AGILYSYS INC
Form 10-K
June 12, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended March 31, 2012

or

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

Commission file number 0-5734

AGILYSYS, INC.

(Exact name of registrant as specified in its charter)

Ohio	34-0907152
State or other jurisdiction of incorporation or organization	(I.R.S. Employer Identification No.)
425 Walnut Street, Suite 1800, Cincinnati, Ohio	45202
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: (770) 810-7800

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Shares, without par value	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act: None

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No þ

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

Large accelerated filer ¨	Accelerated filer þ	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

The aggregate market value of Common Shares held by non-affiliates as of September 30, 2011 (the last business day of the Registrant s most recently completed second fiscal quarter) was $107,364,331 computed on the basis of the last reported sale price per share ($7.13) of such shares on the Nasdaq Stock Market LLC.

As of June 1, 2012, the Registrant had the following number of Common Shares outstanding: 21,935,487 of which 7,518,422 were held by affiliates.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s definitive Proxy Statement to be used in connection with its 2012 Annual Meeting of Shareholders are incorporated by reference into Part III of this Form 10-K.

AGILYSYS, INC.

ANNUAL REPORT ON FORM 10-K

Year Ended March 31, 2012

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Forward Looking Information

This Annual Report and other publicly available documents, including the documents incorporated herein and therein by reference, contain, and our officers and representatives may from time to time make, forward-looking statements within the meaning of the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements can be identified by words such as: anticipate, intend, plan, goal, seek, believe, project, estima strategy, future, likely, may, should, will and similar references to future periods. These statements are not guarantees of future performance and involve uncertainties, and assumptions that are difficult to predict. These statements are based on management s current expectations, intentions, or beliefs and are subject to a number of factors, assumptions, and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. Factors that could cause or contribute to such differences or that might otherwise impact the business include the risk factors set forth in Item 1A of this Annual Report. We undertake no obligation to update any such factor or to publicly announce the results of any revisions to any forward-looking statements contained herein whether as a result of new information, future events, or otherwise.

Part I

Item 1. Business.
Overview

We are a leading provider of innovative technology solutions for the hospitality and retail markets including property and lodging management, inventory and procurement, point-of-sale (POS), document management, mobile, wireless and other types of guest-engagement software. We also provide support, maintenance, resold hardware products and software hosting or subscription services. Our customers include retailers, casinos, resorts, cruise and other hospitality and retail customers, and a significant portion of our consolidated revenue is derived from contract support, maintenance agreements and professional services.

We operate extensively throughout North America, with additional sales and support offices in the United Kingdom and Asia. Agilysys has two operating segments: Hospitality Solutions Group (HSG) and Retail Solutions Group (RSG).

Reference herein to any particular year or quarter refers to periods within the fiscal year ended March 31. For example, fiscal 2012 refers to the fiscal year ended March 31, 2012.

History and Significant Events

Organized in 1963 as Pioneer-Standard Electronics, Inc., an Ohio corporation, we changed our name to Agilysys, Inc., in 2003. Our principal executive offices are located at 425 Walnut Street, Suite 1800, Cincinnati, Ohio, 45202 and our corporate services are located at 1000 Windward Concourse, Alpharetta, Georgia, 30005. We began operations as a distributor of electronic components and, later, enterprise computer solutions. Exiting the former in fiscal 2003 with the sale of our Industrial Electronic Division, we used the proceeds to reduce debt, fund growth of our enterprise solutions business and acquire businesses focused on higher-margin and more specialized solutions for the hospitality and retail industries. With the fiscal 2004 acquisition of Kyrus Corporation, we became the leading provider of IBM retail solutions and services in the supermarket, chain drug, general-retail and hospitality segments. In that same year, with the acquisition of Inter-American Data, Inc., we became the leading developer and provider of technology solutions for property and inventory management in the casino and resort industries.

In 2007, we divested KeyLink Systems and exited the enterprise computer distribution business. We used the proceeds from that sale to return cash to shareholders and fund a number of acquisitions that broadened our solutions and capabilities portfolios. In calendar 2007, we acquired InfoGenesis and Visual One Systems Corp., significantly expanding our specialized offerings to the hospitality industry through enterprise-class, point-of-sale (POS) and software solutions tailored for a variety of applications in cruise, golf and spa, gaming, lodging, resort and catering. These offerings feature highly intuitive, secure and robust solutions, easily scalable across multiple departments or property locations. In fiscal 2008, we began reporting three primary operating segments: Hospitality Solutions Group (HSG), Retail Solutions Group (RSG) and Technology Solutions Group (TSG).

In fiscal 2012, we sold our TSG segment and restructured the business model to focus on higher-margin opportunities in the hospitality and retail sectors, which also hold greater potential for profitable growth. In that same year, we reduced our real-estate footprint and lowered overhead costs by relocating corporate services from Solon, Ohio to Alpharetta, Georgia, which moved senior management closer to our operating units.

Today, we are focused on providing end-to-end solutions that utilize state-of-the-art technology to enhance guest experiences for our customers wishing to promote their respective brands. We help our customers win the guest recruitment battle and, in turn, grow revenue, reduce costs and increase efficiency. This is accomplished by developing and deploying intuitive solutions that increase speed and accuracy, enabling more effective management, intelligent upselling, reduced shrinkage, improved brand recognition and better control of the customer relationship. Our strategy is to increase the proportion of revenue we derive from ongoing support and maintenance agreements, software as a subscription service, cloud applications and professional services.

Products, Support and Professional Services

We are a leading developer and marketer of end-to-end technology solutions for the hospitality and retail industries, including hardware and software products; support, maintenance and subscription services; and professional services. Areas of specialization are point-of-sale, property management, inventory and procurement, mobile and wireless solutions designed to streamline operations, improve efficiency and enhance the guest experience.

To align with our strategic restructuring in fiscal 2012 and enhance transparency into the business, we commenced presenting revenue and costs of goods sold in three categories:

- Products (hardware and software)
- Support, maintenance and subscription services
- Professional services

Total revenue from continuing operations for these three specific areas of offerings follows:

	For The Year Ended March 31,		
(In thousands)	**2012**	2011	2010
Products	**$ 105,141**	$ 104,769	$ 103,501
Support, maintenance and subscription services	**73,171**	70,729	63,218
Professional services	**30,577**	27,183	26,787
Total	**$ 208,889**	$ 202,681	$ 193,506

Products: Products revenue includes resold hardware and proprietary and remarketed software that are deployed as an integral component of the solutions we provide. Our proprietary product suite is comprised of:

Property Management Systems (PMS)

- Agilysys Lodging Management System® (LMS) is web-enabled and runs 24/7 to automate every aspect of hotel operations in properties of 1,000 rooms or more. Its foundation expands to incorporate modules for sales and catering, activities scheduling, attraction ticketing and more.
- Agilysys Visual One PMS is installed in hotels ranging from 50-1,500 rooms. For complex resorts that require an enterprise-wide system, Visual One provides an integrated solution with interfaces to leading global distribution systems (GDSs) and other Agilysys products.
- Agilysys Guest Express Kiosk module is a self-service kiosk system for both the LMS PMS and the Visual One PMS that expedites front desk check-in and check-out. Using the Guest Express Kiosk module, hotel guests can check in, encode a room key, check out and obtain a receipt all without having to wait in line at the front desk.

Point-of-Sale

- Agilysys InfoGenesis POS is award-winning, enterprise level software primarily for food and beverage products. The software is centralized and designed for 24/7 environments where reliability and availability are critical. The solution is built on an open system platform using industry-standard hardware, operating system and database platforms.
- Agilysys MPOS is a handheld point-of-sale solution that integrates with InfoGenesis POS to enable guest service in any location.
- Agilysys eMenu, an online ordering application, enables our customers to capitalize on the popularity of Web and kiosk ordering while maintaining their existing company brand and workflow.
- Agilysys eCash takes traditional cashless payment and stored value card capabilities and integrates them directly with InfoGenesis POS, increasing customers payment options.

InfoGenesis POS, eMenu and eCash are available through either traditional software licensing or via subscription.

Inventory & Procurement

- Agilysys Stratton Warren System (SWS) integrates with all leading financial and POS software products. The software manages the entire procurement process via e-commerce, from the point of business development to managing enterprise-wide backend systems and daily operations.
- Agilysys Eatec®, along with its core purchasing, inventory, recipe, forecasting, production and sales analysis functions, is unique in offering catering, restaurant, buffet management and nutrition modules in a single web-enabled solution.

- Agilysys EatecTouch is an optional software applet that operates on any Windows®-based POS terminal, providing users with access to the Eatec application from any terminal location.
- Agilysys EatecPocket is a Microsoft® Windows® Mobile compatible application designed to work on a handheld wireless device, enabling users to perform inventory transactions. The software incorporates a barcode scanner for mobile updates of the database.

Eatec and Stratton Warren System solutions are available either through traditional software licensing or via subscription.

Document Management

- Agilysys DataMagine provides a U.S.-patented imaging module and archiving solution that allows users to capture and retrieve documents and system-generated information. DataMagine integrates with all Agilysys products, adding functionality and increasing benefit to customers.

Activities

- Agilysys GolfPro is a module that offers golf property managers complete pro shop management. Tee time scheduling, member profile/billing, tournament management and Web and e-mail access are bundled into one solution.
- Agilysys Spa Management software covers all aspects of running a spa business, from scheduling guests for services to managing staff schedules. The software also integrates with Agilysys PMS solutions.
- Agilysys LMS ARTS® interfaces with hotel guest data, allowing reservationists to pre-plan activities when booking a guest s room. The application also places canceled activities back into inventory for resale, resulting in optimum property utilization and profitability.
- Agilysys Visual One Activities software streamlines the management of all of the amenities and activities a property has to offer. Staff can easily schedule and personalize reservations for guests; activities then appear on itinerary/confirmations.

Support, Maintenance and Subscription Services: Contracted technical support, maintenance and subscription services are a significant portion of our consolidated revenue. Growth has been driven by a strategic focus on developing and promoting these offerings, which typically generate higher profit margins than products revenue. In addition to our deliberate positioning, market demand for proper maintenance and updates that enhance reliability, as well as the desire for flexibility in purchasing options, are reinforcing this trend. Our commitment to exceptional service has enabled us to become a trusted partner with customers who wish to optimize the level of service they provide to their guests and maximize commerce opportunities both on- and off-premise.

Professional Services: We have industry-leading expertise in designing, implementing, integrating and installing customized solutions into both legacy and newly created platforms. For existing enterprises, we seamlessly integrate new systems; and for start-ups and fast-growing customers, we become a partner that can manage large-scale rollouts and tight construction schedules. Extensive experience ranges from staging equipment to phased rollouts and training staff in a manner that saves time and money for our customers.

Prior to the divestiture of TSG operations, we resold IT products and services from the Hewlett-Packard Company (HP), International Business Machines Corporation (IBM), Oracle Corporation (Oracle) and other original equipment manufacturers (OEMs). Operating results from the former TSG are reported as components of discontinued operations.

We have maintained our strong relationship with IBM Retail Services and intend to continue to be a leading provider of related solutions and services in the supermarket, drug chain, general-retail and other hospitality segments.

Segment Reporting

Subsequent to the sale of our TSG business in fiscal 2012, we were left with two remaining reportable business segments: HSG and RSG. Prior to that, we had been reporting three business segments: HSG, RSG and TSG. See Note 16 to Consolidated Financial Statements titled *Business Segments* for a discussion of our segment reporting.

Hospitality Solutions Group (HSG)

HSG develops, markets and sells property and lodging management, point-of-sale, and inventory and procurement applications to operate hotel, casino, destination resort, cruise line and foodservice management establishments in the hospitality industry. We offer solutions that provide comprehensive control of the customer s property operations from reservations, check in, point-of-sale and other guest-engagement activities to inventory and procurement management and document management.

Retail Solutions Group (RSG)

RSG is one of the largest North American systems integrators of retail point-of-sale, self-service and wireless solutions with proprietary business consulting, implementation and hardware maintenance and support services. Our extensive experience in all phases of wireless infrastructure and integration with legacy systems enables our customers to capture the promise of today s mobile technology. Our mobile solutions extend the customer s operations to portable devices, increasing customer satisfaction and productivity with integrated software that reduces security exposure. We also sell POS and mobile POS (MPOS) solutions to facilitate the check-out process as well as other self-service capabilities.

Our RSG expertise encompasses a suite of support and professional services including consultation, analysis, design, installation and implementation, as well as onsite maintenance and ongoing help-desk support. Our comprehensive portfolio of support services provides total lifecycle management for our customers in-store solutions to help increase their return on investment and lower their total cost of ownership.

Representative Agilysys clients include:

Ameristar Casinos, Inc.	Copper Mountain	Royal Caribbean International
Banner Health	The Cosmopolitan of Las Vegas	Royal Lahaina Resort
Bed Bath & Beyond	CSU Fullerton Auxiliary Services Corporation	Rudy s Country Store & BBQ
Benchmarc Restaurants	Delhaize America	Sandals Emerald Bay
BJ s Wholesale Club	Helzberg Diamonds	Sands Casino Resort Bethlehem
Black Rock Resort	Ho-Chunk Gaming	SAVOR
Boyd Gaming Corporation	The Landmark London Hotel	The Sea Pines Resort
BR Guest Hospitality	Maryland Live! Casino	Sephora
The Breakers Palm Beach	Norwegian Cruise Line	Sugar Factory
The Broadmoor	Oxford Casino	The Venetian Resort Hotel Casino
Cannizaro House	Pinehurst Resort	Vail Resorts
Casino del Sol	Rack Room Shoes	Valley View Casino & Hotel
Charming Charlie	Rosen Hotels & Resorts	Wakefern Food Corp

Industry and Markets

The hospitality and retail industries encompass a wide variety of market sectors and customers. We operate extensively throughout North America, with additional sales and support offices in the United Kingdom, Singapore and Hong Kong. Sales to customers outside of the United States represent less than 10% of our total revenue.

The hospitality industry is made up of a number of defined markets including lodging, casinos, cruise ships, resorts and spas, franchise operators, restaurant chains, stadiums, arenas and other customer-service providers. The industry is highly fragmented. For example, in the lodging segment, no single hotel brand accounts for more than 4% of all hotel rooms in the United States. According to *Smith Travel Research*, the U.S. lodging industry generated $108 billion in room revenue in calendar 2011, with an average of approximately 60% of 4.9 million available rooms occupied. This compares with 57.5% in 2010 and a market-cycle peak occupancy rate of 63.1% in 2006.

The hospitality industry is economically sensitive. Business and destination-resort travel are correlated with the economic conditions in their respective markets. Competition is intense for consumer spending, and hospitality industry participants are seeking ways to enhance the experience of their guests. We are seizing this opportunity by providing guests connectivity and intuitive engagement tools, enabling our customers to enhance their brands and better manage their operations growth and profitability. In addition to product solutions that are designed and customized to meet unique facility or multi-facility needs, we also provide an array of support and subscription options for maintaining systems and professional services for implementation and rollouts.

We have a significant customer base in the commercial casino and gaming sector. Roughly one-quarter of the U.S. adult population visits a casino at least once a year. Amenities in contemporary casinos extend well beyond gaming to include a variety of entertainment and leisure options as well as modern convention centers and meeting facilities to attract the business market. International gaming markets are growing rapidly both in size and new jurisdictions. Asian gaming markets are reporting robust growth. In 2006, gross gaming revenue in Macau surpassed that of the Las Vegas Strip with a significant number of U.S.-based operators seeking to open new properties in the region. As the market-share leader in providing Property Management Systems (PMS) to casinos on the Las Vegas Strip, we are well positioned to benefit from these strong and long-standing relationships as our customer base expands into international markets. Additionally, as modern facilities evolve toward cashless operations and digital track-and-log of unique guest behavior, we are able to provide the requisite technologies and expertise to satisfy their needs.

We also have expertise in serving the unique needs of Cruise ship operators. According to the *Cruise Industry Overview 2011 State of the Cruise Industry* report, the cruise industry is the fastest growing category in the leisure travel market. In 2011, the industry anticipated a total of 16 million passengers, a 6.6% increase from 2010. In addition, 14 new ships were introduced, featuring such modern amenities as planetariums, golf simulators, water parks, ice-skating rinks and rock-climbing walls. The current order book, which extends through 2014, includes 26 new builds.

Similarly, the modern retail industry is rapidly transitioning to a higher level of engagement with customers. Retailers selling directly to consumers include: purveyors of softlines, such as clothing, accessory/shoe and department stores; and hardlines, such as home improvement, home furnishings and electronics; as well as staples such as groceries. Integrating our innovative technology with marketing is allowing Retail Solutions customers to enjoy the benefits of gift cards and loyalty programs. Other solutions such as mobile POS enable them to reduce wait times, increase accuracy and accelerate management reporting. For rapidly expanding retailers and retailers that are engaged in large store-wide POS technology refreshment, we manage large-scale implementation and roll-out including procurement, staging and installation, post-sale service and maintenance contracts to ensure a reliable and secure environment.

Customers

Our customers include large, medium-sized and boutique companies, and divisions or departments of large corporations in the hospitality and retail industries. We concentrate on serving the needs of customers in a range of customer-focused settings where brand differentiation is important, particularly in the lodging, casino, destination resort, cruise line, foodservice and retail industries where competition for guest recruitment is intense.

Currently, our customer base is highly fragmented, with no single customer representing more than 10% of consolidated revenue from continuing operations.

Seasonality

Prior to the sale of TSG, we traditionally had experienced a seasonal increase in sales during our fiscal third quarter ending December 31. The HSG and RSG operating units have traditionally experienced a seasonal decrease in revenue during our fiscal first quarter ending June 30. Although we are unable to predict whether uneven sales patterns will continue over the long term, we believe this particular pattern is moderating as a result of exiting the TSG business. For example, third-quarter revenue from continuing operations was 25%, 29% and 31% of annual revenue for fiscal years 2012, 2011 and 2010, respectively. In addition, occasionally the timing of large one-time orders such as those associated with substantial retail product rollouts will create volatility in our quarterly results.

Competition

We face a competitive market environment for the solutions we provide. Competition exists with respect to developing and maintaining relationships with customers, pricing for products and solutions, levels of support and customer service. We compete with a number of other solution providers and, occasionally, with some of our own suppliers in the RSG business segment.

Within HSG, we compete with other full-service providers that sell and service bundled POS and PMS solutions comprised of hardware, software, support and services. These companies, some of which are much larger than we are, include MICROS Systems, Inc., NCR, Par Technology, Multi-System, Inc., and Infor. We also compete with software companies like IDeaS Revenue Solutions, POSitouch, Northwind and Xpient Solutions and, to a lesser extent, hardware vendors such as IBM, HP, Dell, Casio, and Toshiba. In addition, we compete with PMS systems that are designed and maintained in-house by large hotel chains.

RSG s competitive market place is highly fragmented and regionalized. We compete primarily with regional integrators, regional and national Value Added Resellers Solution Providers and niche vendors.

Environmental Matters

We believe we are in compliance in all material respects with all applicable environmental laws. Presently, we do not anticipate that such compliance will have a material effect on capital expenditures, earnings or competitive position with respect to any of our operations.

Employees

As of June 1, 2012, we had 751 employees. We are not a party to any collective bargaining agreements, have had no strikes or work stoppages and consider our employee relations to be good.

Access to Information

Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to these reports are available free of charge through our corporate website, http://www.agilysys.com, as soon as reasonably practicable after such material is electronically filed with, or furnished to, the Securities and Exchange Commission (SEC). The information posted on our website is not incorporated into this Annual Report on Form 10-K (Annual Report). Reports, proxy and information statements, and other information regarding issuers that file electronically, are maintained on the SEC website, http://www.sec.gov.

Item 1A. Risk Factors.
Risks Relating to Our Business

Continuing challenging global economic conditions could adversely affect our business and financial results.

The continued global economic downturn has significantly adversely affected global economic conditions. Our revenue and profitability depend significantly on general economic conditions and the level of capital available to our customers. Our business trends and revenue growth continue to be affected by the challenging economic climate. These difficult economic conditions and the uncertainty about future economic conditions may adversely affect our customers level of spending, ability to obtain financing for purchases, ability to make timely payments to us and adoption of new technologies, which could require us to increase our allowance for doubtful accounts, negatively impact our days sales outstanding, lead to increased price competition and adversely affect our results of operations.

Our future success will depend on our ability to develop new products, product upgrades and services that achieve market acceptance.

Our business is characterized by rapid and continual changes in technology and evolving industry standards. We believe that in order to remain competitive in the future we will need to continue to develop new products, product upgrades and services, requiring the investment of significant financial resources. If we fail to accurately anticipate our customer s needs and technological trends, or are otherwise unable to complete the development of a product or product upgrade on a timely basis, we will be unable to introduce new products or product upgrades into the market on a timely basis, if at all, and our business and operating results would be materially and adversely affected.

The development process for most new products and product upgrades is complicated, involves a significant commitment of time and resources and is subject to a number of risks and challenges including:

- Managing the length of the development cycle for new products and product enhancements, which has frequently been longer than we originally expected;
- Adapting to emerging and evolving industry standards and to technological developments by our competitors and customers; and
- Extending the operation of our products and services to new and evolving platforms, operating systems and hardware products, such as mobile devices.

If we are not successful in managing these risks and challenges, or if our new products, product upgrades, and services are not technologically competitive or do not achieve market acceptance, our business and operating results could be adversely affected.

We face extensive competition in the markets in which we operate, and our failure to compete effectively could result in price reductions and/or decreased demand for our products and services.

Several companies offer products and services similar to ours. The rapid rate of technological change in the hospitality market makes it likely we will face competition from new products designed by companies not currently competing with us. We believe our competitive ability depends on our product offerings, our experience in the hospitality industry, our product development and systems integration capability, and our customer service organization. There is no assurance, however, we will be able to compete effectively in the hospitality technology market in the future.

If we fail to meet our customers performance expectations, our reputation may be harmed, causing us to lose customers or exposing us to legal liability.

Our ability to attract and retain customers depends to a large extent on our relationships with our customers and our reputation for high quality professional services and integrity. As a result, if a customer is not satisfied with our services or solutions, our reputation may be damaged. Moreover, if we fail to meet our clients performance expectations, we may lose clients and be subject to legal liability, particularly if such failure adversely impacts our clients businesses.

In addition, many of our projects are critical to the operations of our customers businesses. While our contracts typically include provisions designed to limit our exposure to legal claims relating to our products and services, these provisions may not adequately protect us or may not be enforceable in all cases. The general liability insurance coverage that we maintain, including coverage for errors and omissions, is subject to important exclusions and limitations. We cannot be certain that this coverage will continue to be available on reasonable terms or will be available in sufficient amounts to cover one or more large claims, or that the insurer will not disclaim coverage as to any future claim. A successful assertion of one or more large claims against us that exceeds our available insurance coverage or changes in our insurance policies, including premium increases or the imposition of large deductible or co-insurance requirements, could adversely affect our profitability.

We are subject to pricing pressures for our products and services which could cause us to lose market share and decrease revenue and profitability.

We compete for customers based on several factors, including price. In some cases, we may have to reduce our pricing to obtain business. If we are not able to maintain favorable pricing for our products and services, our gross profit and our profitability could suffer.

Our cloud-based solutions present execution and competitive risks.

Our solutions offered in the cloud accessible via the web without hardware installation or software downloads present new and difficult technology challenges. These offerings depend on integration of third-party hardware, software and cloud hosting vendors working together with our products. As a result, we may be subject to claims if customers experience service disruptions, breaches or other quality issues related to our cloud-based solutions.

Actual or perceived security vulnerabilities in our software products may result in reduced sales or liabilities.

Our software may be used in connection with processing sensitive data (e.g., credit card numbers), and is sometimes used to store such data. It may be possible for the data to be compromised if our customer does not maintain appropriate security procedures. In those instances, the customer may attempt to seek damages from us. While we believe that all of our current software complies with applicable industry security requirements and that we take appropriate security measures to reduce the possibility of breach through our support and other systems, we cannot assure that our customers systems will not be breached, or that all unauthorized access can be prevented. If a customer, or other person, seeks redress from us as a result of a security breach, our business could be adversely affected.

Hosting of software applications presents increased security risks.

As we expand our software hosting capabilities and offer more of our software applications to our customers on a hosted basis, our responsibility for data and system security with respect to data held in our hosting centers increases significantly. While we believe that our current software applications comply with applicable laws and industry security requirements, and while we believe that we use appropriate security measures to reduce the possibility of unauthorized access or misuse of data in the hosting center, we cannot provide absolute assurance that our hosted systems will not be breached, or that all unauthorized access can be prevented. If a security breach were to occur, a customer, regulatory agency, or other person could seek redress from us, which could adversely affect our business.

Additionally, as we expand our software hosting capabilities and offer more of our software applications to our customers on a hosted basis, our potential liability increases significantly. Specifically, an outage in our data centers can affect numerous customers. While we believe that our data centers have been designed and engineered to reduce the likelihood of outages, we cannot provide assurance that our hosted systems will not suffer from unanticipated outages or deficient performance. If an unanticipated outage were to occur, a customer could suffer economic damages and seek redress from us, which could adversely affect our business.

We may not be able to enforce or protect our intellectual property rights.

We rely on a combination of copyright, patent, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. We cannot be certain that the steps we have taken will prevent unauthorized use of our technology. Any failure to protect our intellectual property rights would diminish or eliminate the competitive advantages that we derive from our proprietary technology.

We may be subject to claims of infringement of third-party intellectual property rights.

While we do not believe that our products and services infringe any patents or other intellectual property rights, from time to time, we receive claims that we have infringed the intellectual property rights of others. Any such claim, with or without merit, could result in costly litigation and distract management from day-to-day operations. If we are found liable, we could be obligated to pay significant damages or enter into license agreements.

We are subject to litigation, which may be costly.

As a company that does business with many customers, employees and suppliers, we are subject to litigation. The results of such litigation are difficult to predict, and we may incur significant legal expenses if any such claim were filed. While we generally take steps to reduce the likelihood that disputes will result in litigation, litigation is very commonplace and could have an adverse effect on our business.

If we acquire new businesses, we may not be able to successfully integrate them or attain the anticipated benefits.

As part of our operating history and growth strategy, we have acquired other businesses. In the future, we may continue to seek acquisitions. We can provide no assurance that we will be able to identify and acquire targeted businesses or obtain financing for such acquisitions on satisfactory terms. The process of integrating acquired businesses into our operations may result in unforeseen difficulties and may require a disproportionate amount of resources and management attention. If integration of our acquired businesses is not successful, we may not realize the potential benefits of an acquisition or suffer other adverse effects.

Our dependence on certain strategic partners makes us vulnerable to the extent we rely on them.

We rely on a concentrated number of vendors for the majority of our hardware and for certain software and related services needs. We do not have long term agreements with many of these vendors. If we can no longer obtain these hardware, software or services needs from our major suppliers due to mergers, acquisitions or consolidation within the marketplace, material changes in their partner programs, their refusal to continue to supply to us on reasonable terms or at all, and we cannot find suitable replacement suppliers, it may have a material adverse impact on our future operating results and gross margins.

If we fail to retain key employees, our business may be harmed.

Our success depends on the skill, experience and dedication of our employees. If we are unable to retain and attract sufficiently experienced and capable personnel, especially in product development, sales and management, our business and financial results may suffer. For example, if we are unable to retain and attract a sufficient number of skilled technical personnel, our ability to develop high quality products and provide high quality customer service may be impaired. Experienced and capable personnel in the technology industry remain in high demand, and there is continual competition for their talents. When talented employees leave, we may have difficulty replacing them, and our business may suffer. There can be no assurance that we will be able to successfully retain and attract the personnel that we need.

Our profitability is partly dependent upon restructuring and executing planned cost savings.

To allow us to operate more efficiently and control costs, we have incurred restructuring charges related to the consolidation and streamlining of various functions of our workforce. As part of our restructuring efforts, we incurred severance costs, lease termination costs and exit costs. We may not realize the expected benefits of these initiatives and may incur additional restructuring costs in the future. In addition, we could experience delays, business disruptions, unanticipated employee turnover and increased litigation-related costs in connection with our restructuring efforts. The complex nature of these restructuring initiatives could cause difficulties or delays in the implementation of any such initiative or the impact of the restructuring initiatives may not be immediately apparent. There can be no assurance that our estimates of the savings achievable by these initiatives will be realized, which could have an adverse impact on our financial condition or results of operations.

If we fail to maintain an effective system of internal controls, we may not be able to detect fraud, which could have a material adverse effect on our business.

While we believe our internal control over financial reporting is effective, a controls system cannot provide absolute assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that control issues and instances of fraud, if any, within our company have been detected.

We have encountered risks associated with maintaining large cash balances.

While we have attempted to invest our cash balances in investments generally considered to be relatively safe, we nevertheless confront credit and liquidity risks. Bank failures could result in reduced liquidity or the actual loss of money held in deposit accounts in excess of federally insured amounts, if any.

We may incur additional goodwill and intangible asset impairment charges that adversely affect our operating results.

We review our goodwill and other intangible asset balances for impairment on at least an annual basis. During the fourth quarter of fiscal 2012, we concluded that certain software developed technology within HSG was no longer available for sale. As a result we recorded an impairment charge of $9.7 million, which impacted HSG s operations. In fiscal 2011, we recognized non-cash impairment charges for goodwill and intangible assets totaling $1.0 million. Our future operating results and the market price of our common stock could be materially adversely affected if we are required to further write down the carrying value of goodwill and/or other intangible assets associated with any of our reporting units in the future.

We may have exposure to greater than anticipated tax liabilities.

Some of our products and services may be subject to sales taxes in states where we have not collected and remitted such taxes from our customers. We have reserves for certain state sales tax contingencies based on the likelihood of obligation. These contingencies are included in Accrued liabilities in our Consolidated Balance Sheets. We believe we have appropriately accrued for these contingencies. In the event that actual results differ from these reserves, we may need to make adjustments, which could materially impact our financial condition and results of operations.

Risks Relating to the Industries We Serve

Our business depends to a significant degree on the hospitality and retail industries, and a weakening could adversely affect our business and results of operations.

Because our customer base is concentrated in the hospitality and retail industries, our business is largely dependent on the health of those industries. Our sales are dependent in large part on the health of the hospitality and retail industries, which in turn is dependent on the domestic and international economy. Instabilities or downturns in the hospitality and retail industries could disproportionately impact our revenue, as clients may exit the industry or delay, cancel or reduce planned expenditures for our products. A general downturn in the hospitality and retail industries could disproportionately impact our revenue, as clients may exit the industry or delay, cancel or reduce planned expenditures for our products.

Higher oil and gas prices worldwide could have a material adverse impact on the hospitality industry, and indirectly, on our business.

Material increases in oil and gas prices tend to reduce discretionary spending by consumers, such as on travel and dining, as well as on retail spending generally. Reductions in discretionary spending by consumers adversely affect our customers and, indirectly, our business. Moreover, increases in oil and gas prices also directly adversely affect our customer base in other ways. For example, oil and gas price increases can result in higher ingredient and food costs for our restaurant customers.

Consolidation in the industries that we serve could adversely affect our business.

Customers that we serve may seek to achieve economies of scale and other synergies by combining with or acquiring other companies. Many of the industries that we serve have experienced recent consolidations, including the hotel, casino, quick serve restaurant and grocery industries. Although recent consolidations in these industries have not materially adversely affected our business, there is no assurance that future consolidation will not have such affect. For example, if one of our current customers merges or consolidates with a company that relies on another provider s products or services, it could decide to reduce or cease its purchases of products or services from us, which could have an adverse effect our business.

Risks Relating to Our Stock

Our stock has been volatile and we expect that it will continue to be volatile.

Our stock price has been volatile, and we expect it will continue to be volatile. For example, during the year ended March 31, 2012, the trading price of our common stock ranged from a high of $10.00 to a low of $4.43. The volatility of our stock price may be due to factors other than those specific to our business, such as economic news or other events generally affecting the trading markets. Additionally, our ownership base has been and may continue to be concentrated in a few shareholders, which could increase the volatility of our common share price over time.

Our largest shareholder, MAK Capital, currently holds approximately 31% of our common shares, which could impact corporate policy and strategy, and MAK Capital s interests may differ from those of other shareholders.

Pursuant to the approval by shareholders of a control share acquisition proposal, MAK Capital holds approximately 31% of our outstanding common shares. As a significant shareholder whose responses could potentially affect the interests of Agilysys and the other shareholders, our Board may consider MAK Capital s potential response to a particular decision of the Board in considering the range of possible corporate policies and strategies in the future, potentially influencing corporate policy and strategic planning.

MAK entered into a Voting Trust Agreement with Computershare, as trustee, which provides that, for both strategic and other transactions requiring at least two-thirds of the voting power to approve, the trustee will vote a certain percentage of MAK Capital s shares in favor of, against, or abstaining from voting in the same proportion as all other shares voted by shareholders (including MAK Capital s shares not being voted by the trustee). If the Voting Trust Agreement, as amended, that MAK entered into with Computershare were to terminate for any reason, MAK Capital would have a level of control that would highly influence the approval or disapproval of transactions requiring under Ohio law the approval of two-thirds of the outstanding common shares, such as a business combination, or majority share acquisition involving the issuance of common shares entitling the holders to exercise one-sixth or more of the voting power of Agilysys, each of which requires approval by two-thirds of the outstanding common shares. MAK Capital might also be able to initiate or substantially assist any such transaction. Even with the limitations on MAK Capital s voting power imposed by the Voting Trust Agreement, as amended, it would be more difficult for the other shareholders to approve such a transaction if MAK Capital opposed it, and MAK Capital s interests may differ from those of other shareholders.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

Agilysys corporate services are located in Alpharetta, Georgia where we lease approximately 23,000 square feet of office space. In addition, we lease approximately 27,000 square feet of office space in Las Vegas, Nevada and 77,500 square feet of warehouse and office space in Taylors, South Carolina. Our major leases contain renewal options for periods of up to 10 years. We believe that our current facilities and office space are sufficient to meet our needs and do not anticipate any difficulty securing additional space as needed.

Item 3. Legal Proceedings.

We are involved in legal actions that arise in the ordinary course of business. It is the opinion of management that the resolution of any current pending litigation will not have a material adverse effect on our financial position or results of operations.

On April 6, 2012, Ameranth, Inc. filed a complaint against us for patent infringement in the United States District Court for the Southern District of California. The complaint alleges, among other things, that point-of-sale and property management and other hospitality information technology products, software, components and/or systems sold by us infringe three patents owned by Ameranth purporting to cover generation and synchronization of menus, including restaurant menus, event tickets, and other products across fixed, wireless and/or internet platforms as well as synchronization of hospitality information and hospitality software applications across fixed, wireless and internet platforms. The complaint seeks monetary damages, injunctive relief, costs and attorneys fees. We dispute the allegations of wrongdoing and intend to vigorously defend ourselves in this matter.

Item 4. Mine Safety Disclosures.

Not applicable.

Part II

Item 5. Market for Registrant s Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities.
Our common shares, without par value, are traded on the NASDAQ Stock Market LLC under the symbol AGYS . The high and low sales prices for the common shares for each quarter during the past two fiscal years are presented in the table below.

Fiscal 2012	**High**	**Low**
Fourth quarter	**$ 9.60**	**$ 6.92**
Third quarter	**$ 9.00**	**$ 6.50**
Second quarter	**$ 10.00**	**$ 6.60**
First quarter	**$ 8.62**	**$ 4.43**

Fiscal 2011	High	Low
Fourth quarter	$ 6.50	$ 4.74
Third quarter	$ 7.45	$ 4.66
Second quarter	$ 8.31	$ 4.30
First quarter	$ 12.50	$ 6.09

The closing price of the common shares on June 1, 2012, was $7.25 per share. There were 1,999 shareholders of record.

We did not pay dividends in fiscal 2012 or fiscal 2011 and are unlikely to do so in the foreseeable future. The current policy of the Board of Directors is to retain any available earnings for use in the operations of our business.

Repurchase of Common Shares

The following table sets forth repurchases during the fourth quarter of fiscal 2012:

	Total Number of Shares Purchased (1)	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans (2)	Maximum Number of Shares That May Yet Be Purchased Under the Plans
January 1-31	112,957	$ 8.07	112,957	16,087
February 1-29	16,087	$ 8.31	16,087	
March 1-31	5,924	$ 8.99		
Total	134,968	$ 8.14		

(1) The total number of shares includes shares purchased under our share repurchase plan described below and shares surrendered by employees to Agilysys to satisfy tax withholding obligations in connection with the vesting of restricted stock total 5,924 shares in March 2012, which do not count against shares authorized under the share repurchase plan.

(2) In August 2011, we announced that our Board of Directors provided authorization to repurchase up to 1.6 million of our common shares. As of March 31, 2012, we had repurchased all our common shares under this plan. No repurchases of common shares were made by us or on our behalf during fiscal 2011.

Shareholder Return Performance Presentation

The following chart compares the value of $100 invested in our common shares, including reinvestment of dividends, with a similar investment in the Russell 2000 Index (the Russell 2000) and with the companies listed in the SIC Code 5045-Computer and Computer Peripheral Equipment and Software for the period March 31, 2007 through March 31, 2012. The stock price performance in this graph is not necessarily indicative of the future performance of our common shares.

Comparison of 5 Year Cumulative Total Return

INDEXED RETURNS

		Fiscal Years Ended March 31,				
Company Name / Index	Base Period 2007	2008	2009	2010	2011	2012
Agilysys, Inc.	$ 100.00	$ 51.97	$ 19.68	$ 51.69	$ 26.57	$ 41.61
Russell 2000	$ 100.00	$ 87.01	$ 54.38	$ 88.51	$ 111.34	$ 111.13
Peer Group	$ 100.00	$ 80.67	$ 60.08	$ 87.11	$ 107.02	$ 95.98

This performance graph shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended or incorporated by reference into any of our filings under the Securities Act of 1933, as amended, of the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

Item 6. Selected Financial Data.

The following selected consolidated financial and operating data was derived from our audited consolidated financial statements and the current and prior period operating results of TSG have been classified within discontinued operations for all periods presented as discussed in Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations. The selected financial data should be read in conjunction with the Consolidated Financial Statements and Notes thereto, and Item 7 contained in Part II of this Annual Report.

	For the year ended March 31,				
(In thousands, except per share data)	**2012**	2011	2010	2009	2008
Operating results					
Net revenue	**$ 208,889**	$ 202,681	$ 193,506	$ 220,888	$ 214,601
Gross profit	**79,836**	75,639	74,008	86,099	75,690
Operating loss	**(41,190)**	(21,625)	(14,880)	(184,371)	(29,777)
Loss from continuing operations, net of taxes	**(34,239)**	(22,975)	(7,630)	(178,644)	(13,331)
Income (loss) from discontinued operations, net of taxes	**11,456**	(32,500)	11,177	(105,490)	16,990
Net (loss) income	**$ (22,783)**	$ (55,475)	$ 3,547	$ (284,134)	$ 3,659
Per share data (1)					
Basic and diluted					
Loss from continuing operations	**$ (1.53)**	$ (1.01)	$ (0.34)	$ (7.91)	$ (0.47)
Income (loss) from discontinued operations	**0.51**	(1.43)	0.49	(4.67)	0.60
Net (loss) income	**$ (1.02)**	$ (2.44)	$ 0.15	$ (12.58)	$ 0.13
Weighted-average shares outstanding Basic and diluted	**22,432**	22,785	22,627	22,587	28,252
Balance sheet data at year end					
Cash and cash equivalents	**$ 97,587**	$ 74,354	$ 65,535	$ 36,451	$ 70,596
Working capital	**76,286**	83,005	88,978	72,150	90,536
Total assets (2)	**204,139**	312,398	330,449	374,436	695,871
Total debt	**994**	1,906	819	623	987
Total shareholders equity	**114,438**	148,104	198,924	192,717	479,465

(1) When a loss is reported, the denominator of diluted earnings per share cannot be adjusted for the dilutive impact of share-based compensation awards because doing so would be anti-dilutive. In addition, when a loss from continuing operations is reported, adjusting the denominator of diluted earnings per share would also be anti-dilutive to the loss per share, even if the entity has net income after adjusting for a discontinued operation. Therefore, for the fiscal years ended March 31, 2012, 2011 and 2010, basic weighted-average shares outstanding were used in calculating the diluted net loss per share.

(2) The decrease in assets from fiscal 2008 to 2009 is primarily due to a goodwill impairment charge of $246.3 million and a finite intangible impairment charge of $3.8 million. The decrease in assets from fiscal 2011 to 2012 is due to the sale of TSG.

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.

In Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A), management explains the general financial condition and results of operations for Agilysys and subsidiaries including:

- *what factors affect our business;*
- *what our earnings and costs were;*
- *why those earnings and costs were different from the year before;*
- *where the earnings came from;*
- *how our financial condition was affected; and*
- *where the cash will come from to fund future operations.*

The MD&A analyzes changes in specific line items in the Consolidated Statements of Operations and Consolidated Statements of Cash Flows and provides information that management believes is important to assessing and understanding our consolidated financial condition and results of operations. The discussion should be read in conjunction with the Consolidated Financial Statements and related Notes that appear in Item 15 of this Annual Report titled, Financial Statements and Supplementary Data. Information provided in the MD&A may include forward-looking statements that involve risks and uncertainties. Many factors could cause actual results to be materially different from those contained in the forward-looking statements. See Forward-Looking Information on page 3 and Item 1A Risk Factors in Part I of this Annual Report for additional information concerning these items. Management believes that this information, discussion, and disclosure is important in making decisions about investing in Agilysys.

Overview

Agilysys is a leading provider of innovative technology solutions for the hospitality and retail markets. Our intuitive solutions include property and lodging management, inventory and procurement, point-of-sale (POS), document management, mobile, wireless and other types of guest-engagement software. We also provide support, maintenance, resold hardware products and software hosting services. Our customers include retailers, casinos, resorts, restaurants and other customer-facing service providers, and a significant portion of our consolidated revenue is derived from contract support, maintenance agreements and professional services.

We operate extensively throughout North America, with additional sales and support offices in the United Kingdom and Asia. We have two operating segments: Hospitality Solutions Group (HSG) and Retail Solutions Group (RSG).

Our top priority is increasing shareholder value by improving operating and financial performance and profitability growing the business through superior products and services. To that end, we expect to invest a certain portion of our cash on hand to develop and market new software products, to fund enhancements to existing software products, to expand our customer breadth, both geographically and vertically, and to make select acquisitions.

The primary objective of our ongoing strategic planning process is to create shareholder value by exploiting growth opportunities and strengthening our competitive position within the specific technology solutions and in the end markets we service. The plan builds on our existing strengths and targets industry leading growth and peer beating financial and operating results driven by new technology trends and market opportunities. Industry leading growth and peer beating financial and operational results will be achieved through tighter coupling and management of operating expenses of the business and sharpening the focus of our investments to concentrate on growth opportunities with the highest return by seeking the highest margin revenue opportunities in the markets in which we compete.

Our strategic plan specifically focuses on:

- Strong customer focus, with clear and realistic service commitments.
- Growing sales of our proprietary offerings: products, support, maintenance and subscription services and professional services.
- Diversifying our customer base across geographies and industries.
- Capitalizing on our intellectual property and emerging technology trends.

Revenue Defined

As required by the SEC, we separately present revenue earned as either products revenue, support, maintenance and subscription services revenue or professional services revenue in our Consolidated Statements of Operations. In addition to the SEC requirements, we may, at times, also refer to revenue as defined below. The terminology, definitions, and applications of terms we use to describe our revenue may be different from those used by other companies and caution should be used when comparing these financial measures to those of other companies. We use the following terms to describe revenue:

- Revenue We present revenue net of sales returns and allowances.

- Products revenue   Revenue earned from the sales of hardware equipment and proprietary and remarketed software.
- Support, maintenance and subscription services revenue   Revenue earned from the sale of proprietary and remarketed ongoing support, maintenance and subscription or hosting services.
- Professional services revenue   Revenue earned from the delivery of implementation, integration and installation services for proprietary and remarketed products.

Matters Affecting Comparability

On August 1, 2011, we completed the sale of our Technology Solutions Group (TSG) business to OnX Enterprise Solutions Limited and its subsidiary OnX Acquisition LLC (together   OnX). For financial reporting purposes, TSG s operating results for fiscal 2012 through the completion of the sale and for the fiscal 2011 and fiscal 2010 periods presented were classified within discontinued operations. Accordingly, the discussion and analysis presented below, including comparisons to prior year periods, reflects the continuing business of Agilysys.

Results of Operations

Fiscal 2012 Compared with Fiscal 2011

Net Revenue and Operating Loss

The following table presents our consolidated revenue and operating results for the fiscal years ended March 31, 2012 and 2011:

	Year ended March 31,		Increase (decrease)	
(Dollars in thousands)	**2012**	2011	$	%
Net revenue:				
Products	**$ 105,141**	$ 104,769	$ 372	0.4%
Support, maintenance and subscription services	**73,171**	70,729	2,442	3.5%
Professional services	**30,577**	27,183	3,394	12.5%
Total	**208,889**	202,681	6,208	3.1%
Cost of goods sold:				
Products	**83,550**	80,090	3,460	4.3%
Support, maintenance and subscription services	**25,706**	25,507	199	0.8%
Professional services	**19,797**	21,445	(1,648)	(7.7)%
Total	**129,053**	127,042	2,011	1.6%
Gross profit	**79,836**	75,639	4,197	5.5%
Gross profit margin	***38.2%***	*37.3%*		
Operating expenses:				
Product development	**30,309**	27,531	2,778	10.1%
Sales and marketing	**24,006**	22,212	1,794	8.1%
General and administrative	**32,889**	37,121	(4,232)	(11.4)%
Depreciation of fixed assets	**4,602**	3,914	688	17.6%
Amortization of intangibles	**3,686**	5,122	(1,436)	(28.0)%
Asset impairments and related charges	**9,681**	959	8,722	nm
Restructuring and related charges	**15,853**	405	15,448	nm
Operating loss	**$ (41,190)**	$ (21,625)	$ (19,565)	90.5%
Operating loss percentage	***(19.7)%***	*(10.7)%*		

nm   not meaningful.

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The following table presents the percentage relationship of our Consolidated Statement of Operations line items to our consolidated net revenues for the periods presented:

	Year ended March 31,		
	2012	2011	
Net revenue:			
Products	**50.3%**	51.7%	
Support, maintenance and subscription services	**35.0**		
Online game services	172,210,217	519,715,215	62,794,081
Advertising services	55,751,057	102,458,256	12,379,418
Wireless value-added and other fee-based premium services	228,710,524	97,620,961	11,794,957
Total gross profit	456,671,798	719,794,432	86,968,456
Gross margin:			
Online game services	89.2%	92.0%	92.0%
Advertising services	66.9%	68.6%	68.6%
Wireless value-added and other fee-based premium services	86.1%	67.0%	67.0%
Total gross margin	84.2%	83.7%	83.7%

The decrease in total gross margin was primarily due to the fact that the decrease in gross margin for wireless value-added and other fee-based premium services outweighed the increases in gross margin for online game services and advertising services.

The increase in gross margin for online game services in 2004 was mainly due to increased revenue resulting from the increased popularity of Westward Journey Online II in 2004 and the commercial launching of Fantasy Westward Journey in January 2004, which outpaced the increase in cost of revenues. The cost of revenues for online games is mainly composed of payments to celebrity spokespersons, staff-related costs and business tax payable on intra-group revenues. Except for the payments to the spokespersons, which increased proportionately to the increase in revenue, all of the other cost components increased at a much lower pace, resulting in the improvement in gross margin.

The increase in gross margin for advertising services was mainly due to the overall enhancement in economies of scale. The cost of revenues for advertising services is mainly composed of costs of purchased content, staff costs for our content editors and business tax payable on intra-group revenues. Revenue from advertising services increased at a significantly faster rate than the increase in cost of revenues, resulting in the improvement in gross margin.

The gross margin for wireless value-added and other fee-based premium services decreased in 2004, compared to 2003. This decrease resulted from the fact that the significant reduction in revenues from wireless value-added services was not accompanied by a corresponding decrease in cost of revenues from these services, as a significant portion of the costs associated with those services, particularly allocated bandwidth, are fixed in nature.

Operating Expenses

Total operating expenses increased by 109.6% to RMB272.3 million (US$32.9 million) in 2004 from RMB129.9 million in 2003. Operating expenses as a percentage of total revenue increased from 22.8% in 2003 to 30.1% as a percentage of total net revenues in 2004. The increase was driven by an increase in all categories of operating expenses, particularly selling and marketing expenses, which resulted from the ongoing expansion of our business. This increase was partially offset by a one-time settlement of US$2.0 million resulting from an insurance claim made by us which was related to the now-settled class action litigation in the United States that involved our company, the underwriters for our initial public offering and certain of our current and former officers and directors.

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Selling and marketing expenses increased by 254.3% to RMB152.8 million (US$18.5 million) in 2004 from RMB43.1 million in 2003 primarily due to the following reasons:

- Additional marketing and promotional events during 2004 as compared to 2003. This resulted in an increase in marketing spending of approximately RMB91.2 million (US$11.0 million) which was related primarily to the production costs and airing of TV commercials and the production and placement of outdoor billboard and bus advertisements as part of the marketing campaign for the launching of our new MMORPG Fantasy Westward Journey, the revamping of the front pages of the NetEase websites and corporate branding.

- Increase in staff-related costs of approximately RMB14.7 million (US$1.8 million) as a result of an increase in salaries and commissions paid to our advertising sales team. Such increase was consistent with the increase in advertising revenues in 2004 when compared to 2003.

General and administrative expenses increased by 50.3% to RMB101.6 million (US$12.3 million) in 2004 from RMB67.6 million in 2003 primarily due to the following reasons:

- Increase in staff-related costs, including salaries, bonuses and welfare benefits, of approximately RMB13.0 million (US$1.5 million) as a result of an increase in the number of employees.

- Increase in legal and professional fees of approximately RMB5.5 million (US$0.7 million) which were primarily attributable to the consultancy and legal fees payable to third parties for statutory compliance and other corporate matters.

- Increase in allowance for doubtful accounts by RMB4.4 million to RMB8.0 million (US$1.0 million) in 2004 from RMB3.6 million in 2003.

- Amortization of the issuance costs related to our Zero Coupon Convertible Subordinated Notes due July 15, 2023 of approximately RMB4.3 million (US$0.5 million).

- Increase in office rentals and office renovation costs for new offices in Guangzhou of approximately RMB2.5 million (US$0.3 million) in 2004.

- Increase in depreciation charges for office equipment and other miscellaneous administrative costs of approximately RMB2.3 million (US$0.3 million).

Research and development expenses increased 79.7% to RMB34.4 million (US$4.2 million) in 2004 from RMB19.1 million in 2003. This increase was primarily due to the increase in research and development staff-related costs of RMB14.0 million (US$1.7 million) stemming largely from the recruitment of programmers and technicians to assist our online games and wireless value-added and other fee-based premium services business.

Allowances for Doubtful Accounts

As of December 31, 2003, our receivable balances were due from Guangzhou NetEase and Guangyitong Advertising because they were not consolidated into NetEase.com, Inc. until January 1, 2004. Since we started consolidating our VIEs in 2004, our receivable balances have been due from third parties which appear on the books of accounts of our VIEs. Because NetEase.com, Inc. relies on Guangzhou NetEase, Guangyitong Advertising and Ling Yi to collect monies from their customers to realize its revenues earned from providing consulting services, NetEase.com, Inc. also assists these affiliates to manage their receivable balances.

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As of December 31, 2004, the gross accounts receivable balance before any allowance for bad and doubtful accounts was RMB74.4 million (US$9.0 million). After providing for doubtful accounts in the amount of RMB18.1 million (US$2.2 million), the net balance of accounts receivable was RMB56.3 million (US$6.8 million) as of December 31, 2004. All of the RMB18.1 million (US$2.2 million) allowance for doubtful accounts represented general provisions (as opposed to specific provisions for specific debtors).

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

The amount of additional provision made for bad and doubtful debts amounted to RMB8.0 million in 2004 compared to RMB3.6 million in 2003. The additional provision in 2004 was entirely composed of an increase in the balance of general provisions. The additional provision in 2003 was mainly comprised of specific provisions on specific debtors and, to a lesser extent, an increase in the balance of general provisions.

As of December 31, 2004, we had one customer with a receivable balance exceeding 10% of the total accounts receivable balance, namely EachNet Information Services (Shanghai) Co., Ltd. which owed us approximately RMB7.8 million (US$0.9 million), representing 10.5% of the total outstanding accounts receivable balance then outstanding. No provision for such accounts receivable balance was made because of the current nature of such balance.

Other Income (Expenses)

Other income and expenses in 2004 mainly consisted of interest income. Interest income increased to RMB22.3 million (US$2.7 million) in 2004 from RMB11.3 million in 2003, mainly due to the increase in short-term bank deposits in China and abroad. The cash for such deposits was generated largely from our operations as well as from the proceeds of our US$100 million Zero Coupon Convertible Subordinated Notes issued in July 2003. Investment income increased to RMB3.5 million (US$0.4 million) in 2004 from RMB0.5 million in 2003, mainly due to interest income generated from investments in US treasury notes and bonds. Interest expense increased to RMB3.9 million (US$0.5 million) in 2004 from nil in 2003, mainly due to the accrual of interest payable to the holders of our convertible notes from January 10, 2004 which became due because we were not able to register the notes with the SEC by the contractually required deadline. Such interest ceased to accrue on January 26, 2005, but thereafter may again become payable if we fail to maintain the effectiveness of a registration statement for such notes with the SEC for the required period of time.

Income Tax

Income tax increased to RMB28.6 million (US$3.5 million) in 2004 from RMB21.1 million in 2003. The increase was mainly due to an increase in revenues and taxable income in 2004. Our effective tax rate in 2004 was 6.1%, which reflects the effect of tax holidays and lower tax rates applicable to our subsidiaries, NetEase Beijing and Guangzhou Interactive. Our effective tax rate for 2003 was also 6.1%.

Net Profit

As a result of the foregoing, net profit increased by 36.7% to RMB441.4 million (US$53.3 million) in 2004 from RMB322.9 million in 2003. Net profit increased at a slower rate than gross profit for the year ended December 31, 2004, principally because of the relatively higher rate of increase in operating expenses compared to gross profit. In particular, marketing expenses increased significantly in 2004, as we increased our marketing activities to promote awareness of our company and our services.

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002

Revenues

Total revenues increased by 144.7% to RMB569.1 million in 2003 from RMB232.6 million in 2002. Revenue from online games, advertising services and wireless value-added and other fee-based premium services constituted 35.7%, 15.2% and 49.1%, respectively, of our total revenue in 2003. This compares with 15.9%, 14.7% and 69.4%, respectively, of our total revenue in 2002.

Online Games

Revenue from online games increased by 448.5% to RMB203.2 million in 2003 from RMB37.1 million in 2002. This increase was mainly due to the increase in popularity of Westward Journey Online II. The number of average concurrent players for this game increased to approximately 127,000 in December 2003 from approximately 41,000 in December 2002. This increase was partially offset by a decrease in popularity of PristonTale. Revenue generated from PristonTale accounted for only approximately 5.7% of our total revenues from online games in 2003.

Advertising services

Our advertising services revenues increased by 151.9% to RMB86.2 million in 2003 from RMB34.2 million in 2002, primarily due to the increase in average spending by traditional advertisers (i.e., customers which do not advertise through our search and classified ad services). Average net revenue per traditional advertiser increased to approximately RMB239,000 in 2003 from RMB122,000 in 2002. The number of traditional advertisers using the NetEase websites increased to 337 in 2003 from 280 in 2002, with revenues from our top ten advertisers comprising 27.4% of our total advertising services revenues in 2003 as compared to 23.2% in 2002.

Wireless Value-Added and Other Fee-based Premium Services

Revenue from wireless value-added and other fee-based premium services increased by 73.4% to RMB279.7 million from RMB161.3 million in 2002. This increase was primarily due to the increase in paying customers for our SMS services in 2003. The number of monthly active users for SMS services increased to approximately 3.9 million in December 2003 from approximately 2.6 million in December 2002. This increase was consistent with the increase in overall popularity of SMS among the expanding population of mobile phone users in China.

However, the growth in our revenue from wireless value-added services was adversely affected in 2003 by a number of market developments. In particular, China Mobile banned all cooperative arrangements known as website unions in June 2003, effectively precluding large service providers from aggregating unregistered websites and utilizing China Mobile s billing platform to gather fees for these services. Also, in August 2003, China Mobile further banned service providers from using its network to charge customers for services which were deemed by it to be not purely wireless services. China Mobile s adoption of these policies described above was one of the main factors which contributed to a significant decline in our revenues from wireless value-added and other fee-based premium services between the second quarter ended June 30, 2003 and the third quarter ended September 30, 2003. This decline significantly lowered the overall growth in our revenue from wireless value-added and other fee-based premium services between 2002 and 2003.

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Cost of Revenues

Our cost of revenues increased by 19.2% to RMB85.5 million in 2003 from RMB71.7 million in 2002 due primarily to increased cost of revenues for online games and wireless value-added and other fee-based premium services. In 2003, costs relating to online games, advertising services, and wireless value-added and other fee-based premium services represented 24.4%, 32.3% and 43.3% of total cost of revenues, respectively. This compares with 21.7%, 37.1% and 41.2%, respectively, in 2002.

Online Games

Cost of revenues from our online games increased 34.4% to RMB20.9 million in 2003 from RMB15.5 million in 2002. This increase in cost of revenues in 2003 was primarily due to a combination of the following factors:

Payments to the celebrity acting as our spokesperson for our online game Westward Journey Online II increased RMB4.4 million. These payments were calculated on the basis of a percentage of revenues we earned from the game, and the increase in payments in 2003 was directly related to the increase in revenue from the game due to its increased popularity in 2003; and

Production costs for printing prepaid point cards, which are sold to end-customers who use the point cards to pay for our online games and other fee-based premium services, increased RMB3.5 million to RMB4.8 million in 2003 from RMB1.3 million in 2002 due to increased production of cards in 2003.

These increases were partially offset by a decrease in bandwidth and server custody fees of RMB2.1 million to RMB2.7 million in 2003 from RMB4.8 million in 2002.

Advertising Services

Cost of revenues from our advertising services increased 3.8% to RMB27.6 million in 2003 from RMB26.6 million in 2002 due primarily to an increase in staff and staff-related costs. Staff and staff-related costs increased RMB2.9 million to RMB9.9 million in 2003 as compared to RMB7.0 million in 2002 as a result of the expansion of our content staff from 78 as of December 31, 2002 to 118 as of December 31, 2003. This increase was partially offset by a decrease of RMB1.3 million in depreciation and amortization of computers and software attributable to our advertising services to RMB5.7 million in 2003 from RMB7.0 million in 2002 as a result of the full depreciation of certain computer equipment in 2003.

Wireless Value-added and Other Fee-based Premium Services

Cost of revenues from our wireless value-added and other fee-based premium services increased 25.2% to RMB37.0 million in 2003 from RMB29.5 million in 2002. This increase in cost of revenues in 2003 consisted primarily of RMB7.4 million in referral fees paid to third-party websites as part of the website unions. The referral program pursuant to which these payments were made commenced at the beginning of 2003, and no such referral payments were made in 2002. The program ended in June 2003. This increase was also due, in part, to increased SMS network transmission fees of RMB3.4 million due to the provision of free SMS messaging through our instant messaging service, POPO, in late 2003. These increases were partially offset by a decrease in depreciation and amortization of computers and software attributable to our wireless value-added and other fee-based premium services of RMB2.4 million to RMB6.3 million in 2003 from RMB8.7 million in 2002.

Gross Profit

As a result of the strong revenue growth in 2003, our gross profit increased by 205.9% to RMB456.7 million in 2003 from RMB149.3 million in 2002. The following table sets forth the audited consolidated gross profits and gross margins of our business activities for the periods indicated.

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	For the Year Ended December 31,	
	2002	2003
	RMB	RMB
Gross profit:		
Online game services	19,670,242	172,210,217
Advertising services	5,876,481	55,751,057
Wireless value-added and other fee-based premium services	123,716,955	228,710,524
Total gross profit	149,263,678	456,671,798
Gross Margin:		
Online game services	55.9%	89.2%
Advertising services	18.1%	66.9%
Wireless value-added and other fee-based premium services	80.7%	86.1%
Total gross margin	67.6%	84.2%

The increase in gross margin for online game services in 2003 was mainly due to the commercial launching of Westward Journey Online II in August 2002 and the increase in popularity of that game in 2003. The online game services revenue increased at a significantly faster rate than the increase in the cost of revenues.

The substantial increase in gross margin for advertising services was mainly due to an overall enhancement in economies of scale. The revenue from advertising services increased substantially in 2003, but the cost of revenue did not increase proportionately as a major portion of such costs are relatively fixed in nature.

The gross margin for our wireless value-added and other fee-based premium services increased due to enhanced economies of scale. However, such economies of scale were offset to a significant extent by our payment of substantial referral fees to third-party websites as part of the website unions until that program was terminated in June 2003. In addition, the increased SMS network transmission fees we incurred due to the temporary provision of free SMS messaging through our instant messaging service, POPO, in late 2003 also negatively affected the gross margin in 2003.

Operating Expenses

Total operating expenses decreased by 10.6% to RMB129.9 million in 2003 from RMB145.2 million in 2002. The decrease in 2003 was mainly due to a one-time provision for the class action settlement of RMB36.0 million in 2002. Excluding such one-time provision, total operating expenses were 18.9% higher in 2003 than in 2002. Operating expenses as a percentage of total revenue decreased from 62.4% in 2002 to 22.9% in 2003.

Selling and marketing expenses increased by 64.4% to RMB43.1 million in 2003 from RMB26.2 million in 2002 primarily due to the following reasons:

- Increase in staff costs of approximately RMB8.9 million as a result of increase in salaries and commissions paid to our advertising sales team. Such increase was consistent with the increase in advertising revenue in 2003 when compared to 2002; and

- Additional marketing and promotional events in 2003 when compared to 2002. This resulted in an increase in marketing spending of approximately RMB5.5 million

General and administrative expenses remained relatively stable between 2002 and 2003.

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Research and development expenses increased 34.8% to RMB19.1 million in 2003 from RMB14.2 million in 2002. This increase was due to the following reasons:

- Increase in research and development staff-related costs of RMB2.4 million stemming largely from the recruitment of programmers and technicians to assist in our online games business; and

- Approximately RMB2.2 million in license fees in 2003 paid to a third-party vendor to license a 3-D game engine for the development of further online games. We did not incur such license fees in 2002.

Allowances for Doubtful Accounts

As of December 31, 2003, our receivable balances were due from Guangzhou NetEase and Guangyitong Advertising because they were not consolidated into NetEase.com, Inc. until January 1, 2004. Prior to January 1, 2004, NetEase.com, Inc. made corresponding bad debt provisions when those affiliated companies did so in their books of accounts.

As of December 31, 2003, the gross accounts receivable balance before any allowance for bad and doubtful accounts was RMB82.0 million. After providing for doubtful accounts in the amount of RMB10.2 million, the net balance of accounts receivable was RMB71.8 million as of December 31, 2003. Of the RMB10.2 million allowance for doubtful accounts, RMB4.7 million and RMB5.5 million represented general and specific provisions, respectively.

The amount of additional provision made for bad and doubtful debts amounted to RMB3.6 million for fiscal year 2003. The additional provision mainly comprised specific provisions on specific debtors and, to a lesser extent, the increase in the balance of general provisions.

As of December 31, 2003, Guangzhou NetEase and Guangyitong Advertising had two customers with receivable balances exceeding 10% of the total accounts receivable balance, namely China Mobile and China Unicom which owed Guangzhou NetEase approximately RMB28.5 million and RMB11.7 million, respectively, representing 34.7% and 14.3% of the total outstanding accounts receivable balance then outstanding. No provision for such accounts receivables balances was made because of the current nature of such balances.

Other Income (Expenses)

Other income and expenses in 2003 mainly consisted of interest income. Interest income increased to RMB11.3 million in 2003 from RMB7.6 million in 2002, mainly due to the increase in short-term bank deposits in China and abroad. The cash for such deposits was generated largely from our operations as well as from the proceeds of our US$100 million aggregate principal amount of Zero Coupon Convertible Subordinated Notes issued in July 2003. Interest expense decreased to zero in 2003 from RMB1.4 million in 2002, as all our bank loans were repaid during 2002.

We recognized other net income of RMB5.4 million in 2003. This income primarily consisted of the write back of provisions for certain subscription receivable balances. The subscription receivable balances were related to certain loans to related parties under the family and friends program during our initial public offering in 1999. Full provision was made for such loans in 2001, but a portion of the loans was subsequently repaid in 2003. As a result, a portion of the provisions made in 2001 was reversed and recognized as other income in 2003.

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Deferred Tax Valuation Allowance

For the year ended December 31, 2003, we considered all relevant factors that are material to our business, including positive indicators (such as improved profitability outlook, an indication of market acceptance of our services, and industry statistics signaling continued strong growth in the market for a portion of our services) and certain negative indicators (such as an increase in competition and our dependency on relationships with the mobile operators in China), and determined that it was more likely than not that we would be able to take advantage of all of our tax loss carryforwards from the prior fiscal years before their expiration. Accordingly, we decreased our deferred tax valuation allowance from RMB16.7 million to zero as of December 31, 2003.

Income Tax

Income tax increased to RMB21.1 million in 2003 from a credit of RMB2.4 million in 2002. The increase in 2003 was mainly due to an increase in revenues and taxable income in 2003, partially offset by an increase in deferred tax assets recognized in 2003 as compared to 2002. Our effective tax rate in 2003 was 6.1%.

Net Profit

As a result of the foregoing, net profit increased significantly to RMB322.9 million in 2003 from RMB16.3 million in 2002.

Quarterly Results of Operations Data

The following table sets forth selected unaudited quarterly consolidated statements of operations data for each of the four fiscal quarters for the year ended December 31, 2004 in Renminbi. Our management believes this data has been prepared substantially on the same basis as the consolidated audited financial statements, including all necessary adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of such data. Operating results for any quarter are not necessarily indicative of results for any future quarter. You should read the quarterly data for the four quarters set forth below in conjunction with our consolidated financial statements and the related notes included elsewhere in this annual report.

	Quarter Ended			
	March 31, 2004	**June 30, 2004**	**September 30, 2004**	**December 31, 2004**
	(Unaudited) RMB	**(Unaudited) RMB**	**(Unaudited) RMB**	**(Unaudited) RMB**
Revenues:				
Online game services	111,389,272	139,458,471	169,832,982	208,255,497

Wireless value-added and other fee-based premium services	62,004,416	38,826,085	51,031,147	44,685,971
Advertising services	34,484,069	40,853,119	32,539,861	24,939,955
	207,877,757	219,137,675	253,403,990	277,881,423
Business tax	(11,304,182)	(12,410,057)	(14,825,004)	(16,163,775)
Net revenues	196,573,575	206,727,618	238,578,986	261,717,648
Cost of revenues:				
Online game services	(15,100,851)	(17,254,130)	(19,263,623)	(23,010,912)
Wireless value-added and other fee-based premium services	(11,593,504)	(11,635,880)	(14,677,587)	(17,210,474)
Advertising services	(11,510,839)	(13,583,906)	(14,843,036)	(14,118,654)
Total cost of revenues	(38,205,194)	(42,473,916)	(48,784,246)	(54,030,040)
Gross profit	158,368,381	164,253,702	189,794,740	207,377,608
Operating expenses:				
Selling and marketing expenses	(21,226,018)	(29,621,319)	(60,407,604)	(41,587,393)
General and administrative expenses	(22,128,436)	(25,597,031)	(28,577,672)	(25,327,931)
Research and development expenses	(7,202,306)	(8,426,551)	(8,570,850)	(10,163,099)
Insurance claims settlement for the now-settled class action litigation			16,553,200	
Total operating expenses	(50,556,760)	(63,644,901)	(81,002,926)	(77,078,423)
Operating profit	107,811,621	100,608,801	108,791,814	130,299,185
Other income (expenses):				
Investment income	1,363,507	553,552	906,364	698,746
Interest income	3,782,606	4,837,105	5,875,131	7,838,669
Interest expenses	(931,171)	(1,034,531)	(846,210)	(1,065,217)
Other, net	1,800	551,000		(45,372)
Profit before tax	112,028,363	105,515,927	114,727,099	137,726,011
Income tax expenses	(8,116,327)	(7,223,334)	(5,666,455)	(7,570,603)
Net profit	103,912,036	98,292,593	109,060,644	130,155,408

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Liquidity and Capital Resources

Our capital requirements relate primarily to financing:

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

Operating Activities

Cash provided by operating activities was RMB614.2 million (US$74.2 million), RMB373.7 million and RMB26.8 million for the years ended December 31, 2004, 2003 and 2002, respectively. For the year ended December 31, 2004, cash provided by operating activities consisted primarily of our operating profit of RMB441.4 million (US$53.3 million), adjusted for:

- depreciation and amortization charges of RMB34.3 million (US$4.1 million),
- an increase in provisions for doubtful debts of RMB8.0 million (US$1.0 million),

an increase in accounts payable and other liabilities totaling RMB112.8 million (US$13.6 million),

a decrease in accounts receivable of RMB7.6 million (US$0.9 million),

a decrease in prepayments and other current assets of RMB0.4 million (US$0.1 million) and

a decrease in deferred tax assets of RMB9.7 million (US$1.2 million).

For the year ended December 31, 2003, cash provided by operating activities consisted primarily of our operating profit of RMB322.9 million, adjusted for:

depreciation and amortization charges of RMB20.9 million,

an increase in provisions for doubtful debts of RMB3.6 million,

a decrease in the net amount due from related parties of RMB25.7 million, and

an increase in accounts payable and other liabilities totaling RMB13.5 million, offset in part by an increase in prepayments and other current assets of RMB5.8 million and an increase in deferred tax assets of RMB7.3 million.

For the year ended December 31, 2002, cash used in operating activities consisted primarily of our operating profit of RMB16.3 million, adjusted for:

depreciation charges of RMB21.8 million,

share compensation cost of RMB3.8 million,

a write down of software costs of RMB0.7 million,

an increase in provision for doubtful debts, taxes payable and other payables totaling RMB16.0 million, and

a decrease in prepayments and other assets of RMB3.8 million, offset in part by a decrease in accounts payable and accrued liabilities totaling RMB9.8 million, and an increase in net amounts due from related parties and deferred tax assets totaling RMB25.8 million.

Investing Activities

Cash provided by investing activities was RMB105.8 million (US$12.8 million) for the year ended December 31, 2004, cash used in investing activities was RMB360.3 million for the year ended December 31, 2003, and cash provided by investing activities was RMB42.7 million for the year ended December 31, 2002. For the year ended December 31, 2004, cash provided by investing activities mainly consisted of the decrease in held-to-maturity investments of RMB166.6 million (US$20.1 million), offset in part by the purchase of fixed assets of RMB60.1 million (US$7.3 million). For the year ended December 31, 2003, cash used in investing activities mainly consisted of the purchase of held-to-maturity investments of RMB332.1 million and fixed assets of RMB27.8 million. For the year ended December 31, 2002, cash provided by investing activities mainly consisted of the decrease in temporary cash investments of RMB45.5 million and the disposal of convertible preference shares of RMB9.7 million, which was offset in part by the cash used in the purchase of fixed assets of RMB12.6 million.

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Financing Activities

Cash provided by financing activities was RMB32.0 million (US$3.9 million) and RMB781.4 million for the years ended December 31, 2004 and 2003, and cash used in financing activities for the year ended December 31, 2002 was RMB78.1 million. For the year ended December 31, 2004, cash provided by financing activities mainly consisted of proceeds from the issuance of ordinary shares upon the exercise of employee share options of RMB30.7 million (US$3.7 million) and an increase in other long-term payables of RMB1.3 million (US$0.2 million). For the year ended December 31, 2003, cash provided by financing activities mainly consisted of the proceeds from the issuance of convertible notes of RMB827.7 million and proceeds from the issuance of ordinary shares upon the exercise of share options of RMB15.1 million, which was offset in part by the use of cash for the repurchase of Series B preference shares issued in 2000 of RMB38.2 million. For the year ended December 31, 2002, cash used in financing activities mainly consisted of the repayment of bank loans of RMB84.0 million, which was offset in part by the partial collection of a subscription receivable for the Series B preference shares issued in 2000 of RMB2.0 million and proceeds from the issuance of ordinary shares upon the exercise of share options of RMB3.9 million.

Although we have been profitable in the last two fiscal years, we cannot be certain that we can sustain or grow this level of profitability in future periods. In particular, our selling and marketing expenses and our general and administrative expenses have remained relatively high due primarily to staff costs, while our revenues from advertising and wireless value-added services has been uneven in the last several years. Further, although our revenue has grown significantly in the last two fiscal years, we have only a limited track record offering our services, including our online games, and cannot be certain that we will be able to maintain or grow such revenue. Nonetheless, given our positive cash flows in recent years and our issuance of US$100 million aggregate principal amount of Zero Coupon Convertible Subordinated Notes in July 2003, we believe that such cash and revenue will be sufficient for us to meet our obligations for the foreseeable future.

Indebtedness

As of December 31, 2004, we had US$100 million aggregate principal amount of Zero Coupon Convertible Subordinated Notes due July 15, 2023 outstanding. Because we did not register the notes and the ordinary shares issuable upon conversion of the notes with the SEC in accordance with the Registration Rights Agreement dated July 8, 2003 between our company and the initial purchaser of the notes, for the benefit of the holders of the notes and the ordinary shares issuable upon conversion of the notes, interest became payable on the notes from January 10, 2004 until January 25, 2005 at a rate of 0.50% per annum.

Research and Development

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

We have utilized and will continue to utilize the products and services of third parties to enhance our platform of technologies and services to provide competitive and diverse Internet and wireless services to our users. We also have utilized and will continue to utilize third-party advertisement serving technologies. In addition, we plan to continue to expand our technologies, products and services and registered user base through diverse online community products and services developed internally, particularly with respect to our online game services. We will seek to continually improve and enhance our existing services to respond to rapidly evolving competitive and technological conditions. For the years 2002, 2003 and 2004, we spent RMB14.2 million, RMB19.1 million and RMB34.4 million (US$4.2 million), respectively, on research and development activities.

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Trend Information

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

We believe that there has been increasing demand by online game users for new and unique online games and increasing competition in this area. We believe that these trends will force us to devote additional resources to developing and launching additional games, updating existing games at a faster rate than we have in the past and licensing games from third parties. In particular, the online game industry in China appears to be entering a transition phase from 2D to 3D games, with numerous new 3D game titles being launched in the market during 2004 and thereafter. In response to this trend, we have been devoting additional resources to developing or licensing 3D games. Nonetheless, we also believe that the market for 2D online games will continue to grow in popularity for the foreseeable future.

Our online games business may be adversely affected if, as is predicted by some industry commentators, the Chinese government takes steps to slow the growth in this market. Such steps could include, for example, the widespread closure of Internet cafes where a significant portion of our users access our online games or restrictions on the content of games which has the effect of making them less appealing. We may not be able to adequately respond to any such regulatory changes in the online games market.

The rapid expansion of the wireless value-added services market in China in recent years is expected by China s Ministry of Information Industry and industry commentators to continue for the next several years. We expect that this expansion, if it occurs, will encourage additional competitors to enter the market which may adversely affect revenue growth in this area and could have a material adverse effect on our business and financial condition.

In addition, as discussed above under Revenue Wireless Value-added and Other Fee-based Premium Services, the mobile operators in China have recently begun more rigorously enforcing their policies than in the past and have adopted certain new policies, which have slowed the growth of our SMS business. Any non-compliance with the mobile operators policies by us, whether inadvertent or not, could result in a material and adverse effect on our revenues and profitability.

We expect that the wireless value-added services industry and customers preferences will continue to evolve rapidly, particularly as a result of the transition from SMS-based services to new services which are compatible with, and take full advantage of the capabilities of, next generation mobile technologies such as 2.5G, which has begun in China. We believe that the rapid evolution of this industry will require us to continue to devote significant resources to developing and deploying new wireless valued-added services.

If wireless value-added services which are compatible with next generation mobile technologies become popular in China, we believe that users will demand increasingly engaging and content-rich services. We anticipate that this transition, if it occurs, may increase competition among wireless value-added service providers in China for content and strategic partnerships, and may increase the prices we may have to pay for content.

The pace of development of widely accepted online payment systems in China has remained slow thus far. In response, we have developed and deployed a prepaid point card as an alternative online payment system for our services.

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The decrease in the rate of growth of Internet users in China in recent years may continue. In that case, we may have to increase our service offerings or increase our marketing and advertising efforts in order for us to continue to grow our business.

A general increase in competition for online services has elevated the importance of brand building and brand awareness. We believe that this trend may require us to increase our marketing and advertising efforts and budgets in order to keep our brand names and the NetEase websites visible and prominent. For example, in 2004 we launched a new marketing campaign which focused on increasing brand awareness of our company and specific product driven advertisements, through television advertisements and off-line media, such as newspapers, outdoor billboards and advertisements on buses and bus stops.

We expect that for at least the next several quarters, our fixed costs in connection with our Internet portal business will increase, without a corresponding increase in revenue, due to our introduction of expanded storage capacity for our free e-mail service in the third quarter of 2004 and increasing bandwidth fees resulting from increased usage of the NetEase websites.

We expect that an increasing portion of our agreements with advertisers will provide that the advertiser will pay us only if the user performs a certain action, such as registering with the advertiser. Such performance-based payment arrangements may generate more or less revenues for us than advertising contracts which provide for a fixed fee to be paid in exchange for the posting of the advertisement for a specified period of time, depending on whether users actually perform the requisite actions.

Off-Balance Sheet Arrangements

We do not have any outstanding derivative financial instruments, off-balance sheet guarantees, interest rate swap transactions or foreign currency forward contracts. We do not engage in trading activities involving non-exchange traded contracts.

Tabular Disclosure of Contractual Obligations

We have entered into leasing arrangements relating to our office premises. We also have commitments in respect of long-term payables related to installment payments for the purchase of servers, server custody fees and capital expenditures related to the purchase of servers. The following sets forth our commitments for long-term payables, operating leases, server custody fees and capital expenditures as of December 31, 2004 (in U.S. dollars):

	Long-term payables	Operating lease commitments	Server custody fee commitments	Capital commitments	Total
Less than one year		1,130,788	1,903,731	934,828	3,969,347
1 -3 years	65,194	708,707	102,491		876,392
3 - 5 years					
More than 5 years	1,354,437				1,354,437
Total	1,419,631	1,839,495	2,006,222	934,828	6,200,176

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

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Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

Our exposure to market rate risk for changes in interest rates relates primarily to the interest income generated by excess cash invested in short term money market accounts and certificates of deposit. We have not used derivative financial instruments in our investment portfolio. Interest earning instruments carry a degree of interest rate risk. We have not been exposed nor do we anticipate being exposed to material risks due to changes in interest rates. However, our future interest income may fall short of expectations due to changes in interest rates.

Foreign Currency Risk

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

We have not had any material foreign exchange gains or losses to date. However, we have not engaged in any hedging activities, and we may experience economic loss as a result of any foreign currency exchange rate fluctuations.

Recent Accounting Pronouncements

In March 2004, the FASB issued EITF Issue No. 03-01, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (EITF 03-01) which provides new guidance for assessing impairment losses on debt and equity investments. Additionally, EITF 03-01 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF 03-01; however, the disclosure requirements remain effective and have been adopted by our company (see Note 4 Held-to-maturity investments in the attached notes to our consolidated financial statements). We will evaluate the effect, if any, of EITF 03-01 when final guidance is released.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which replaces SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123) and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. In March 2005, the SEC issued SAB No. 107 (SAB 107), which amends the effective date of SFAS 123R. SFAS 123R and SAB 107 require all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values, beginning with the first annual period after June 15, 2005. The pro forma disclosures previously permitted under SFAS 123 will no longer be an alternative to financial statement recognition. We are required to adopt SFAS 123R in our financial statements for the fiscal year beginning January 1, 2006. Under SFAS 123R, we must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. Under the retroactive options, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of

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adoption of SFAS 123R, while the retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. We are evaluating the requirements of SFAS 123, and we expect that the adoption of SFAS 123R will have a material impact on our consolidated results of operations and earnings per share. We have not yet determined the method of adoption or the effect of adopting SFAS 123R, and we have not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS 123.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets , an amendment of APB Opinion No. 29 (SFAS 153). The guidance in Opinion 29, Accounting for Nonmonetary Transactions , is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. SFAS 153 amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. We are required to adopt SFAS 153 from the quarter ending September 30, 2005. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. We do not believe that the adoption of SFAS No. 153 will have a material effect on our financial position, results of operation, or cash flow.

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NETEASE.COM, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of NetEase.com, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations and comprehensive income, of shareholders equity and of cash flows expressed in Chinese Renminbi (RMB) present fairly, in all material respects, the financial position of NetEase.com, Inc. and its subsidiaries as of December 31, 2003 and 2004, and the results of their operations and their cash flows for each of the three years ended December 31, 2002, 2003 and 2004, in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the related Financial Statement Schedule I as of December 31, 2003 and 2004 and for each of the three years ended December 31, 2002, 2003 and 2004 presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These consolidated financial statements and Financial Statement Schedule I are the responsibility of NetEase.com, Inc. s management. Our responsibility is to express an opinion on these financial statements and Financial Statement Schedule I based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States), which require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers Zhong Tian CPAs Limited Company

Beijing, People s Republic of China

April 27, 2005

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Consolidated Balance Sheets

	Note	December 31, 2003	December 31, 2004	December 31, 2004
		RMB	RMB	US$
Assets				
Current assets:				
Cash		1,356,069,544	2,123,891,537	256,617,113
Held-to-maturity investments	4	332,093,546	165,532,000	20,000,242
Account receivable, net	7		56,304,762	6,802,968
Prepayments and other current assets	5	19,749,369	20,722,068	2,503,723
Due from related parties, net of allowance for doubtful accounts of RMB10,157,789 at December 31, 2003	6, 7	15,182,589		
Deferred tax assets	10	9,669,543		
Total current assets		1,732,764,591	2,366,450,367	285,924,046
Non-current assets:				
Rental deposit		1,430,544	2,140,394	258,611
Property, equipment and software, net	8	40,410,264	77,303,013	9,340,061
Deferred assets	2(o)	12,086,693	4,246,624	513,094
Total non-current assets		53,927,501	83,690,031	10,111,766
Total assets		1,786,692,092	2,450,140,398	296,035,812
Liabilities & Shareholders Equity				
Current liabilities:				
Accounts payable		10,738,090	19,344,096	2,337,232
Salary and welfare payable	9	17,405,624	36,283,138	4,383,875
Taxes payable	11	15,976,342	44,009,342	5,317,386
Deferred revenue	13		134,896,863	16,298,781
Accrued liabilities	12	11,698,761	22,961,861	2,774,344
Due to a related party, net	6, 7	21,947,411		
Total current liabilities		77,766,228	257,495,300	31,111,618
Long-term payable:				
Zero Coupon Convertible Subordinated Notes due July 15, 2023	14	827,670,000	827,650,000	100,000,000
Other long-term payable		231,449	11,749,578	1,419,631
Total long-term payable		827,901,449	839,399,578	101,419,631
Total liabilities		905,667,677	1,096,894,878	132,531,249
Commitments and contingencies	18			
Shareholders equity:				
Ordinary shares,US$0.0001 par value: 1,000,300,000,000 shares authorized, 3,128,958,189 shares issued and outstanding as of December 31, 2003, and	15	2,589,756	2,635,419	318,422

3,184,167,189 shares issued and outstanding as of December 31, 2004				
Additional paid-in capital	15	993,254,740	1,023,954,160	123,718,258
Statutory reserves	2(n)	33,699,834	90,882,108	10,980,742
Deferred compensation	16	(69,175)	(13,835)	(1,672)
Translation adjustments		210,838	210,838	25,474
Retained earnings/(Accumulated deficit)		(148,661,578)	235,576,830	28,463,339
Total shareholders equity		881,024,415	1,353,245,520	163,504,563
Total liabilities and shareholders equity		1,786,692,092	2,450,140,398	296,035,812

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

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Consolidated Statements of Operations and Comprehensive Income

		For the year ended December 31,			
	Note	2002	2003	2004	2004
		RMB	RMB	RMB	US$
Revenues:	19				
Online game services		37,053,414	203,246,114	628,936,223	75,990,603
Advertising services		34,209,376	86,183,733	171,054,305	20,667,469
Wireless value-added and other fee-based premium services		161,305,678	279,659,170	158,310,317	19,127,689
		232,568,468	569,089,017	958,300,845	115,785,761
Business tax	10(b), 19	(11,627,216)	(26,954,502)	(54,703,018)	(6,609,439)
Net revenues	19	220,941,252	542,134,515	903,597,827	109,176,322
Cost of revenues	19	(71,677,574)	(85,462,717)	(183,803,395)	(22,207,865)
Gross profit		149,263,678	456,671,798	719,794,432	86,968,457
Operating expenses:					
Selling and marketing expenses		(26,242,778)	(43,135,804)	(152,842,334)	(18,467,025)
General and administrative expenses		(68,064,835)	(67,634,599)	(101,631,070)	(12,279,474)
Research and development expenses		(14,184,724)	(19,120,827)	(34,362,806)	(4,151,852)
Asset impairment loss		(746,857)			
Class action settlement		(36,005,385)			
Insurance claims settlement for the now-settled class action litigation				16,553,200	2,000,024
Total operating expenses		(145,244,579)	(129,891,230)	(272,283,010)	(32,898,327)
Operating profit		4,019,099	326,780,568	447,511,422	54,070,130
Other income (expenses):					
Investment income			538,278	3,522,169	425,563
Interest income		7,562,322	11,273,685	22,333,511	2,698,425
Interest expenses		(1,401,041)		(3,877,129)	(468,450)
Other, net		3,725,370	5,410,171	507,428	61,309
Profit before tax		13,905,750	344,002,702	469,997,401	56,786,977
Income tax benefit (expense)	10	2,395,888	(21,129,978)	(28,576,719)	(3,452,754)
Net profit		16,301,638	322,872,724	441,420,682	53,334,223
Other comprehensive income (loss)					
Currency translation adjustments		11,583	(18,072)		
Comprehensive income		16,313,221	322,854,652	441,420,682	53,334,223
Net earnings per share, basic	17	0.01	0.10	0.14	0.02

Net earnings per ADS, basic		0.53	10.34	14.10	1.70
Net earnings per share, diluted	2(m), 17	0.01	0.10	0.13	0.02
Net earnings per ADS, diluted		0.52	9.73	12.98	1.57
Weighted average number of ordinary shares outstanding, basic	17	3,051,395,100	3,122,257,952	3,157,841,781	3,157,841,781
Weighted average number of ADS outstanding, basic		30,513,951	31,222,580	31,578,418	31,578,418
Weighted average number of ordinary shares outstanding, diluted	2(m), 17	3,127,837,900	3,353,659,329	3,491,430,437	3,491,430,437
Weighted average number of ADS outstanding, diluted		31,278,379	33,536,593	34,914,304	34,914,304
Share compensation cost included in:					
Cost of revenues	15, 16	(1,908,125)			
Selling and marketing expenses		(239,021)			
General and administrative expenses		(1,283,348)	(151,166)	(55,340)	(6,686)
Research and development expenses		(376,364)	(88,236)		-
		(3,806,858)	(239,402)	(55,340)	(6,686)

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

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Consolidated Statements of Shareholders Equity

	Ordinary shares		Additional paid-in capital	Subscriptions receivable	Deferred compensation	Statutory reserves	Retained Earnings/ (Accumulated deficit)	Translation adjustments	Total shareholders equity
	Share	Amount							
		RMB	RMB	RMB	RMB	RMB	RMB	RMB	RMB
Balance as of December 31, 2001	3,024,175,192	2,503,626	1,044,889,829	(35,100,568)	(3,344,574)		(454,136,106)	217,327	555,029,534
Collection of subscriptions receivable for Series B preference shares issued in 2000				1,986,720					1,986,720
Ordinary shares issued to a senior officer of the Company as compensation (see Note 15)	11,250,000	9,315	(9,315)		604,729				604,729
Ordinary shares issued for services to be provided by certain employees (see Note 15)	15,959,245	13,214	625,056		467,631				1,105,901
Ordinary shares issued upon exercise of employee stock options	48,778,100	40,388	3,847,031						3,887,419
Share compensation cost			298,753		1,797,475				2,096,228
Net profit							16,301,638		16,301,638
Translation adjustments								11,583	11,583
Balance as of December 31, 2002	3,100,162,537	2,566,543	1,049,651,354	(33,113,848)	(474,739)		(437,834,468)	228,910	581,023,752
Repurchase of 27,142,000	(27,142,000)	(22,891)	(71,248,494)	33,113,848					(38,157,537)

ordinary shares and collection of outstanding subscriptions receivable (Note 15)									
Ordinary shares issued to a senior officer of the Company as compensation (see Note 15)	2,500,000	2,070	(2,070)		134,060				134,060
Ordinary shares issued for services to be provided by certain employees (see Note 15)	853,952	707	(707)		88,236				88,236
Share compensation cost					111,856				111,856
Reversal of deferred compensation arising from options due to employee resignation			(166,162)		71,412				(94,750)
Appropriation to statutory reserves						33,699,834	(33,699,834)		
Ordinary shares issued upon exercise of employee stock options	52,583,700	43,327	15,020,819						15,064,146
Net profit							322,872,724		322,872,724
Translation adjustments								(18,072)	(18,072)
Balance as of December 31, 2003	3,128,958,189	2,589,756	993,254,740		(69,175)	33,699,834	(148,661,578)	210,838	881,024,415
Ordinary shares issued upon exercise of employee stock options	55,209,000	45,663	30,699,420						30,745,083
Share compensation cost					55,340				55,340
Appropriation to statutory reserves						57,182,274	(57,182,274)		
Net profit							441,420,682		441,420,682

Balance as of December 31, 2004	3,184,167,189	2,635,419	1,023,954,160		(13,835)	90,882,108	235,576,830	210,838	1,353,245,520

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

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Consolidated Statements of Cash Flows

	For the year ended December 31,			
	2002	**2003**	**2004**	**2004**
	RMB	**RMB**	**RMB**	**US$**
Cash flows from operating activities:				
Net profit	16,301,638	322,872,724	441,420,682	53,334,223
Adjustments for:				
Depreciation	21,797,267	17,429,212	26,452,040	3,196,042
Share compensation cost	3,806,858	239,402	55,340	6,686
Provision for doubtful debts	3,254,783	3,551,682	7,953,883	961,020
Amortization of issuance cost of convertible note		3,511,275	7,840,069	947,269
Write down of property, equipment and software	746,857			
Decrease in accounts receivable			7,568,165	914,416
(Increase) decrease in prepayments and other current assets	3,025,673	(5,798,662)	423,383	51,155
(Increase) decrease in due from/to related parties	(23,413,088)	25,661,649		
Decrease in deferred assets	783,352			
(Increase) decrease in deferred tax assets	(2,395,888)	(7,273,655)	9,669,543	1,168,311
Increase (decrease) in accounts payable	(9,301,828)	3,288,082	6,009,418	726,082
Increase in salary and welfare payable	6,087,169	1,382,244	14,103,693	1,704,065
Increase in taxes payable	6,480,019	7,723,392	5,466,691	660,508
Increase (decrease) in deferred revenue	165,115	(165,115)	77,169,729	9,323,957
Increase (decrease) in accrued liabilities	(539,565)	1,300,376	10,021,222	1,210,804
Net cash provided by operating activities	26,798,362	373,722,606	614,153,858	74,204,538
Cash flows from investing activities:				
(Increase) decrease in held-to-maturity investments		(332,093,546)	166,561,546	20,124,636
Decrease in temporary cash investments	45,521,300			
Purchase of property, equipment and software	(12,567,218)	(27,824,900)	(60,142,252)	(7,266,630)
Proceeds from disposal of convertible preference shares	9,701,293			
(Increase) decrease in non-current rental deposit	21,575	(364,632)	(584,810)	(70,659)
Net cash (used in) provided by investing activities	42,676,950	(360,283,078)	105,834,484	12,787,347

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

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Consolidated Statements of Cash Flows (Cont d)

	For the year ended December 31,			
	2002	2003	2004	2004
	RMB	RMB	RMB	US$
Cash flows from financing activities:				
Repayment of short-term bank loans	(84,000,000)			
Proceeds from employees exercising stock options	3,887,419	15,064,146	30,745,083	3,714,745
Collection of subscriptions receivable for Series B preference shares issued in 2000 and collection of outstanding subscriptions receivable	1,986,720			
Re-purchase of ordinary shares		(38,157,537)		
Proceeds from issuance of Zero Coupon Convertible Subordinated Notes		827,670,000		
Increase in other long-term payable		231,449	1,298,129	156,845
Payment for issuance cost of convertible notes		(23,437,986)		
Net cash provided by (used in) financing activities	(78,125,861)	781,370,072	32,043,212	3,871,590
Effect of exchange rate changes on cash	11,583	(18,072)		
Net increase (decrease) in cash	(8,638,966)	794,791,528	752,031,554	90,863,475
Decrease in restricted cash	89,100,143	1,208,305		
Cash, beginning of year	479,608,534	560,069,711	1,371,859,983	165,753,638
Cash, end of year	560,069,711	1,356,069,544	2,123,891,537	256,617,113
Supplemental disclosures of cash flow information:				
Cash paid during the year for income taxes		20,793,510	24,374,799	2,945,061
Cash paid during the year for interest	1,057,225			
Supplemental schedule of non-cash investing and financing activities:				
Compensation costs, arising from transfer of ordinary shares and issuance of stock options in the Company to employees and certain consultants of the Company (see Notes 15 and 16)	3,806,858	239,402	55,340	6,686

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

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Notes to the Consolidated Financial Statements

(Amounts expressed in Renminbi (RMB), unless otherwise stated)

1. Organization and Nature of Operations

(a) The Group

NetEase.com, Inc. (the Company) was incorporated in the Cayman Islands on July 6, 1999. As of December 31, 2004, the Company had six wholly owned subsidiaries and three variable interest entities (VIEs) for which the Company is the primary beneficiary. The Company, its subsidiaries and VIEs are hereinafter collectively referred to as the Group .

Details of the controlled entities and VIEs are described below:

Name	Place and date of incorporation
Controlled entities:	
NetEase Information Technology (Beijing) Co., Ltd. (NetEase Beijing)	Beijing, China August 30, 1999
NetEase Information Technology (Shanghai) Co., Ltd. (NetEase Shanghai)	Shanghai, China May 14, 2000
NetEase (U.S.) Inc. (NetEase US)	Delaware, United States of America September 10, 1999
NetEase Interactive Entertainment Ltd. (NetEase Interactive)	British Virgin Islands April 12, 2002
Guangzhou NetEase Interactive Entertainment Ltd. (Guangzhou Interactive)	Guangzhou, China October 15, 2002
Guangzhou Boguan Telecommunication Technology Ltd.	Guangzhou, China December 8, 2003
VIEs:	
Guangzhou NetEase Computer System Co., Ltd. (Guangzhou NetEase)	Guangzhou, China

	June 24, 1997
Beijing Guangyitong Advertising Co., Ltd. (Guangyitong Advertising)	Beijing, China
	November 8, 1999
Guangzhou Ling Yi Electronics Technology Ltd. (Ling Yi)	Guangzhou, China
	October 27, 2003

The Company has been listed on the Nasdaq National Market in the United States since July 2000.

The Group is principally engaged in developing and providing a range of Internet-related services including online games, advertising and wireless value-added and other fee-based premium services in China. The details of the business are described in note 1(b) below.

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1. Organization and Nature of Operations (Cont d)

(b) Nature of operations

The industry in which the Group operates is subject to a number of industry-specific risk factors, including, but not limited to, rapidly changing technologies; stringent rules imposed by the mobile operators; significant numbers of new entrants; dependence on key individuals; competition from similar services from larger companies; customer preferences; and the need for the continued successful development, marketing, and selling of its services.

The Group is currently targeting the Chinese market. The Chinese government regulates Internet access, telecommunications services, the distribution of news and other information and the provision of commerce through strict business licensing requirements and other governmental regulations, which include, among others, those restricting foreign ownership in Chinese companies providing Internet advertising and other Internet or telecommunications value-added services. To comply with the existing Chinese laws and regulations, the Company and certain of its wholly owned subsidiaries have entered into a series of contractual arrangements with certain VIEs (see Note 2 (a) and 6) with respect to the operation of the NetEase websites in connection with the provision of online games, Internet content and wireless value-added services, as well as the provision of advertising services. The revenue earned by the VIEs largely flows through to the Company and its wholly owned subsidiaries pursuant to the series of contractual arrangements. Based on these agreements, NetEase Beijing, NetEase Shanghai and Guangzhou Interactive provide technical consulting and related services to the VIEs. Guangzhou NetEase and Guangyitong Advertising are legally owned by two citizens of China, one of whom is the principal shareholder of the Company and the other is his brother. Ling Yi is legally owned by three citizens of China: the principal shareholder of the Company, his brother and a former employee of the Group. Management believes that the Group s present operations are structured to comply with Chinese law. However, many Chinese regulations are subject to extensive interpretive powers of governmental agencies and commissions. The Group cannot be certain that the Chinese government will not take action to prohibit or restrict its business activities. Future changes in Chinese government policies affecting the provision of information services, including the provision of online services, Internet access, e-commerce services and online advertising, may impose additional regulatory requirements on the Group or its service providers or otherwise harm its business.

2. Principal Accounting Policies

(a) Basis of consolidation

The consolidated financial statements include the financial statements of the Company, its subsidiaries and VIEs, except that the Company did not consolidate the VIEs prior to the adoption of Financial Accounting Standards Board (FASB) Interpretation No. 46: Consolidation of Variable Interest Entities, an interpretation of ARB 51 (FIN 46), which was further revised in December 2003 (FIN 46-R), on January 1, 2004 in accordance with the transitional provisions. Prior to the consolidation of the VIEs, the VIEs have adopted the same accounting policies as the ones adopted by the Company and its subsidiaries. All significant transactions and balances among the Company, its subsidiaries and VIEs have been eliminated upon consolidation.

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2. Principal Accounting Policies (Cont d)

(a) Basis of consolidation (cont d)

According to the requirements of FIN 46 and FIN 46-R, the Company has evaluated its relationship with two previously unconsolidated related companies, namely Guangzhou NetEase and Guangyitong Advertising during the year ended December 31, 2004. Guangzhou NetEase and Guangyitong Advertising are considered to be VIEs of the Company. The Company has concluded it is the primary beneficiary of these two VIEs. Effective January 1, 2004, the Company has prospectively consolidated these two VIEs in accordance with the transitional provisions of FIN 46 and FIN 46-R in the Company s consolidated financial statements.

In addition, the Company has evaluated its relationship with Ling Yi based on the underlying contractual agreements and considered that the Company has the right to enjoy all residual benefits and effectively bear the risk of operating losses of Ling Yi. As a result, the Company has determined that it is the primary beneficiary of Ling Yi and accordingly, has consolidated the financial statements of Ling Yi from May 2004, the effective date of the aforesaid agreement.

(b) Basis of presentation

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP). The consolidated financial statements are prepared based on the historical cost convention. This basis of accounting differs from that used in the statutory accounts of those entities within the Group established in China (PRC Statutory Accounts), which are prepared in accordance with accounting principles and the relevant financial regulations applicable to enterprises established in China (PRC GAAP).

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the balance sheet dates and the reported amounts of revenues and expenses during the reporting periods. Actual results might differ from those estimates.

The principal differences between US GAAP and PRC GAAP applicable to the Group include the following:

- Recognition of compensation costs arising from grants of stock options and shares to the Company s employees, directors, consultants and advisory board members;
- Basis for revenue recognition;
- Tax effects related to the above adjustments; and

Consolidation of VIEs.

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2. Principal Accounting Policies (Cont d)

(c) Revenue recognition

The Group recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collectibility is reasonably assured.

Revenues presented in consolidated statements of operations and comprehensive income represent online game services, advertising services and wireless value-added and other fee-based premium services revenue recognized by Guangzhou NetEase, Guangyitong Advertising and Ling Yi net of sales discount.

Online game services and wireless value-added and other fee-based premium services

The Group currently provides its online game services and wireless value-added and other fee-based premium services through Guangzhou NetEase and Ling Yi.

Prior to the consolidation of Guangzhou NetEase and Ling Yi upon the adoption of FIN 46, the Group s revenues from online game services and wireless value-added and other fee-based premium related services are derived from the agreements entered into between NetEase Beijing and Guangzhou Interactive, on the one hand and Guangzhou NetEase and Ling Yi, on the other hand. Such agreements allow NetEase Beijing and Guangzhou Interactive to unilaterally adjust the amount of fees they are entitled to from the technical services provided to Guangzhou NetEase and Ling Yi such that all of the online game services and wireless value-added and other fee-based premium services revenues recognized by Guangzhou NetEase and Ling Yi will fully accrue to NetEase Beijing and Guangzhou Interactive. Accordingly, NetEase Beijing and Guangzhou Interactive recognized revenues from online game related services and wireless value-added and other fee-based premium related services at the same time Guangzhou NetEase and Ling Yi recognized their revenues based on the same revenue recognition policies adopted by the Group as described below.

(i) Online game services

The Group sells prepaid point cards through Guangzhou NetEase to the end customers who may use the points on such cards for online game services provided by the Group. The Group recognizes the related revenue when the registered points are consumed for the Group s online game services. The Group effectively charges players according to their playtime of the Group s online games.

(ii) Wireless value-added and other fee-based premium services

A substantial portion of the Group s revenue from wireless value-added services (WVAS) is currently predominantly derived from activities related to short messaging services (SMS) and non-SMS services such as multimedia messaging, wireless application protocol and interactive voice response services. The Group derives WVAS revenues principally from providing value-added services such as friends matching, news and information services, ring-tone and logo downloads and various other related products to mobile phone users under co-operative arrangements with mobile phone operators. WVAS revenues recognized by the Group represent its share of the revenues under these co-operative arrangements net of the amounts retained by the mobile phone operators for their services performed. The Group recognizes revenue under these co-operative arrangements in the month in which the services are performed based on the monthly confirmation from the mobile phone operators for the service period when the message/content is delivered. Where a confirmation has not been received from a mobile phone operator, the Group estimates the revenue, as well as the amounts of billing and transmission failures, applicable to the services provided through that operator and recognizes the estimated revenue net of estimated billing and transmission failures.

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2. Principal Accounting Policies (Cont d)

(c) Revenue recognition (cont d)

Other fee-based premium services revenues are derived principally from providing premium e-mail, friends matching and dating services, personal homepage hosting, online shopping mall and premium electronic greeting card services, which are all operated on a monthly subscription basis. Prepaid subscription fees are deferred and revenues from such services are recognized by the Group on a straight-line basis over the period in which the services are provided.

Advertising services

The Group provides its advertising services through Guangyitong Advertising. As such, the Group s revenues from advertising related services are derived from the agreements entered into between NetEase Beijing and Guangyitong Advertising. Such agreements allow NetEase Beijing to unilaterally adjust the amount of fees NetEase Beijing is entitled to from the technical consulting and related services provided to Guangyitong Advertising such that all of the advertising revenues recognized by Guangyitong Advertising, less all of the accrued expenses incurred by Guangyitong Advertising, will fully accrue to NetEase Beijing. Prior to the consolidation of Guangyitong Advertising upon adoption of FIN 46, the Group recognized revenues from advertising related services at the same time Guangyitong Advertising recognized its revenues based on the same revenue recognition policies adopted by the Group as described below.

The Group derives its advertising fees principally from short-term advertising contracts. Revenues from advertising contracts are generally recognized ratably over the period in which the advertisement is displayed and only if collection of the resulting receivables is probable. The Group s obligations may also include guarantees of a minimum number of impressions or times that an advertisement appears in pages viewed by users. To the extent that minimum guaranteed impressions are not met within the contractual time period, the Group defers recognition of the corresponding revenues until the remaining guaranteed impression levels are achieved. In addition, Guangyitong Advertising occasionally enters into cost per action (CPA) advertising contracts whereby revenue is received by it when an online user performs a specific action such as purchasing a product from or registering with the advertiser. Revenue for CPA contracts is recognized when the specific action is completed.

The Group has adopted the consensus reached in Emerging Issue Task Force (EITF) 99-17 to account for barter transactions. According to EITF 99-17, revenue and expense should be recognized at fair value from a barter transaction involving advertising services provided by the Group only if the fair value of the advertising services surrendered in the transaction is determinable based on the entity s own historical practice of receiving cash, marketable securities, or other consideration that is readily convertible to a known amount of cash for similar advertising from buyers unrelated to the counterparty in the barter transaction. There was no revenue and expense recognized for such barter transactions for the years ended December 31, 2002, 2003 and 2004. During the years ended December 31, 2002, 2003 and 2004, the Group also engaged in certain advertising barter transactions for which the fair value is not determinable within the limits of EITF 99-17 and therefore no revenues or expenses derived from these barter transactions were recognized. These transactions primarily involved exchanges of advertising services rendered by the Group for advertising, promotional benefits, information content, consulting services, and software provided by the counterparties.

2. Principal Accounting Policies (Cont d)

(d) Cost of revenues

Costs of online game services, advertising services and wireless value-added and other fee-based premium services consist primarily of staff costs of those departments directly involved in providing such services, depreciation and amortization of computers and software, server custody fees, bandwidth, business tax paid by the Company and its subsidiaries on intra-group revenues from the VIEs, and other direct costs of providing these services. These costs are charged to the statement of operations as incurred.

(e) Research and development costs

The Group recognizes costs to develop its online game products in accordance with SFAS No. 86, Accounting for Costs of Computer Software to be Sold, Leased or Otherwise Marketed (SFAS No. 86). Costs incurred for the development of online game services prior to the establishment of technological feasibility are expensed when incurred. Once an online game has reached technological feasibility, all subsequent online game development costs are capitalized until that game is available for marketing. Technological feasibility is evaluated on a service-by-service basis, but typically encompasses both technical design and game design documentation and only occurs when the online game has a proven ability to operate in the Chinese market.

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

(f) Cash

Cash represents cash on hand and demand deposits placed with banks or other financial institutions. Included in the cash balance as of December 31, 2003 and 2004 are amounts denominated in United States dollars totaling US$103.3 million and US$125.7 million, respectively (equivalent to approximately RMB854.7 million and RMB1,040.3 million, respectively).

(g) Financial instruments

Financial instruments of the Group primarily consist of temporary cash investments, held-to-maturity investments, accounts receivable, balances with related parties, investment in convertible preference shares, accounts payable and convertible notes payable. As of the balance sheet dates, their estimated fair value approximated their carrying values.

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2. Principal Accounting Policies (Cont d)

(h) Property, equipment and software

Property, equipment and software are stated at cost less accumulated depreciation. Depreciation is calculated on the straight-line basis over the following estimated useful lives, taking into account any estimated residual value:

Computers	3 years
Furniture and office equipment	5 years
Software	2-3 years
Vehicles	5 years
Leasehold improvements	lesser of the term of the lease and the estimated useful lives of the assets

(i) Advertising expenses

The Group recognizes advertising expenses in accordance with AICPA SOP 93-7 Reporting on Advertising Costs . As such, the Group expenses the costs of producing advertisements at the time production occurs, and expenses the cost of communicating advertising in the period in which the advertising space or airtime is used. Advertising expenses totaled approximately RMB2.4 million, RMB3.8 million and RMB64.0 million during the years ended December 31, 2002, 2003 and 2004, respectively.

(j) Foreign currency translation

The functional currency of the Group is RMB. Transactions denominated in currencies other than RMB are translated into RMB at the exchange rates quoted by the People s Bank of China (the PBOC) prevailing at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are translated into RMB using the applicable exchange rates quoted by the PBOC at the balance sheet dates. The resulting exchange differences are included in the determination of income.

The financial records of certain of the Company s subsidiaries are maintained in US dollars, which is their functional currency. For consolidation purposes, the assets and liabilities of such subsidiaries are translated at the exchange rates at the balance sheet dates, equity accounts are translated at historical exchange rates and revenues, expenses, gains and losses are translated using the average exchange rate for the year. Translation adjustments are reported as cumulative translation adjustments and are shown as a separate component in the consolidated statement of shareholders equity.

Translations of amounts from RMB into United States dollars for the convenience of the reader were calculated at the noon buying rate of US$1.00 = RMB8.2765 on December 31, 2004 in The City of New York for cable transfers of RMB as certified for customs purposes by the Federal Reserve Bank of New York. No representation is made that the RMB amounts could have been, or could be, converted into United States dollars at such rate.

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2. Principal Accounting Policies (Cont d)

(k) Stock-based compensation

In accordance with the provisions of SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure , the Group has selected the disclosure only provisions related to employee stock options and share purchases and follows the provisions of Accounting Principles Board Opinion No. 25 (APB 25) in accounting for stock options and shares issued to employees. Under APB 25, compensation expense, if any, is recognized as the difference between the exercise price and the estimated fair value of the ordinary shares on the measurement date, which is typically the date of grant, and is expensed ratably over the service period, which is typically the vesting period.

Stock-based employee compensation cost of RMB3.8 million, RMB0.2 million and RMB0.1 million in 2002, 2003 and 2004, respectively, has been expensed. The following table illustrates the effect on net income and earnings per share if the Group had applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation , to stock-based employee compensation.

		For the year ended December 31,		
		2002	2003	2004
		RMB	RMB	RMB
Net profit:				
As reported		16,301,638	322,872,724	441,420,682
Add:	Stock-based employee compensation expense included in the determination of net income as reported, net of tax	3,806,858	239,402	55,340
Less:	Stock-based employee compensation expense determined under fair value based method for all awards, net of tax	(223,046)	(20,281,210)	(54,085,221)
Pro forma		19,885,450	302,830,916	387,390,801
Basic net earnings per ordinary share:				
As reported		0.01	0.10	0.14
Pro forma		0.01	0.10	0.12
Diluted net earnings per ordinary share:				
As reported		0.01	0.10	0.13
Pro forma		0.01	0.09	0.11

(l) Income taxes

Deferred income taxes are provided using the balance sheet liability method. Under this method, deferred income taxes are recognized for the tax consequences of significant temporary differences by applying enacted statutory rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided to reduce the amount of deferred tax assets if it is considered more likely than not that some portion of, or all of, the deferred tax assets will not be realized.

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2. Principal Accounting Policies (Cont d)

(m) Net earnings per share (EPS) and per American Depositary Share (ADS)

In accordance with SFAS No. 128, Computation of Earnings Per Share, basic EPS is computed by dividing net profit attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the year. Diluted EPS is calculated using the weighted average number of ordinary and dilutive ordinary equivalent shares outstanding during the year. Ordinary equivalent shares consist of the ordinary shares issuable upon conversion of the Zero Coupon Convertible Subordinated Notes (using the if-converted method) and ordinary shares issuable upon the exercise of outstanding stock options (using the treasury stock method).

Net earnings per ADS has been computed by multiplying the net earnings per share by 100, which is the number of shares represented by each ADS.

When calculating the fully diluted earnings per ADS for the year ended December 31, 2004, the Company adopted the consensus reached on EITF Issue No. 04-08, The Effect of Contingently Convertible Instruments on Diluted Earnings per Share , which is effective for periods ended after December 15, 2004. EITF 04-08 is applicable to the Company because the conversion of its Zero Coupon Convertible Subordinated Notes (the Convertible Notes) depends on, among other things, whether the market price of the Company s ADS exceeds a pre-scripted conversion price. Application of the consensus requires the dilutive impact of the Convertible Notes to be included in the calculation of diluted earnings per share, notwithstanding the fact that the market prices of the Company s ADS in December 2003 and December 2004 did not exceed the pre-scripted conversion price of the Convertible Notes. The EITF 04-08 has been retroactively applied such that the diluted earnings per ADS for all prior periods presented were restated.

(n) Statutory reserves

In accordance with the Regulations on Enterprises with Foreign Investment of China and their articles of association, NetEase Beijing, NetEase Shanghai and Guangzhou Interactive, being foreign invested enterprises established in China, are required to provide for certain statutory reserves, namely general reserve, enterprise expansion fund and staff welfare and bonus fund which are appropriated from net profit as reported in their PRC Statutory Accounts. NetEase Beijing, NetEase Shanghai and Guangzhou Interactive, being wholly foreign owned enterprises, are required to allocate at least 10% of their after-tax profit to the general reserve until such reserve has reached 50% of their respective registered capital. Appropriations to the enterprise expansion fund and staff welfare and bonus fund are at the discretion of the board of directors of NetEase Beijing, NetEase Shanghai and Guangzhou Interactive, respectively. These reserves can only be used for specific purposes and are not distributable as cash dividends. Appropriations to the staff welfare and bonus fund are charged to selling, general and administrative expenses.

NetEase Shanghai has been in an accumulated loss position according to its PRC Statutory Accounts and no appropriations to statutory reserves have been made.

NetEase Beijing has made appropriations of approximately RMB22.4 million and RMB33.7 million for the years ended December 31, 2004 and 2003, respectively, to the general reserve.

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2. Principal Accounting Policies (Cont d)

(n) Statutory reserves (cont d)

The year ended December 31, 2004 was the first year in which Guangzhou Interactive had cumulative retained earnings according to its PRC Statutory Accounts. Accordingly, an amount of approximately RMB34.7 million, representing 10% of the net profit, after recouping all losses carried forward, according to its PRC Statutory Accounts for the year ended December 31, 2004 was appropriated to the general reserve.

General reserve, upon certain approvals and subject to certain limitations, can be used to offset prior year losses, if any, and can also be converted into paid-in capital for PRC legal purposes.

(o) Deferred assets

Deferred assets mainly include the offering costs of the Company s Zero Coupon Convertible Subordinated Notes. The Company amortizes the offering costs over a period of 35 to 36 months from the date of issuance of the notes by the Company to the first date when the Company may be required to repurchase all or any portion of the principal amount of the notes.

(p) Related parties

Parties are considered to be related if one party has the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or common significant influence.

(q) Comprehensive income

Comprehensive income is defined as the change in equity of the Group during a period arising from transactions and other events and circumstances excluding transactions resulting from investments by shareholders and distributions to shareholders.

(r) Segment reporting

SFAS No. 131 Disclosures about Segments of an Enterprise and Related Information establishes standards for reporting information about operating segments on a basis consistent with the Group s internal organizational structure as well as information about geographical areas, business segments and major customers in financial statements (see Note 19 for details on the Group s business segments).

(s) Recent accounting pronouncements

In March 2004, the FASB issued EITF Issue No. 03-01, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (EITF 03-01) which provides new guidance for assessing impairment losses on debt and equity investments. Additionally, EITF 03-01 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF 03-01; however, the disclosure requirements remain effective and have been adopted by the Company (see Note 4 Held-to-maturity investments). The Company will evaluate the effect, if any, of EITF 03-01 when final guidance is released.

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2. Principal Accounting Policies (Cont d)

(s) Recent accounting pronouncements (cont d)

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which replaces SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123) and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees . In March 2005, the SEC issued SAB No. 107 (SAB 107), which amends the effective date of SFAS 123R. SFAS 123R and SAB 107 require all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values, beginning with the first annual period after June 15, 2005. The pro forma disclosures previously permitted under SFAS 123 will no longer be an alternative to financial statement recognition. The Company is required to adopt SFAS 123R in its financial statements for the fiscal year beginning January 1, 2006. Under SFAS 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. Under the retroactive options, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R, while the retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. The Company is evaluating the requirements of SFAS 123, and it expects that the adoption of SFAS 123R will have a material impact on its consolidated results of operations and earnings per share. The Company has not yet determined the method of adoption or the effect of adopting SFAS 123R, and it has not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS 123.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets , and amendment of APB Opinion No. 29 (SFAS 153). The guidance in Opinion 29, Accounting for Nonmonetary Transactions , is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. SFAS 153 amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The Company is required to adopt SFAS 153 from its interim three-month period ending September 30, 2005. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The Company does not believe that the adoption of SFAS 153 has a material effect on financial position, results of operation, or cash flow.

3. Concentrations

(a) Dependence on mobile phone operators

Wireless value-added services revenues, which represent a significant portion of the Group s total revenue, are derived from co-operative arrangements with the two mobile phone operators in China. If the various contracts with either mobile phone operator are terminated or scaled-back, or if the mobile phone operators alter the fee sharing percentages, it will be difficult, if not impossible, to find appropriate replacement partners with the requisite licenses and permits, infrastructure and customer base to offer these services, which would adversely affect the Group s businesses.

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3. Concentrations (Cont d)

(b) Bandwidth and server custody service provider

The Group relies on two telecommunications service providers and their affiliates for bandwidth and server custody service.

(c) Credit risk

The Group is principally developing and providing a range of Internet-related services including online game services, wireless value-added and other related services and advertising services in China. The Group generally does not require collateral for its accounts receivable.

4. Held-to-Maturity Investments

Held-to-maturity investments represent investments in Federal Home Loan debt securities with maturity dates in 2005.

5. Prepayments and Other Current Assets

	December 31, 2003	December 31, 2004
	RMB	RMB
Deferred issuance costs of convertible notes	7,840,018	7,839,923
Prepayments	5,215,394	5,127,114
Interest receivable	1,931,777	3,314,839
Employee advances	1,291,741	2,502,632
Low-value consumables	1,463,523	1,232,163
Rental deposits	435,789	568,320
Other	1,571,127	137,077
	19,749,369	20,722,068

6. Related Party Transactions

Prior to the consolidation of Guangzhou NetEase and Guangyitong Advertising upon the adoption of FIN 46 in 2004, the transactions and balances with these two companies were regarded as related party transactions and disclosed as below.

During the years ended December 31, 2002 and 2003, the Group derived approximately RMB34.2 million and RMB86.2 million, respectively, of advertising services revenues from Guangyitong Advertising, a related company which is controlled by the principal shareholder of the Company, for advertising-related technical consulting services performed.

During the years ended December 31, 2002 and 2003, the Group derived approximately RMB197.4 million and RMB482.7 million, respectively, of online game and wireless value-added and other fee-based premium services revenues from Guangzhou NetEase, a related company which is controlled by the principal shareholder of the Company.

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6. Related Party Transactions (Cont d)

During the years ended December 31, 2002 and 2003, the Group reimbursed Guangzhou NetEase a total of approximately RMB29.6 million and RMB54.6 million, respectively, for the costs of revenue and operating expenses associated with the NetEase websites.

Due from related parties mainly represents amounts receivable from Guangyitong Advertising and/or Guangzhou NetEase for services performed in the normal course of business. Due to a related party mainly represents amounts received in advance from Guangzhou NetEase for services to be performed, primarily in relation to online game services. The balances with these two entities were unsecured, interest-free and repayable on demand.

In addition, in January 2001, the Group advanced RMB1.9 million to Mr. William Ding, the principal shareholder of the Company. The advance bore an annual interest rate of 6% compounded annually and was repayable by monthly installments with the entire amount repayable by November 2006. The advance was repaid in full in 2003.

In June 2000, the Group advanced RMB2.0 million to an employee who is a relative of the principal shareholder. The advance bore an annual interest rate of 5% and was repayable one year from the date of advance. The advance was in default in June 2001, thus a full provision was made during the year ended December 31, 2001. However, the amount was subsequently repaid in 2003. As such, the provision was reversed during the year ended December 31, 2002.

As of December 31, 2002 and 2003, the amounts due from related parties included amounts denominated in US dollars of US$0.2 million (equivalent to approximately RMB1.3 million) and US$ nil, respectively. All other related party balances are denominated in RMB.

7. Allowance for Doubtful Accounts

Movements of the allowance for doubtful accounts for the years ended December 31, 2003 and 2004 were as follows:

	Balance at January 1	Charged to cost and expenses	Write-off of receivable balances and corresponding provisions	Balance at December 31
	RMB	RMB	RMB	RMB
2003	8,703,307	3,551,682	2,097,200	10,157,789
2004	10,157,789	7,953,883		18,111,672

Upon the adoption of FIN 46 and consolidation of Guangzhou NetEase and Guangyitong Advertising in January 2004, amounts due from/ to these two related parties were eliminated in the consolidated financial statements of the Company. The major effect of consolidation of these companies on the Company s consolidated financial statements was the recognition of the VIEs accounts receivable, deferred revenue and taxes payable and others, and a corresponding elimination of the due to and due from related parties balances. The net effect on shareholders equity was nil. The following figures represent the due from and due to related parties balances as of December 31, 2003, and the corresponding balances of accounts receivable, deferred revenue and taxes payable and others on the balance sheet of the VIEs as of that date:

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7. Allowance for Doubtful Accounts (Cont d)

	December 31, 2003
Due from related parties, net	15,182,589
Due to related parties, net	(21,947,411)
Amount due to related parties, net	(6,764,822)
Represented by:	
Accounts receivable, net	71,826,810
Deferred revenue	(57,727,133)
Taxes payable and others, net	(20,864,499)
Amount due to related parties, net	(6,764,822)

8. Property, Equipment and Software

	December 31, 2003	December 31, 2004
Computers	73,926,310	114,996,152
Furniture and office equipment	2,892,207	4,694,747
Software	20,398,009	36,472,644
Vehicles	358,705	553,992
Leasehold improvements	8,588,410	13,892,804
	106,163,641	170,610,339
Less: Accumulated depreciation	(65,753,377)	(93,307,326)
Net book value	40,410,264	77,303,013

9. Employee Benefits

The full-time employees of those entities within the Group which are established in China are entitled to staff welfare benefits including medical care, welfare subsidies and unemployment insurance, etc. These entities are required to accrue for these benefits based on certain percentages of the employees salaries in accordance with the relevant regulations. The total provision for such employee benefits amounted to RMB6.4 million, RMB2.9 million and RMB14.1 million for the years ended December 31, 2002, 2003 and 2004, respectively. These entities are also required to make contributions to the state-sponsored pension and medical plans out of the amounts accrued for medical and pension benefits. These contributions for the years ended December 31, 2002, 2003 and 2004 amounted to approximately RMB3.4 million, RMB5.0 million and RMB12.8 million, respectively. The Chinese government is responsible for the medical benefits and ultimate pension liability to these employees.

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10. Taxation

(a) Income taxes

Cayman Islands

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

British Virgin Islands (BVI)

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

China

In accordance with Income Tax Law of China for Enterprises with Foreign Investment and Foreign Enterprises , foreign invested enterprises are generally subject to enterprise income tax (EIT) at the rate of 30% plus a local income tax of 3%. NetEase Beijing, being a foreign invested enterprise and located in the New Technology Industrial Development Experimental Zone in Beijing, has been recognized as a New and High Technology Enterprise . According to an approval granted by the Haidian State Tax Bureau in November 2000, NetEase Beijing is entitled to a reduced EIT rate of 15% commencing from the year 2000. In addition, the approval also granted NetEase Beijing with a full exemption from EIT from 2001 to 2002, a 50% reduction in EIT from 2003 to 2005, and a full exemption from the local income tax from 2000 onwards. Consequently, NetEase Beijing was exempted from EIT and local income tax for each of the years ended December 31, 2001 and 2002, and enjoyed or will enjoy a 50% reduction in EIT for each of the years ended December 31, 2003, 2004 and 2005.

The combined effects of EIT exemption and reduction available to NetEase Beijing during the years ended December 31, 2002, 2003 and 2004 are as follows:

	For the year ended December 31,		
	2002	2003	2004
	RMB	RMB	RMB
Aggregate amount		96,572,356	62,257,470
Earnings per share effect, basic		0.03	0.02

The preferential EIT treatments that NetEase Beijing obtained may be subject to review by higher authorities. If these preferential tax treatments were not available to NetEase Beijing, NetEase Beijing would be subject to EIT at 30% plus a local tax of 3% and the exemption and reduction described above would not apply.

Guangzhou Interactive was recognized as a New and High Technology Enterprise in April 2003. According to an approval granted by the Guangzhou TianHe State Tax Bureau, Guangzhou Interactive was entitled to a full exemption from EIT from 2003 to 2004. Subsequently, in December 2004, Guangzhou Interactive was recognized as a High Technology Enterprise and is entitled to a reduced EIT rate of 15% and a local tax of 3% from 2005 onwards, which is subject to the annual examination by the relevant tax authorities for compliance with the High Technology Enterprise status.

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10. Taxation (Cont d)

(a) Income taxes (cont d)

NetEase Shanghai, Guangzhou NetEase and Guangyitong Advertising are all subject to EIT at the rate of 30% plus a local tax of 3%.

A reconciliation of the differences between the statutory tax rate and the effective tax rate for EIT is as follows:

	For the year ended December 31,		
	2002	2003	2004
EIT statutory rate	33.0%	33.0%	33.0%
Permanent differences (primarily the expenses incurred by the Company which are not deductible for EIT)			
Professional fees	42.0%	1.0%	1.0%
Salaries of the Company s senior officers	40.8%	1.3%	1.4%
Class action settlement	87.7%		
Depreciation	32.7%	0.9%	0.3%
Revenue sharing expenses		0.5%	0.8%
Issuance cost of convertible notes		0.3%	0.6%
Advertising	9.8%		
Technical services	13.0%		
Traveling expenses		0.1%	0.1%
Share compensation costs	9.0%		
Other	14.7%	2.0%	1.1%
Effect of lower tax rate applicable to new and high technology enterprises	(168.9)%	(19.8)%	(9.4)%
Effect of tax holidays applicable to new and high technology enterprises	(140.8)%	(8.3)%	(20.7)%
Additional (reversal of) valuation allowance on tax loss carryforwards	9.8%	(4.9)%	(2.1)%
Effective EIT rate	(17.2)%	6.1%	6.1%

As of December 31, 2003 and 2004, the tax impact of significant temporary differences between the tax and financial statement bases of assets and liabilities that gave rise to deferred tax assets were principally related to the following:

	December 31, 2003	December 31, 2004
	RMB	RMB
Loss carryforwards	9,669,543	
Valuation allowance		

Net deferred tax assets		
- current	9,669,543	
- non-current		

The loss carryforwards were fully utilized during the year ended December 31, 2004.

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10. Taxation (Cont d)

(b) Business tax (BT) and cultural development fee

The Group is subject to BT on the provision of taxable services in China, transfer of intangible assets and the sale of immovable properties in China. The tax rates range from 3% to 20% of the gross receipts, depending on the nature of the revenues. The applicable BT rate for the Group s revenues is generally 3% to 5%.

11. Taxes Payable

	December 31, 2003	December 31, 2004
	RMB	RMB
BT	4,440,053	29,494,102
Individual income taxes for employees	2,490,511	6,252,987
Enterprise income taxes	7,610,123	6,211,894
Other	1,435,655	2,050,359
	15,976,342	44,009,342

12. Accrued Liabilities

	December 31, 2003	December 31, 2004
	RMB	RMB
Advertising expenses	669,935	5,878,580
Content fees	610,889	975,443
Professional fees	5,748,950	5,508,539
Server custody fees	715,131	2,072,696
Interest on convertible notes		2,977,272
Accrued revenue sharing		4,616,072
Other	3,953,856	933,259
	11,698,761	22,961,861

13. Deferred revenue

Deferred revenue represents sales proceeds from prepaid debit point cards sold and prepaid subscription fees for Internet value-added services for which services are yet to be provided as of the balance sheet dates.

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14. Zero Coupon Convertible Subordinated Notes

The Company issued and sold US$75 million and US$25 million aggregate principal amounts of Zero Coupon Convertible Subordinated Notes due July 15, 2023 on July 14, 2003 and on July 31, 2003, respectively, in private offerings. The notes are general unsecured obligations of the Company and are subordinated to any existing or future senior indebtedness of the Company. The notes do not pay any interest except in limited circumstances, have a zero yield to maturity and are convertible into the Company s ordinary shares at a conversion price of US$0.4815 per ordinary share, subject to adjustments and upon the occurrence of certain other events. Holders of notes may require the Company to repurchase all or a portion of their notes for cash on July 15, 2006, July 15, 2007, July 15, 2008, July 15, 2013 and July 15, 2018, at a price equal to 100% of the principal amount of the notes, together with accrued and unpaid interest, if any, subject to certain conditions. On or after July 15, 2008, the Company may redeem for cash all or part of the notes at a price equal to 100% of the principal amount, together with accrued and unpaid interest, if any, subject to certain conditions.

15. Capital Structure

(a) Ordinary shares

The holders of ordinary shares in the Company are entitled to one vote per share and to receive ratably such dividends, if any, as may be declared by the board of directors of the Company. In the event of liquidation, the holders of ordinary shares are entitled to share ratably in all assets remaining after payment of liabilities. The ordinary shares have no preemptive, conversion, or other subscription rights.

On March 23, 2001, the Company entered into an agreement whereby the Company acquired certain software for online games, computers and the related intellectual property rights for cash consideration of US$0.2 million from a private technology company. In addition, the Company agreed to issue 7,742,168 ordinary shares in the Company to the founders of the private technology company by installments on a quarterly basis starting from June 23, 2001 through March 23, 2003 for the service to be provided by such individuals as employees of the Company over such period. The total estimated fair value of these shares of approximately RMB0.8 million, valued at US$0.0125 per share at the date of agreement, was recognized as deferred compensation, which was to be amortized over the related vesting period. During the years ended December 31, 2002 and 2003, the Company issued 3,636,377 shares and 853,952 shares, respectively, to the founders of the private technology company for their service as employees as described above.

According to an agreement dated September 11, 2001 between the Company and a senior officer of the Company, the Company provided the officer with 25,000,000 ordinary shares by quarterly installments over a period of 18 months. As a result, deferred compensation cost of approximately RMB1.3 million was recorded in 2001 and the amount was amortized over the related vesting period of 18 months.

In addition, the Company provided two newly hired members of senior management of the Company with 12,322,868 ordinary shares in the Company over a period of 7 months in 2002. The total estimated fair value of those shares of RMB0.7 million (valued at US$0.006492 per share) at the date of the agreement was recognized as deferred compensation and was amortized over the related vesting periods.

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15. Capital Structure (Cont d)

(b) Convertible preference shares

Series B preference shares

On March 23, 2000, the Company entered into a Series B Preference Shares Purchase Agreement pursuant to which the Company issued 2,560,556 Series B preference shares of US$0.01 each at an issuance price of US$15.60 per share for a total consideration of approximately US$40.0 million, of which US$35.0 million was paid up in cash and US$5.0 million was paid up by advertising to be provided by the shareholder of the Series B preference shares and its affiliated companies on their television channels over a period of three years.

The Series B preference shares were convertible on a basis of 100 ordinary shares for one preference share. These preference shares had an aggregate liquidation preference equal to the total consideration for which they were issued. They carried certain preferences on dividend payment and return of capital in case of a winding up of the Company. These preference shares were automatically converted upon closing of the initial public offering of the ordinary shares in the Company in 2000.

In March 2000, the Company also entered into a strategic co-operation agreement with the shareholder of its Series B preference shares which provided for, among other things, advertising spending of US$5.0 million on NetEase websites from the shareholder over the next three years, cross licensing of Internet tools and technologies, licensing of content information, and other co-operative marketing and promotional events on commercial terms to be agreed between the two parties. Subsequently, in March 2003, the Company entered into a supplemental agreement with the shareholder such that the shareholder was obligated to spend the then remaining advertising spending of US$4.0 million on NetEase websites by March 28, 2004. All other aspects of the strategic co-operation agreement were terminated in March 2003.

The effect of the issuance of Series B preference shares together with the strategic co-operation agreement with the same shareholder is similar to an issuance of shares to the shareholder for cash consideration of US$40.0 million (with US$35.0 million receivable immediately and US$5.0 million receivable over a period of three years from March 2000) and having a barter transaction for advertising between the Company and the shareholder. The accounting for these two transactions in the consolidated financial statements reflects this effect.

On July 4, 2003, the Company entered into an agreement with the shareholder to repurchase 27,142,000 ordinary shares in the Company held by the shareholder. Under the agreement, the Group paid the shareholder a net aggregate amount of approximately US$4.6 million and the obligation of the shareholder to make advertising spending on the NetEase websites described above was waived. As a result of such transaction, the subscriptions receivable from the shareholder were effectively collected and the respective additional paid-in capital was reduced. Moreover, in accordance with the agreement, the Group was entitled to use approximately US$2.0 million worth of advertising on certain media properties of the shareholder at no additional cost until March 28, 2004 or such other date as the parties shall agree. On July 28, 2003, the parties agreed to extend the date from March 28, 2004 to June 30, 2004. The amount had been fully used by the Company.

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16. Stock Options

(a) Stock option plans

In December 1999, the Company adopted an incentive and non-statutory stock option plan for the Company s directors, senior management, employees and consultants (the 1999 Stock Option Plan). The Company had reserved 345,675,000 ordinary shares for issuance under the plan.

According to a resolution of the board of directors of the Company in 2000, the 1999 Stock Option Plan was replaced by the 2000 Stock Option Plan.

According to resolutions of the board of directors and the shareholders of the Company in 2001, the 2000 stock option plan was amended and restated. Under the amended plan, the number of ordinary shares available for issuance was increased from 223,715,000 under the prior plan to 323,715,000. The amended plan also included a mechanism for the automatic increase in the number of ordinary shares available for future issuance. This mechanism, which is known as Evergreen Provision , provided for a periodic increase so that the number of ordinary shares available under the plan would automatically increase by 3% each year up to a maximum at any given time of 17.5% of the Company s total outstanding ordinary shares, on a fully-diluted basis. These increases would occur on June 1 of 2001 and January 1 of each year thereafter. The Evergreen Provision has been suspended pursuant to a resolution of the board of directors dated March 25, 2002.

(b) Deferred compensation costs

In 2004, RMB0.1 million (2002: RMB2.1 million; 2003: RMB0.2 million) of the deferred compensation costs were amortized and charged to expense and RMB nil (2002: RMB0.1 million; 2003: RMB0.1 million) of the deferred compensation costs were reversed against the additional paid in capital as a result of the resignation of employees, senior management, consultants and advisory board members.

The following table presents a summary of the Company s stock options outstanding at and stock option activities during the years ended December 31, 2002, 2003 and 2004.

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16. Stock Options (Cont d)

(a) Stock option plans (cont d)

	Employees	Senior Management	Director and consultants	Advisory Board	Total	Weighted average exercise price
						US$
Number of ordinary shares issuable upon exercise of stock options						
Outstanding at January 1, 2002	41,743,000	91,787,000	1,900,000	1,000,000	136,430,000	0.074
Granted during the year	51,510,000	59,000,000			110,510,000	0.008
Exercised during the year	(6,241,200)	(42,536,900)			(48,778,100)	0.010
Cancelled during the year	(11,635,000)	(59,250,100)		(1,000,000)	(71,885,100)	0.096
Outstanding at December 31, 2002	75,376,800	49,000,000	1,900,000		126,276,800	0.028
Outstanding at January 1, 2003	75,376,800	49,000,000	1,900,000		126,276,800	0.028
Granted during the year	62,750,000	47,200,000	1,450,000		111,400,000	0.128
Exercised during the year	(32,783,700)	(19,200,000)	(600,000)		(52,583,700)	0.035
Cancelled during the year	(7,924,800)	(7,000,000)			(14,924,800)	0.026
Outstanding at December 31, 2003	97,418,300	70,000,000	2,750,000		170,168,300	0.092
Outstanding at January 1, 2004	97,418,300	70,000,000	2,750,000		170,168,300	0.092
Granted during the year	118,088,000	58,400,000			176,488,000	0.300
Exercised during the year	(33,796,500)	(20,500,000)	(912,500)		(55,209,000)	0.067
Cancelled during the year	(8,529,300)	(5,400,000)			(13,929,300)	0.144
Outstanding at December 31, 2004	173,180,500	102,500,000	1,837,500		277,518,000	0.226

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16. Stock Options (Cont d)

(a) Stock option plans (cont d)

As of December 31, 2004, options to purchase 14,340,100 ordinary shares were exercisable. Under the stock option plans, options to purchase 71,913,124 ordinary shares were available for future grant. Prior to the Company s Initial public offering in 2000, the fair value of ordinary shares on the dates of stock option grants was determined by management based on the recent issuance of preference shares and consideration of significant milestones achieved by the Group and other market considerations. After such initial public offering, the fair value was determined based on the market price of the Company s shares on the Nasdaq National Markets. Options outstanding and exercisable by price range as of December 31, 2004 were as follows:

		Options Outstanding at December 31, 2004			Options Exercisable at December 31, 2004	
Exercise Price		**Number Outstanding**	**Weighted Average Remaining Contractual Life**	**Weighted Average Exercise Price**	**Number Exercisable**	**Weighted Average Exercise Price**
			Years	**US$**		**US$**
US$0.007	US$0.009	14,852,000	2.09	0.007	2,696,000	0.007
US$0.012	US$0.015	2,716,000	3.49	0.015	1,100,000	0.015
US$0.021		1,240,000	2.41	0.021	240,000	0.021
US$0.022		3,552,400	2.08	0.022	578,000	0.022
US$0.070	US$0.075	2,000,000	1.67	0.075	2,000,000	0.075
US$0.100		1,154,000	1.14	0.100	1,094,000	0.100
US$0.102		7,500	3.17	0.102		
US$0.110		69,443,600	3.17	0.110	6,376,100	0.110
US$0.122		7,500	3.17	0.122		
US$0.135		345,000	3.21	0.135		
US$0.155	US$0.156	156,000	1.37	0.156	156,000	0.156
US$0.254		7,500,000	3.33	0.254		
US$0.300		170,394,000	4.71	0.300		
US$0.320		3,000,000	4.63	0.320		
US$0.406		750,000	3.88	0.406		
US$0.679		400,000	3.75	0.679	100,000	0.679
		277,518,000	4.05	0.226	14,340,100	0.085

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16. Stock Options (Cont d)

(a) Stock option plans (cont d)

For the purposes of SFAS No.123 pro forma disclosures, the estimated fair value of each senior management or employee option grant is estimated on the date of grant using the Black-Scholes option pricing method with the following assumptions:

	For the year ended December 31,		
	2002	**2003**	**2004**
Risk free interest rate	2.91%	2.79%	3.45%
Expected life (in years)	5	5	5
Expected dividend yield	0%	0%	0%
Volatility	104% -108%	103% -111%	98% -99%
Weighted average estimated fair value of the underlying shares on the date of option grants (US$)	0.008	0.128	0.300

17. Earnings Per Share

The following table sets forth the computation of basic and diluted net earnings per share for the years ended December 31, 2002, 2003 and 2004:

	For the year ended December 31,		
	2002	**2003**	**2004**
Numerator:			
Net profit attributable to ordinary shareholders	16,301,638	322,872,724	441,420,682
Denominator:			
Weighted average number of ordinary shares outstanding, basic	3,051,395,100	3,122,257,952	3,157,841,781
Dilutive effect of employee stock options and convertible notes	76,442,800	231,401,377	333,588,656
Weighted average number of ordinary shares outstanding, diluted	3,127,837,900	3,353,659,329	3,491,430,437
Anti-dilutive effect of stock options	24,972,000	1,400,000	
Net earnings per share, basic	RMB 0.01	RMB 0.10	RMB 0.14
Net earnings per share, diluted	RMB 0.01	RMB 0.10	RMB 0.13

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18. Commitments and Contingencies

(a) Commitments

As of December 31, 2004, future minimum lease and capital commitments were as follows:

	Rental commitments	Server custody fee commitments	Capital commitments	Total
2005	9,358,964	15,756,227	7,737,102	32,852,293
2006	5,437,439	707,767		6,145,206
2007	428,176	140,500		568,676
Beyond 2007				
	15,224,579	16,604,494	7,737,102	39,566,175

In the years ended December 31, 2002, 2003 and 2004, the Company incurred rental expenses in the amounts of approximately RMB7.4 million, RMB6.7 million and RMB8.4 million, respectively. Capital commitments as at December 31, 2004 represented capital commitments contracted but not provided for in the financial statements.

(b) Litigation

Copyright Infringement Lawsuit

In January 2003, Guangzhou NetEase was named in a copyright infringement lawsuit in China in which the plaintiffs claimed damages of US$1.0 million. In December 2004, Guangzhou NetEase received notice from the relevant court advising it that the plaintiff had withdrawn the litigation and that the withdrawal had been approved by the court with all related court charges being borne by the plaintiff.

Wells Notice

As previously disclosed by the Company, the staff of the U.S. Securities and Exchange Commission (SEC) has been conducting an investigation related to the Company s restatement of its financial statements for the year ended December 31, 2000. The Company subsequently announced that it received a Wells notice from the SEC staff on March 15, 2004, which states that the staff intends to recommend that the SEC bring a civil injunctive action against the Company for alleged violations of the federal securities laws, which action the Company believes will be in connection with the circumstances relating to the restatement. The Company is still in discussions with the SEC.

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19. Segment Information

In the third quarter of 2003, the Group changed the manner of reporting internal departmental information. Accordingly, the Group has restated its 2002 segment disclosures to conform with the change in segments that occurred in the third quarter of 2003. The following are the breakdowns of revenue for the years ended December 31, 2002, 2003 and 2004 and cost of revenue for the years ended December 31, 2002, 2003 and 2004. The Group does not allocate any operating costs or assets to its business segments as management does not use this information to measure the performance of the operating segments.

The Group s total revenues as previously reported in its financial statements for the years ended December 31, 2002 and 2003 (prior to the adoption of FIN 46 and consolidation of VIEs) is equivalent to the Group s total net revenues as reported in its financial statements for the year ended December 31, 2004 (after the adoption of FIN 46 and consolidation of the VIEs prospectively). Both total revenues in 2002 and 2003 and total net revenues in 2004 represent gross revenue receivable from final customers, net of business tax payable by the VIEs.

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19. Segment Information (Cont d)

	For the year ended December 31,		
	2002	2003	2004
	RMB	RMB	RMB
Total revenues:			
Online game services	37,053,414	203,246,114	628,936,223
Advertising services	34,209,376	86,183,733	171,054,305
Wireless value-added and other fee-based premium services	161,305,678	279,659,170	158,310,317
Total revenues	232,568,468	569,089,017	958,300,845
Business tax (Note a):			
Online game services	(1,852,671)	(10,162,395)	(34,591,492)
Advertising services	(1,710,469)	(2,809,238)	(14,539,615)
Wireless value-added and other fee-based premium services	(8,064,076)	(13,982,869)	(5,571,911)
Total sales taxes	(11,627,216)	(26,954,502)	(54,703,018)
Net revenues:			
Online game services	35,200,743	193,083,719	594,344,731
Advertising services	32,498,907	83,374,495	156,514,690
Wireless value-added and other fee-based premium services	153,241,602	265,676,301	152,738,406
Total net revenues	220,941,252	542,134,515	903,597,827
Cost of revenues:			
Online game services	(15,530,501)	(20,873,502)	(74,629,515)
Advertising services	(26,622,426)	(27,623,438)	(54,056,435)
Wireless value-added and other fee-based premium services	(29,524,647)	(36,965,777)	(55,117,445)
Total cost of revenues	(71,677,574)	(85,462,717)	(183,803,395)
Gross profit:			
Online game services	19,670,242	172,210,217	519,715,216
Advertising services	5,876,481	55,751,057	102,458,255
Wireless value-added and other fee-based premium services	123,716,955	228,710,524	97,620,961
Total gross profit	149,263,678	456,671,798	719,794,432
Share compensation cost included in cost of revenue by segments:			
Online game services			
Advertising services			
Wireless value-added and other fee-based premium services	1,908,125		
	1,908,125		

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19. Segment Information (Cont d)

Note a: The Company adopted the provisions of FIN 46 and consolidated its VIEs on a prospective basis in the Company s consolidated financial statements since January 1, 2004. The Company and its subsidiaries are effectively providing their services to the final customers via the VIEs in order to comply with the current Chinese regulatory requirements. Under the series of agreements entered with the VIEs, substantially all of the revenue of the VIEs, net of the applicable business tax payable by the VIEs, are passed to the Company and its subsidiaries in form of technology and consulting service revenues. Prior to the consolidation of the VIEs in accordance with FIN 46, revenues in the Company s financial statements represented revenues received by the Company and its subsidiaries from Guangzhou NetEase and Guangyitong Advertising, net of applicable business tax payable (Note I) by these entities. The business tax presented in the Company s financial statements represented business tax payable by the Company and its subsidiaries on their technology and consulting service revenues received from Guangzhou NetEase and Guangyitong Advertising. After the consolidation of the VIEs in accordance with FIN 46, revenues in the Company s financial statements represent revenues generated from the final customers by the VIEs, before deducting any applicable business tax payable by the VIEs which is now presented under a separate line item after revenues. The business tax payable (Note II) by the Company and its subsidiaries on intra-group revenues from the VIEs is recorded under cost of revenue as it is considered a cost in providing the services by the consolidated group.

Note I: The business tax payable by Guangzhou NetEase and Guangyitong Advertising, which was netted against revenues in the Company s financial statements for the years ended December 31, 2002 and 2003 (in which Guangzhou NetEase and Guangyitong Advertising were not consolidated) amounted to RMB14,623,491 and RMB30,036,513, respectively, segmentally analyzed as below:

	2002	2003
	RMB	RMB
Business tax:		
Online game services	(2,156,548)	(11,829,265)
Advertising services	(3,177,920)	(8,045,323)
Wireless value-added and other fee-based premium services	(9,289,023)	(10,161,925)
	(14,623,491)	(30,036,513)

Note II: In addition, the business tax payable by the Company and its subsidiaries on intra-group revenues from the VIEs for the year ended December 31, 2004 amounted to RMB43,833,162, segmentally analyzed as below:

	2004
	RMB
Business tax:	
Online game services	(29,717,237)
Advertising services	(7,118,999)
Wireless value-added and other fee-based premium services	(6,996,926)
	(43,833,162)

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FINANCIAL STATEMENTS SCHEDULE I

CONDENSED FINANCIAL INFORMATION OF NETEASE.COM, INC.

Condensed Balance Sheets

	December 31, 2003	December 31, 2004	December 31, 2004
	RMB	RMB	US$
Assets			
Current assets:			
Cash	828,992,541	1,009,444,911	121,965,192
Held-to-maturity investments	332,093,546	165,532,000	20,000,242
Prepayments and other current assets	9,024,491	9,787,195	1,182,528
Total current assets	1,170,110,578	1,184,764,106	143,147,962
Non-current assets:			
Investment in subsidiaries	540,769,793	1,009,839,517	122,012,870
Deferred assets	12,086,693	4,246,624	513,094
Total assets	1,722,967,064	2,198,850,247	265,673,926
Liabilities and Shareholders Equity			
Current liabilities:			
Accounts payable and other liabilities	3,638,388	5,165,366	624,101
Salary and welfare payable	4,059,708	4,830,836	583,681
Taxes payable	760,040	253,911	30,679
Accrued liabilities	5,814,513	7,704,614	930,902
Total current liabilities	14,272,649	17,954,727	2,169,363
Long-term payable:			
Zero Coupon Convertible Subordinated Notes due July 15, 2023	827,670,000	827,650,000	100,000,000
Total long-term liabilities	827,670,000	827,650,000	100,000,000
Total liabilities	841,942,649	845,604,727	102,169,363
Shareholders equity:			
Ordinary shares, US$0.0001 par value: 1,000,300,000,000 shares authorized, 3,128,958,189 shares issued and outstanding as of December 31, 2003 and 3,184,167,189 shares issued and outstanding as of December 31, 2004	2,589,756	2,635,419	318,422
Additional paid-in capital	993,254,740	1,023,954,160	123,718,258
Less: Subscriptions receivable			
Deferred compensation	(69,175)	(13,835)	(1,672)
Translation adjustments	210,838	210,838	25,474

Retained earnings/(Accumulated deficit)	(114,961,744)	326,458,938	39,444,081
Total shareholders equity	881,024,415	1,353,245,520	163,504,563
Total liabilities and shareholders equity	1,722,967,064	2,198,850,247	265,673,926

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FINANCIAL STATEMENTS SCHEDULE I

CONDENSED FINANCIAL INFORMATION OF NETEASE.COM, INC.

Condensed Statements of Operations

	For the year ended December 31,			
	2002	2003	2004	2004
	RMB	RMB	RMB	US$
Net revenues				
Cost of revenues				
Gross profit				
Operating expenses:				
Selling, general and administrative expenses	(39,732,955)	(31,598,423)	(37,089,290)	(4,481,276)
Research and development expenses	(773,660)	(336,530)	(82,107)	(9,920)
Class action settlement	(36,005,385)		16,553,200	2,000,024
Total operating expenses	(76,512,000)	(31,934,953)	(20,618,197)	(2,491,172)
Operating loss	(76,512,000)	(31,934,953)	(20,618,197)	(2,491,172)
Equity in profit of subsidiary companies, net	86,336,353	341,572,867	451,254,979	54,522,441
Other income:				
Investment income		538,278	3,480,168	420,488
Interest income	6,477,285	6,979,497	7,303,732	882,466
Other, net		5,717,035		
Profit before tax	16,301,638	322,872,724	441,420,682	53,334,223
Income tax expense				
Net profit	16,301,638	322,872,724	441,420,682	53,334,223

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FINANCIAL STATEMENTS SCHEDULE I

CONDENSED FINANCIAL INFORMATION OF NETEASE.COM, INC.

Condensed Statements of Cash Flows

	For the year ended December 31,			
	2002	2003	2004	2004
	RMB	RMB	RMB	US$
Net cash used in operating activities	(162,105,740)	(4,468,154)	(16,854,258)	(2,036,400)
Cash flows from investing activities				
Decrease (Increase) in held-to-maturity investments		(332,093,546)	166,561,546	20,124,636
Net cash provided by (used in) investing activities		(332,093,546)	166,561,546	20,124,636
Cash flows from financing activities:				
Proceeds from issuance of ordinary shares upon exercise of employee stock options	3,887,419	15,064,146	30,745,083	3,714,745
Collection of subscriptions receivable for Series B preference shares issued in 2000 and collection of outstanding subscriptions receivable	1,986,720			
Re-purchase of ordinary shares		(38,157,537)		
Proceeds from issuance of Zero Coupon Convertible Subordinated Notes		827,670,000		
Payment for issuance cost of convertible notes		(23,437,986)		
Net cash provided by financing activities	5,874,139	781,138,623	30,745,083	3,714,745
Effect of exchange rate changes on cash	11,583	(18,072)		
Net increase (decrease) in cash	(156,220,018)	444,558,851	180,452,371	21,802,981
Cash, beginning of the year	540,653,708	384,433,690	828,992,540	100,162,211
Cash, end of the year	384,433,690	828,992,541	1,009,444,911	121,965,192

FINANCIAL STATEMENTS SCHEDULE I

CONDENSED FINANCIAL INFORMATION OF NETEASE.COM, INC.

Notes to the Condensed Financial Statements

(Amounts expressed in Renminbi (RMB), unless otherwise stated)

The condensed financial statements of NetEase.com, Inc. (the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America except for accounting of the Company s subsidiaries and certain footnote disclosures as described below.

The Company records its investment in its Subsidiaries under the equity method of accounting as prescribed in APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock . Such investment is presented on the balance sheet as Investment in subsidiaries and 100% of the profit or loss of the Subsidiaries as Equity in profit (loss) of subsidiary companies on the statement of operations and comprehensive income.

The Subsidiaries did not pay any dividend to the Company for the years presented.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. The footnote disclosures contain supplemental information relating to the operations of the Company and, as such, these statements should be read in conjunction with the notes to the consolidated financial statements of the Company.

The Company did not have any significant commitment as at December 31, 2003 and 2004.

The United States dollar (US$) amounts disclosed in the financial statements are presented solely for the convenience of the readers. Translations of amounts from RMB into United States dollars for the convenience of the reader were calculated at the noon buying rate of US$1.00 = RMB8.2765 on December 31, 2004 in The City of New York for the cable transfers of RMB as certified for customs purposes by the Federal Reserve Bank of New York. No representation is made that the RMB amounts could have been, or could be, converted into US$ at that rate on December 31, 2004, or at any other certain date.

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CORPORATE INFORMATION

Management Team

Ted Sun

Acting Chief Executive Officer

Denny Lee

Chief Financial Officer

Michael Tong

Chief Operating Officer

Wendy Foo

Senior Vice President, Sales and Marketing

Janelle Wu

Senior Vice President, Technology and Products

Zhan Zhonghui

Senior Vice President, Online Game Business Department

Board of Directors

William Ding

Founder and Chief Architect

NetEase.com, Inc.

Ted Sun

Acting Chief Executive Officer

NetEase.com, Inc.

Denny Lee

Chief Financial Officer

NetEase.com, Inc.

Michael Tong

Chief Operating Officer

NetEase.com, Inc.

Ronald Lee

Co-Founder and Managing Director

BEENET

Donghua Ding*

Former Director and Chief Financial Officer

China Mobile (Hong Kong) Limited

Michael Leung*

Director

AR Evans Capital Limited

Joseph Tong*

Management Consultant

Parworld Investment Management Limited

* Member of audit committee

Corporate Headquarters

2/F, Tower B, Keeven International Research & Development Centre

No. 43 West Road North Third Ring Road

Haidian District

Beijing 100086, People s Republic of China

Shanghai Office

10/F Shanghai Real Estate Mansion

9 Dong Hu Road

Shanghai 200031, People s Republic of China

Guangzhou Office

36/F Peace World Plaza

362-366 Huan Shi Dong Road

Guangzhou 510060, People s Republic of China

Nasdaq Symbol: NTES

(American Depositary Shares, each of which represents 100 of our ordinary shares, trade on the Nasdaq National Market)

Independent Registered Public Accounting Firm

PricewaterhouseCoopers Zhong Tian CPAs Limited Company

18th Floor, North Tower, Beijing Kerry Centre

1 Guang Hua Lu, Chao Yang District

Beijing 100020, People s Republic of China

Legal Counsel

Morrison & Foerster

21/F, Entertainment Building

30 Queen s Road Central

Hong Kong

Table of Contents

Transfer Agent

The Bank of New York

101 Barclay Street

New York, NY 10286

USA

Investor Relations

Olive Wang

owang@corp.netease.com

(+8610) 8518 0163 x 8243

Investor Relations Website

http://corp.netease.com