awards to employees, consultants or external service advisors of the Company. Options to purchase 105,000,000 ordinary shares are authorized under the 2002 Plan. In 2005, the shareholders authorized additional 32,000,000 options under the 2002 Plan. Under the terms of the 2002 Plan, options are generally granted at prices equal to the fair market value of the Company's shares listed on the Nasdaq National Market. The majority of the options will vest over four years where 25% of the options will vest at the end of the first year, 6.25% will vest quarterly in the second year through the fourth year. The stock options expire 10 years from the date of grant.

As of December 31, 2011, options to purchase 50,685,617 shares of ordinary shares were outstanding, and options to purchase 12,989,343 ordinary shares were available for future grant.

The Company's 2006 Equity Incentive Plan ("2006 Plan") allows the Company to offer a variety of incentive awards to employees, consultants or advisors of the Company. 40,000,000 nonvested ordinary shares are authorized under the 2006 Plan. In December 2008, the shareholders authorized additional 140,000,000 nonvested ordinary shares under the 2006 Plan.

For the nonvested shares granted in 2010, the fair market value of the grant date was used to determine the cost of the nonvested shares. As of December 31, 2011, 56,475,000 shares were outstanding and 1,857,500 shares were available for future grant. The majority of nonvested shares will vest over four years where 25% of the nonvested shares will vest at the end of the first year, and 6.25% will vest quarterly from the second year through the fourth year.

The Company recognizes the compensation costs net of estimated forfeitures on a straight-line basis over the requisite service period of the award, which is generally the vesting period. The estimate of forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized through a cumulative catch-up adjustment in the period of change and will also impact the amount of share-based compensation expense to be recognized in future periods.

### Stock options

A summary of the stock option activities is as follows:

Outstanding options			
	Number of Options	weighted average exercise price	weighted average grant-date fair value
Options outstanding at January 1, 2009	59,534,640	\$0.06	\$0.06
Granted	13,240,000	\$0.12	\$0.15
Forfeited	(11,264,600)	\$0.07	\$0.07
Exercised	(13,398,120)	\$0.04	\$0.04
Options outstanding at December 31, 2009	48,111,920	\$0.08	\$0.09
Granted	6,800,000	\$0.15	\$0.06
Forfeited	(6,926,580)	\$0.08	\$0.04
Exercised	(5,498,560)	\$0.06	\$0.04
Options outstanding at December 31, 2010	42,486,780	\$0.07	\$0.05
Granted	19,800,000	\$0.10	\$0.10
Forfeited	(5,034,283)	\$0.09	\$0.05
Exercised	(6,566,880)	\$0.05	\$0.03
Options outstanding at December 31, 2011	50,685,617	\$0.10	\$0.07

The fair value of each option granted was estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions for each applicable period.

Option grants	2009	2010	2011
Weighted average risk-free interest rate	1.21%	1.21%	0.46%
Weighted average expected option life	2.75 years	2.75 years	2.75 years
Weighted average volatility rate	50%	62%	62%
Weighted average dividend yield			

(1) Risk-free interest rate

Risk-free interest rate was estimated based on the yield to maturity of treasury bonds of the United States with a maturity period close to the expected life of the options.

(2) Expected life

The expected life was estimated based on historical and other economic data trended into the future.

(3) Volatility

The volatility of the underlying ordinary shares during the life of the options was estimated based on the historical stock price volatility of KongZhong over a period comparable to the expected life of the options.

(4) Dividend yield

The dividend yield was estimated by the Company based on its expected dividend policy over the expected life of the options.

(5) Exercise price

The exercise price of the options was determined by the Board of Directors.

(6) Fair value of underlying ordinary shares

The closing market price of the ADSs of KongZhong as of the grant date was used to determine the fair value of the ordinary shares on that date.

The weighted average per share fair value of options granted in each year was as follows:

For the years ended December 31,			
	2009	2010	2011
Stock options	\$ 0.07	\$0.06	\$0.10

The total intrinsic value of options exercised during the year ended December 31, 2009, 2010 and 2011 was \$3,653,699, \$617,438 and \$377,622 respectively.

The following table summarizes information with respect to stock options outstanding at December 31, 2011:

	Options outstanding				Options exercisable			
	Number outstanding	weighted average exercise price	weighted average remaining contractual life	Aggregate intrinsic value	Number exercisable	weighted average exercise price	weighted average remaining contractual life	Aggregate intrinsic value
Average exercise price								
\$0.00	1,560,000			\$157,560	1,560,000			\$157,560
\$0.01	50,040			4,679	50,040			4,679
\$0.07	13,797,537			458,768	9,696,347			322,404
\$0.09	2,000,000			32,500	1,250,000			20,313
\$0.10	17,800,000			151,300	-			-
\$0.12	2,000,000			-	-			-
\$0.13	7,518,040			-	4,598,040			-
\$0.15	5,960,000			-	2,235,000			-
Total	50,685,617	\$0.10	8.08 years	\$ 804,807	19,389,427	\$0.10	6.68 years	\$ 504,956

The number of the options expected to vest was 31,296,190 with a weighted-average exercise price of \$0.10 and the weighted-average remaining contractual term of 8.95 years. The aggregate intrinsic value of the option expected to vest was \$299,851 as of December 31, 2011.

### Nonvested shares

A summary of the nonvested share activities is as follows:

	Number of Nonvested shares outstanding	weight average grant-date fair value
Nonvested shares outstanding at January 1, 2009	122,237,500	\$0.10
Granted	52,400,000	\$0.14
Forfeited	(7,202,500)	\$0.14
Vested	(31,260,833)	\$0.10
Nonvested shares outstanding at December 31, 2009	136,174,167	\$0.11
Granted	14,000,000	\$0.18
Forfeited	(29,450,000)	\$0.09
Vested	(43,130,834)	\$0.11
Nonvested shares outstanding at December 31, 2010	77,593,333	\$0.13
Granted	16,160,000	\$0.10
Forfeited	(1,975,000)	\$0.09
Vested	(35,303,333)	\$0.12
Nonvested shares outstanding at December 31, 2011	56,475,000	\$0.12

The total intrinsic value of shares vested in the year of 2009, 2010 and 2011 was \$9,683,043, \$7,644,940 and \$3,653,895 respectively.

The following table summarizes information with respect to nonvested shares outstanding at December 31, 2011:

Nonvested share outstanding		
	Number outstanding	Aggregate intrinsic value
Grant date		
December 19, 2008	\$13,200,000	\$1,366,200
February 3, 2009	10,000,000	1,035,000
April 1, 2009	2,820,000	291,870
July 10, 2009	5,425,000	561,488
July 15, 2009	120,000	12,420
June 22, 2010	8,750,000	905,625
October 3, 2011	\$16,160,000	\$1,672,560
Total	\$56,475,000	\$5,845,163

The Company recorded share-based compensation expenses of \$4,211,530, \$5,000,256 and \$4,579,522 for the years ended December 31, 2009, 2010 and 2011, respectively. The amount of stock-based compensation currently estimated to be expensed from 2012 through 2015 related to unvested share-based payment awards at December 31, 2011 is \$7,104,988. This amount will be recognized as presented in the following table.

Year	
2012	\$4,464,497
2013	1,549,546
2014	751,532
2015	339,413
Total	\$7,104,988

That cost is expected to be recognized over a weighted average period of 2.06 years. To the extent the actual forfeiture rate is different from the Company's original estimate, share-based compensation related to these awards may require to be adjusted.

### Share repurchase

On September 30, 2011, the Board of Directors, authorized to purchase the ADSs on the open market (the "Purchase Plan"). The number of ADSs to be purchased under the Purchase Plan shall not exceed 5,000,000 ADSs. The aggregate value of ADSs to be purchased under the Purchase Plan shall not exceed \$15,000,000. During the year ended December 31, 2011, the Company repurchased 24,299,120 shares of its ordinary shares for a total consideration of \$2,748,579. 20,000,000 shares repurchased by the Company were cancelled during 2011, and the remaining shares were cancelled in March 2012.

## 16. SEGMENT AND GEOGRAPHIC INFORMATION

### Segment reporting

The Company's chief operating decision maker ("CODM") has been identified as the Chief Executive Officer who reviews results of operations by business lines when making decisions about allocating resources and assessing performance of the Company. The Company has therefore determined that each business line represents an operating segment.

During 2009, the Company was operated in three business lines: WVAS, mobile games and wireless internet services ("WIS"). In 2010, the Company expected revenue growth in partnership with China Mobile's mobile literature platform, which was part of WIS business. This new revenue stream was expected to rely on resources from WVAS business to a significant degree. Due to the anticipated synergy between WVAS and WIS businesses, the Company combined WIS business into its WVAS business and no discrete financial information for WIS would be available any more. Meanwhile, the acquisition of Dacheng bought a new business line, internet games, into the Company in 2010, which was expected to be a significant portion of revenue growth in future. As a result, there were three operating segments presented: WVAS, mobile games and internet games.

The Company does not allocate any assets to its operating segments as management does not believe that allocating these assets is useful in evaluating these segments' performance. Accordingly, the Company has not made disclosure of total assets by reportable segment.

For the years ended December 31,			
	2009	2010	2011
<b>Revenues</b>			
WVAS	\$104,001,623	\$83,280,333	\$80,265,942
Mobile games	27,296,600	49,171,432	40,850,452
Internet games	-	17,131,599	38,892,041
	131,298,223	149,583,364	160,008,435
<b>Sales tax</b>			
WVAS	(2,273,620)	(1,584,382)	(1,390,901)
Mobile games	(611,507)	(925,098)	(621,069)
Internet games	-	(699,453)	(1,815,853)
	(2,885,127)	(3,208,933)	(3,827,823)
<b>Cost of revenues</b>			
WVAS	(54,258,522)	(48,329,474)	(50,758,629)
Mobile games	(11,688,299)	(29,570,886)	(25,247,963)
Internet games	-	(2,338,257)	(15,923,649)
	(65,946,821)	(80,238,617)	(91,930,241)
<b>Gross profit</b>			
WVAS	47,469,481	33,366,477	28,116,412
Mobile games	14,996,794	18,675,448	14,981,420
Internet games	-	14,093,889	21,152,539
	62,466,275	66,135,814	64,250,371
<b>Operating expenses</b>			
Product development	(18,272,008)	(23,964,697)	(15,416,944)
Sales and marketing	(17,821,260)	(18,975,617)	(20,891,615)
General and administrative	(10,186,853)	(10,481,827)	(11,582,200)
Intangible assets and Goodwill impairment loss	-	(8,728,896)	(20,259,169)
Total operating expenses	(46,280,121)	(62,151,037)	(68,149,928)
<b>Changes in fair value of contingent consideration for business acquisition</b>			
	\$ -	\$10,894,533	\$(3,729,513)
<b>Government subsidy</b>			
	\$ -	\$337,663	\$319,319
<b>Income (loss) from operations</b>	<b>\$16,186,154</b>	<b>\$15,216,973</b>	<b>\$(7,309,751)</b>

### Product lines of WVAS

The WVAS include services delivered through the 2.5G mobile networks, which comprise Wireless Application Protocol ("WAP") services and Multimedia Messaging Services ("MMS"), and services delivered through 2G technology platforms, which comprise Short Messaging Services ("SMS"), Interactive Voice Response services ("IVR"), and Color Ring Back Tones ("CRBT"). Revenues of WVAS by product line for the years ended December 31, 2009, 2010 and 2011 are as follows:

For the years ended December 31,			
	2009	2010	2011
WVAS			
2.5 Generation			
- WAP	\$ 13,106,151	\$ 4,485,792	\$ 2,355,376
- MMS	8,203,600	5,544,700	6,573,187
	21,309,751	10,030,492	8,928,563
2 Generation			
- SMS	\$ 44,484,612	\$ 34,485,665	\$ 37,096,542
- IVR	19,512,653	17,706,798	12,661,930
- CRBT and others	18,694,607	21,057,378	21,578,907
	82,691,872	73,249,841	71,337,379
	\$ 104,001,623	\$ 83,280,333	\$ 80,265,942

### Geographical information

The Company's operations are mainly located in its country of domicile (ie. the PRC) and to a lesser extent, overseas. The Company's revenues by geographic areas (based on location of the other signing party of the revenue contract) are detailed below:

For the years ended December 31,			
	2009	2010	2011
PRC	\$131,298,223	\$144,622,646	\$154,455,308
Asia-pacific	-	4,474,499	4,502,636
Other areas	-	486,219	1,050,491
	\$131,298,223	\$149,583,364	\$160,008,435

The Company's long-lived assets as of December 31, 2010 and 2011 were all located in the PRC.

## 17.NET INCOME (LOSS) PER SHARE

The following table sets forth the computation of basic and diluted net income (loss) per share:

For the years ended December 31,			
	2009	2010	2011
Net income (loss) (numerator), basic and diluted	\$ 12,583,381	\$ 11,923,199	\$ (7,654,862)
Shares (denominator):			
Weighted average ordinary shares outstanding used in computing basic net income (loss) per share	1,385,201,479	1,466,947,693	1,607,110,119
Effect of dilutive securities:			
Plus incremental weighted average ordinary shares from assumed conversions of stock options, nonvested shares and warrant using the treasury stock method	152,569,572	80,922,985	-
Total weighted average shares used in computing diluted net income (loss) per share	1,537,771,051	1,547,870,678	1,607,110,119
Net income (loss) per share, basic	\$ 0.01	\$ 0.01	\$ (0.00)
Net income (loss) per share, diluted	\$ 0.01	\$ 0.01	\$ (0.00)

The dilutive effects of the options, nonvested shares and warrant are calculated using the treasury stock method. Under the treasury stock method, the proceeds from the assumed conversion of options, nonvested shares and warrant, which include the benefit of the compensation costs attributable to future services and not yet recognized, are used to repurchase outstanding ordinary shares using a yearly average market price.

The dilutive effect of the convertible senior note was calculated using if-converted method. Under the if-convertible method, the interest less income tax effects applicable to the convertible senior note is added back to the numerator. The convertible senior note is assumed to have been converted at the beginning of the period.

For the years ended December 31, 2009, 2010 and 2011, the Company had the following securities outstanding which could potentially dilute basic net income (loss) per share in the future, but were excluded from the computation of diluted net income (loss) per share in 2009, 2010 and 2011 as their effects would have been antidilutive:

For the years ended December 31,			
	2009	2010	2011
Options, nonvested shares and warrant	-	-	187,160,617
Convertible senior note	76,000,000	76,000,000	22,800,000

## 18. CONCENTRATIONS

### i. Dependence on Mobile Operator

The revenue of the Company is primarily derived from cooperative arrangements with the Mobile Operator in the PRC. The major operators cooperated with the Company are China Mobile, China Unicom and China Telecom. If the strategic relationship with the Mobile Operator in the PRC is terminated or scaled-back, or if the Mobile Operator alters the revenue sharing arrangements, the Company's WVAS business would be adversely affected.

Revenues collected through China Mobile for the years ended December 31, 2009, 2010 and 2011 represent 78%, 72% and 62% of gross revenues, respectively.

Revenues collected through China Unicom for the years ended December 31, 2009, 2010 and 2011 represent 11%, 8% and 7% of gross revenues, respectively.

Revenues collected through China Telecom for the years ended December 31, 2009, 2010 and 2011 represent 8%, 6% and 5% of gross revenues, respectively.

As a percentage of total WVAS revenues, WVAS revenues collected through China Mobile for the years ended December 31, 2009, 2010 and 2011 represent 57%, 40% and 37% of gross revenues respectively; WVAS revenues collected through China Unicom for the years ended December 31, 2009, 2010 and 2011 represent for 11%, 8%, and 7% of gross revenues respectively; WVAS revenues collected through China Telecom for the years ended December 31, 2009, 2010 and 2011 represent 8%, 6% and 5% of gross revenues respectively.

As a percentage of total mobile games revenues, mobile games revenues, which are collected only through China Mobile, for the years ended December 31, 2009, 2010 and 2011 represent 20%, 32% and 25% of gross revenues respectively.

Amounts due from China Mobile as of December 31, 2010 and 2011 represent 76% and 75% of accounts receivable, respectively.

Amounts due from China Unicom as of December 31, 2010 and 2011 represent 1% and 1% of accounts receivable, respectively.

Amounts due from China Telecom as of December 31, 2010 and 2011 represent 8% and 9% of accounts receivable, respectively.

### ii. Credit risk

In WVAS and mobile games services, the Company depends on the billing system of the Mobile Operator to charge the mobile phone users and collect payments from them. The Company generally does not require collateral for its accounts receivable and has not experienced any significant credit losses for any periods presented.

## 19. PRC CONTRIBUTION PLAN AND PROFIT APPROPRIATION

The employees of the Company in the PRC participate in a government-mandated defined contribution plan pursuant to which pension benefits, medical care, unemployment insurance, employee housing fund and other welfare benefits are provided to employees. Chinese labor regulations require the Company accrue these benefits based on certain percentages of the employees' salaries. The total provision for such employee benefit was \$3,143,592, \$4,050,629 and \$3,635,872 for the years ended December 31, 2009, 2010 and 2011, respectively.

Pursuant to the laws applicable to the PRC's Foreign Investment Enterprises and local enterprises, the Company's subsidiaries in the PRC must make appropriations from after-tax profit to non-distributable reserve funds as determined by the boards of directors of the relevant subsidiaries.

For foreign enterprises, these reserve funds include (i) a statutory surplus reserve fund and (ii) a general surplus reserve fund. Subject to certain cumulative limits, the general reserve fund requires annual appropriations of 10% of after-tax profit (as determined under PRC accounting standards and regulation at each year-end); the other fund appropriations are at the

Company's discretion. These reserve funds can only be used for specific purposes of enterprise expansion and staff welfare and bonus and are not distributable as cash dividends.

As of December 31, 2010 and 2011, the total statutory reserve amounted to \$9,392,790 and \$10,341,491, respectively.

## 20. RELATED PARTY TRANSACTIONS

Prior to the acquisition of Dacheng by the Company in January 2010, Leilei Wang, the Chief Executive Officer of the Company and the Chairman of the Board of Directors, held approximately 24.8% equity interest of Dacheng. As a result of the acquisition, Leilei Wang, as one of the selling shareholders, received a consideration of 14.6 million and 53.1 million ordinary shares of KongZhong in 2010 and 2011, respectively.

Leilei Wang indirectly owns more than 10% of Prosten Technology Holdings Limited ("Prosten"). Prosten and its subsidiaries engage in the business of providing solutions to companies that provide mobile and search services. In 2009, 2010 and 2011, Prosten and its subsidiaries provided the Company mobile value-added services valued at \$1.1 million, \$3.2 million and \$3.8 million, respectively. The accounts payable to Prosten and its subsidiaries as of December 31, 2010 and 2011 were \$0.1 million and \$nil, respectively.

## 21. COMMITMENT AND CONTINGENCY

### i. Operating lease as lessee

The Company leases certain office premises under non-cancelable leases. Rental expenses under operating leases for the years ended December 31, 2009, 2010 and 2011 were \$1,808,401, \$2,282,956 and \$2,087,203, respectively.

Future minimum lease payments under non-cancelable operating leases agreements are as follows:

Year ending	
2012	\$ 1,526,266
2013	\$ 213,297
2014	\$ 102,455
2015 and thereafter	-

### ii. Purchase obligations

The Company entered into a series of agreements with content providers to develop WVAS, mobile games and internet games. The future minimum purchase obligations payments under non-cancelable purchase agreements were approximately as follows:

Year ending	
2012	\$ 3,550,790
2013	\$ 612,284
2014	\$ 232,036
2015	\$ 973
2016 and thereafter	\$ --

### iii. Sales tax

The subsidiaries and VIEs incorporated in the PRC are subject to the sales tax at rates of 3% to 5% on PRC taxable revenues, as defined by the related tax rules and regulations. When determining the PRC taxable revenues for sales tax purpose, the subsidiaries and VIEs adopted a "net" basis, i.e. deducting profit sharing with content providers from revenues. However, as the deductible items for sales tax purposes are not clearly defined, the Company would be subject to additional sales tax if the net basis used by the Company was determined inappropriate for the computation of sales tax. Additional business tax amounting to \$3,484,170 could arise had the gross revenue been used for sales tax calculations as of December 31, 2011.

## 22. RESTRICTED NET ASSETS

Relevant PRC statutory laws and regulations restrict the payments of dividends by the Company's PRC subsidiaries and VIEs from their retained earnings, if any, as determined in accordance with PRC accounting standards and regulations. As described in note 19, general reserve requires annual appropriations of 10% of after-tax profit should be set aside prior to the payment of dividends. As a result of these PRC laws and regulations, the Company's PRC subsidiaries and VIEs are restricted in their ability to transfer a portion of their net assets to the Company. As of December 31, 2010 and 2011, the amounts of restricted net assets were approximately \$48,600,310 and \$51,505,234, respectively.

## 23. SUBSEQUENT EVENTS

### i. U4iA investment

In January 2012, the Company invested \$2.0 million in the series B preferred shares of U4iA Games Incorporated ("U4iA"), a United States based company, a developer and publisher of a free-to-play, console-quality, browser-based first person shooter game, which is still under development. As the Company has no significant influence on U4iA, the investment was recorded as a long-term investment at cost.

### ii. Noumena acquisition

In February 2012, the Company announced to acquire 100% of the shares of Noumena Innovations (BVI) Ltd. ("Noumena") and certain assets from an entity related to Noumena for an aggregate consideration of \$15 million in cash and 40 million ordinary shares of KongZhong (equivalent to 1 million ADSs). Noumena is engaged in mobile games platform development. The acquisition of Noumena is expected to support the development of the Company's mobile games services. The cash consideration is payable over three years, and the shares are subject to a three-year lock-up period from the closing of the transactions. The acquisition was completed in March 2012. Assets acquired and liabilities assumed are impracticable to disclose since the Company is still in the process of preparing purchase price allocation and related accounting.

### iii. NGP conversion

On March 1, 2012, NGP converted all of the outstanding convertible senior note into 22,800,000 ordinary shares of KongZhong.