

NetEase, Inc.  
Form 20-F  
April 22, 2013  
Table of Contents

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

---

**FORM 20-F**

---

(Mark One)

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

**OR**

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

**OR**

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

**OR**

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

Date of event requiring this shell company report . . . . .

Commission file number : 000-30666

Edgar Filing: NetEase, Inc. - Form 20-F

**NETEASE, INC.**

(Exact name of Registrant as specified in its charter)

**N/A**

(Translation of Registrant's name into English)

**Cayman Islands**

(Jurisdiction of incorporation or organization)

**26/F, SP Tower D**

**Tsinghua Science Park Building 8**

**No. 1 Zhongguancun East Road, Haidian District**

**Beijing 100084, People's Republic of China**

(Address of principal executive offices)

**Onward Choi**

**26/F, SP Tower D**

**Tsinghua Science Park Building 8**

**No. 1 Zhongguancun East Road, Haidian District**

**Beijing 100084, People's Republic of China**

**Phone (86 10) 8255-8163**

**Facsimile (86 10) 8261 8627**

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

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

**American Depositary Shares, each representing 25 ordinary shares, par value US\$0.0001 per share,**

**NASDAQ Global Select Market**

(Title of Each Class and Name of Each Exchange on Which Registered)

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

**NONE**

(Title of Class)

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

**NONE**  
(Title of Class)

---

# Edgar Filing: NetEase, Inc. - Form 20-F

## Table of Contents

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

3,246,041,681 ordinary shares, par value US\$0.0001 per share.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or (15) (d) of the Securities Exchange Act of 1934.

Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

U.S. GAAP

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

Other

Edgar Filing: NetEase, Inc. - Form 20-F

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

Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

(APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PAST FIVE YEARS)

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

Yes  No

---

Table of Contents

**TABLE OF CONTENTS**

|                            |   |    |
|----------------------------|---|----|
| <b><u>INTRODUCTION</u></b> |   | 1  |
| <b><u>PART I</u></b>       |   | 2  |
| <u>Item 1.</u>             | <u>Identity of Directors, Senior Management and Advisers</u>                        | 2  |
| <u>Item 2.</u>             | <u>Offer Statistics and Expected Timetable</u>                                      | 2  |
| <u>Item 3.</u>             | <u>Key Information</u>  | 2  |
| <u>Item 4.</u>             | <u>Information on the Company</u>   | 25 |
| <u>Item 4A.</u>            | <u>Unresolved Staff Comments</u>  | 45 |
| <u>Item 5.</u>             | <u>Operating and Financial Review and Prospects</u>                                 | 45 |
| <u>Item 6.</u>             | <u>Directors, Senior Management and Employees</u>                                   | 68 |
| <u>Item 7.</u>             | <u>Major Shareholders and Related Party Transactions</u>                            | 76 |
| <u>Item 8.</u>             | <u>Financial Information</u>  | 78 |
| <u>Item 9.</u>             | <u>The Offer and Listing</u>  | 79 |
| <u>Item 10.</u>            | <u>Additional Information</u>   | 80 |
| <u>Item 11.</u>            | <u>Quantitative and Qualitative Disclosures About Market Risk</u>                   | 89 |
| <u>Item 12.</u>            | <u>Description of Securities Other than Equity Securities</u>                       | 89 |
| <b><u>PART II</u></b>      |   | 91 |
| <u>Item 13.</u>            | <u>Defaults, Dividend Arrearages and Delinquencies</u>                              | 91 |
| <u>Item 14.</u>            | <u>Material Modifications to the Rights of Security Holders and Use of Proceeds</u> | 91 |
| <u>Item 15.</u>            | <u>Controls and Procedures</u>  | 91 |
| <u>Item 16A.</u>           | <u>Audit Committee Financial Expert</u>   | 91 |
| <u>Item 16B.</u>           | <u>Code of Ethics</u>   | 91 |
| <u>Item 16C.</u>           | <u>Principal Accountant Fees and Services</u>                                       | 91 |
| <u>Item 16D.</u>           | <u>Exemptions from the Listing Standards for Audit Committees</u>                   | 92 |
| <u>Item 16E.</u>           | <u>Purchases of Equity Securities by the Issuer and Affiliated Purchasers</u>       | 92 |
| <u>Item 16F.</u>           | <u>Change in Registrants – Certifying Accountant</u>                                | 92 |
| <u>Item 16G.</u>           | <u>Corporate Governance</u>   | 93 |
| <u>Item 16H.</u>           | <u>Mine Safety Disclosure</u>   | 93 |
| <b><u>PART III</u></b>     |   | 94 |
| <u>Item 17.</u>            | <u>Financial Statements</u>   | 94 |
| <u>Item 18.</u>            | <u>Financial Statements</u>   | 94 |
| <u>Item 19.</u>            | <u>Exhibits</u>   | 94 |

Table of Contents

**INTRODUCTION**

This annual report on Form 20-F includes our audited consolidated financial statements as of December 31, 2011 and 2012 and for the years ended December 31, 2010, 2011 and 2012.

**Forward-Looking Information**

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

- the risk that the online game market will not continue to grow or that we will not be able to maintain our leading position in that market, which could occur if, for example, our new online games do not become as popular as management anticipates;
- the risk that we will not be successful in our product diversification efforts, including our focus on item- and fee-based games and entry into strategic licensing arrangements;
- the risk of changes in Chinese government regulation of the online game market that limit future growth of our revenue or causes revenue to decline;
- the risk that we may not be able to continuously develop new and creative online services or that we will not be able to set, or follow in a timely manner, trends in the market;
- the risk that the Internet advertising market in China will not continue to grow and will remain subject to intense competition;
- the risk that we will not be able to control our expenses in future periods;

## Edgar Filing: NetEase, Inc. - Form 20-F

- the impact of any future public health problem in China, including avian influenza, severe acute respiratory syndrome, or SARS, or Influenza A (H1N1), or H1N1;
- governmental uncertainties (including possible changes in the effective tax rates applicable to NetEase and its subsidiaries and affiliates), general competition and price pressures in the marketplace;
- the risk that fluctuations in the value of the Renminbi with respect to other currencies could adversely affect our business and financial results;
- the risk that current or future appointees to management are not effective in their respective positions; and
- other risks outlined in our filings with the Securities and Exchange Commission, or the SEC.

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



Table of Contents**PART I****Item 1. Identity of Directors, Senior Management and Advisers**

Not applicable.

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

Not applicable.

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

The following table presents the selected consolidated financial information for our business. You should read the following information in conjunction with Item 5 Operating and Financial Review and Prospects below. The following data for the years ended December 31, 2010, 2011 and 2012 and as of December 31, 2011 and 2012 have been derived from our audited consolidated financial statements for those years, which were prepared in accordance with generally accepted accounting principles in the United States, or U.S. GAAP, and should be read in conjunction with those statements, which are included in this annual report beginning on page F-1. The following data for the years ended December 31, 2008 and 2009 and as of December 31, 2009 and 2010 have been derived from our audited consolidated financial statements for those years, which were prepared in accordance with U.S. GAAP and are not included in this annual report. The following data as of December 31, 2008 were derived from our unaudited consolidated financial statements for that year (which are unaudited as they have been revised from previously issued audited financial statements to reflect the reclassification of certain facility costs to better reflect staff-related operating cost), which were prepared in accordance with U.S. GAAP and are not included in this annual report.

|  | 2008                                      | 2009      | For the year ended December 31, |           | 2012      | 2012          |
|--|---|-----------|---------------------------------|-----------|-----------|---------------|
|  | RMB                                       | RMB       | 2010                            | 2011      | RMB       | US\$ (Note 1) |
|  |   |           | RMB                             | RMB       |           |               |
|  | (in thousands, except per share/ADS data) |           |                                 |           |           |               |
| <b>Statement of Operations Data:</b>             |   |           |                                 |           |           |               |
| Revenues:  |   |           |                                 |           |           |               |
| Online game services                             | 2,498,518                                 | 3,368,689 | 4,944,439                       | 6,552,431 | 7,287,063 | 1,169,654     |
| Advertising services                             | 405,887                                   | 383,560   | 633,209                         | 795,422   | 850,157   | 136,460       |
| E-mail, wireless value-added services and others | 71,719                                    | 71,202    | 82,141                          | 124,898   | 242,741   | 38,963        |
|  | 2,976,124                                 | 3,823,451 | 5,659,789                       | 7,472,751 | 8,379,961 | 1,345,077     |

Edgar Filing: NetEase, Inc. - Form 20-F

|  |           |           |             |             |             |           |
|--|-----------|-----------|-------------|-------------|-------------|-----------|
| Sales tax benefit (expense)  | 108,460   | (66,504)  | (152,120)   | (182,099)   | (179,005)   | (28,732)  |
| Net revenues   | 3,084,584 | 3,756,947 | 5,507,669   | 7,290,652   | 8,200,956   | 1,316,345 |
| Cost of revenues   | (578,690) | (972,374) | (1,798,841) | (2,372,288) | (2,578,067) | (413,808) |
| Gross profit   | 2,505,894 | 2,784,573 | 3,708,828   | 4,918,364   | 5,622,889   | 902,537   |
| Operating expenses:  |           |           |             |             |             |           |
| Selling and marketing expenses   | (232,487) | (351,661) | (656,976)   | (849,205)   | (906,707)   | (145,537) |
| General and administrative expenses  | (137,118) | (165,205) | (189,621)   | (280,227)   | (286,223)   | (45,942)  |
| Research and development expenses  | (221,726) | (244,272) | (317,929)   | (465,490)   | (718,315)   | (115,298) |
| Total operating expenses   | (591,331) | (761,138) | (1,164,526) | (1,594,922) | (1,911,245) | (306,777) |
| Operating profit   | 1,914,563 | 2,023,435 | 2,544,302   | 3,323,442   | 3,711,644   | 595,760   |
| Other income (expenses):   |           |           |             |             |             |           |
| Investment income  | 1,518     | 354       | 290         | 14,128      | 43,770      | 7,026     |
| Interest income  | 144,805   | 128,168   | 141,001     | 258,053     | 423,634     | 67,998    |
| Exchange (losses) gains  | (167,102) | 9,617     | (89,488)    | (79,058)    | (554)       | (89)      |
| Other, net   | 3,552     | (10,934)  | (19,634)    | 99,164      | 99,718      | 16,006    |
| Income before tax  | 1,897,336 | 2,150,640 | 2,576,471   | 3,615,729   | 4,278,212   | 686,701   |
| Income tax   | (300,673) | (313,861) | (344,446)   | (392,756)   | (691,642)   | (111,016) |
| Net income   | 1,596,663 | 1,836,779 | 2,232,025   | 3,222,973   | 3,586,570   | 575,685   |
| Add: Net loss attributable to noncontrolling interests                     |           |           |             |             |             |           |
|  | 25        | 13,657    | 3,747       | 11,291      | 50,882      | 8,167     |
| Net income attributable to NetEase, Inc. s shareholders                    | 1,596,688 | 1,850,436 | 2,235,772   | 3,234,264   | 3,637,452   | 583,852   |
| Comprehensive income   | 1,596,663 | 1,836,779 | 2,232,025   | 3,222,973   | 3,586,570   | 575,685   |
| Add: Comprehensive loss attributable to noncontrolling interests           |           |           |             |             |             |           |
|  | 25        | 13,657    | 3,747       | 11,291      | 50,882      | 8,167     |
| Comprehensive income attributable to NetEase, Inc. s shareholders          | 1,596,688 | 1,850,436 | 2,235,772   | 3,234,264   | 3,637,452   | 583,852   |
| Cash dividend per share  |           |           |             |             | 0.25        | 0.04      |
| Net income attributable to NetEase, Inc. s shareholders per share, basic   |           |           |             |             |             |           |
|  | 0.51      | 0.57      | 0.69        | 0.99        | 1.11        | 0.18      |
| Net income attributable to NetEase, Inc. s shareholders per share, diluted |           |           |             |             |             |           |
|  | 0.49      | 0.57      | 0.69        | 0.99        | 1.11        | 0.18      |
| Net income attributable to NetEase, Inc. s shareholders per ADS, basic     |           |           |             |             |             |           |
|  | 12.81     | 14.34     | 17.22       | 24.76       | 27.70       | 4.45      |
| Net income attributable to NetEase, Inc. s shareholders per ADS, diluted   |           |           |             |             |             |           |
|  | 12.34     | 14.24     | 17.14       | 24.68       | 27.65       | 4.44      |
| Weighted average number of ordinary shares outstanding, basic              |           |           |             |             |             |           |
|  | 3,117,117 | 3,225,250 | 3,246,426   | 3,265,550   | 3,282,663   | 3,282,663 |
| Weighted average number of ADS outstanding, basic                          |           |           |             |             |             |           |
|  | 124,685   | 129,010   | 129,857     | 130,622     | 131,307     | 131,307   |
| Weighted average number of ordinary shares outstanding, diluted            |           |           |             |             |             |           |
|  | 3,234,214 | 3,248,983 | 3,261,886   | 3,276,704   | 3,288,330   | 3,288,330 |
| Weighted average number of ADS outstanding, diluted                        |           |           |             |             |             |           |
|  | 129,369   | 129,959   | 130,475     | 131,068     | 131,533     | 131,533   |
| Share-based compensation cost included in:                                 |           |           |             |             |             |           |
| Cost of revenues   | 13,679    | 9,021     | 37,342      | 57,318      | 100,540     | 16,138    |
| Selling and marketing expenses   | 8,564     | 2,323     | 8,123       | 11,357      | 13,368      | 2,146     |
| General and administrative expenses  | 23,587    | 9,861     | 31,580      | 17,897      | 33,374      | 5,357     |

Edgar Filing: NetEase, Inc. - Form 20-F

|                                   |             |             |             |             |             |           |
|-----------------------------------|-------------|-------------|-------------|-------------|-------------|-----------|
| Research and development expenses | 22,119      | 10,180      | 25,361      | 35,460      | 55,736      | 8,946     |
|                                   | 67,949      | 31,385      | 102,406     | 122,032     | 203,018     | 32,587    |
| <b>Other Financial Data:</b>      |             |             |             |             |             |           |
| Capital expenditures              | 133,329     | 407,727     | 297,980     | 410,120     | 178,654     | 28,676    |
| Net cash provided by/(used in):   |             |             |             |             |             |           |
| Operating activities              | 2,017,799   | 2,094,495   | 2,854,954   | 4,072,948   | 4,224,290   | 678,044   |
| Investing activities              | (3,409,258) | (1,907,584) | (2,621,162) | (3,208,233) | (4,454,038) | (714,922) |
| Financing activities              | (157,293)   | 40,533      | 24,139      | 73,544      | (390,230)   | (62,636)  |

Table of Contents

|                                       | 2008      | 2009      | As of December 31, |            | 2012       | 2012          |  |
|---------------------------------------|-----------|-----------|--------------------|------------|------------|---------------|--|
|                                       | RMB       | RMB       | 2010               | 2011       | RMB        | US\$ (Note 1) |  |
|                                       |           |           | RMB                | RMB        |            |               |  |
|                                       |           |           | (in thousands)     |            |            |               |  |
| <b>Balance Sheet Data:</b>            |           |           |                    |            |            |               |  |
| Cash and cash equivalent              | 793,408   | 1,041,290 | 1,285,137          | 2,214,618  | 1,590,769  | 255,336       |  |
| Time deposits                         | 4,820,000 | 5,975,378 | 8,193,972          | 9,704,777  | 13,098,661 | 2,102,480     |  |
| Property, equipment and software, net | 258,788   | 557,756   | 755,778            | 848,469    | 815,026    | 130,821       |  |
| Total assets                          | 6,345,893 | 8,803,469 | 11,586,662         | 15,444,931 | 19,277,956 | 3,094,326     |  |
| Total current liabilities             | 829,048   | 1,377,925 | 1,828,227          | 2,282,577  | 3,576,502  | 574,068       |  |
| Total long-term liabilities           | 200       | 200       | 34,797             | 63,890     | 99,968     | 16,046        |  |
| Working capital (Note 2)              | 5,144,731 | 6,594,637 | 8,798,668          | 12,191,609 | 14,292,171 | 2,294,052     |  |
| Total shareholders' equity            | 5,516,645 | 7,425,344 | 9,723,638          | 13,098,464 | 15,601,486 | 2,504,212     |  |

Note 1: See the section titled "Exchange Rate Information" below.

Note 2: Working capital represents total current assets less total current liabilities.

**Exchange Rate Information**

We have published our financial statements in Renminbi, or RMB. Our business is currently conducted in and from China in Renminbi. In this annual report, all references to Renminbi and RMB are to the legal currency of China and all references to U.S. dollars, dollars, \$ and US\$ are to the legal currency of the United States. Translations in this annual report of amounts from RMB into U.S. dollars for the convenience of the reader were calculated at the noon buying rate of US\$1.00: RMB6.2301 on the last trading day of 2012 (December 31, 2012) as set forth in the H.10 statistical release of the U.S. Federal Reserve Board. The prevailing rate on April 8, 2013 was US\$1.00: RMB6.2031. We make no representation that any Renminbi or U.S. dollar amounts could have been, or could be, converted into U.S. dollars or Renminbi, as the case may be, at any particular rate, the rates stated above, or at all, on December 31, 2012 or on any other date. The Chinese government imposes control over its foreign currency reserves in part through direct regulation of the conversion of Renminbi into foreign exchange and through restrictions on foreign trade.

Table of Contents

The following table sets forth the average buying rate for Renminbi expressed as per one U.S. dollar for the years 2008, 2009, 2010, 2011 and 2012.

| <b>Year</b> | <b>Renminbi Average(1)</b> |
|-------------|----------------------------|
| 2008        | 6.9193                     |
| 2009        | 6.8295                     |
| 2010        | 6.7603                     |
| 2011        | 6.4475                     |
| 2012        | 6.2990                     |

---

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

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

| <b>Month Ended</b> | <b>High</b> | <b>Low</b> |
|--------------------|-------------|------------|
| October 31, 2012   | 6.2372      | 6.2877     |
| November 30, 2012  | 6.2221      | 6.2454     |
| December 31, 2012  | 6.2251      | 6.2502     |
| January 31, 2013   | 6.2134      | 6.2303     |
| February 28, 2013  | 6.2213      | 6.2438     |
| March 31, 2013     | 6.2105      | 6.2246     |

**B. Capitalization and Indebtedness**

Not applicable.

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

Not applicable.

**D. Risk Factors**

**RISKS RELATED TO OUR COMPANY**

**Our business depends to a significant extent on certain online games, which accounted for 84.4%, 83.6% and 82.3% of our total net revenues in 2010, 2011 and 2012, respectively. We may not be able to maintain the popularity of these games for a variety of reasons.**

Certain of our internally developed massively multi-player online role-playing games, known as MMORPGs, Westward Journey Online II, Fantasy Westward Journey, Tianxia III, Ghost and Heroes of Tang Dynasty II, as well as World of Warcraft®, a game licensed from Blizzard Entertainment, Inc. (together with its affiliated companies, referred to as Blizzard in this annual report), contributed 84.4%, 83.6% and 82.3% of our total net revenues in 2010, 2011 and 2012, respectively. We expect that we will need to continually introduce new versions or substantive upgrades of these and our other online games on a frequent basis to maintain their popularity, although changes in users' tastes or in the overall market for online games in China could alter the anticipated life cycle of each version or upgrade or even cause our users to stop playing our games altogether. Because of the limited history of the online games market in China, we cannot at this time estimate the total life cycle of any of our games, particularly our more recently launched games. If we are unable to maintain the popularity of our existing online games or are unable to introduce new online games which are popular with online game users in China (as discussed in the next risk factor), our business and results of operations could be materially and adversely affected. In particular, we have devoted, and expect to continue to devote, significant resources to maintain and raise the popularity of our time-based games through the release of new versions and/or expansion packs on a periodic basis and various promotional activities such as media advertising and game tournaments. For example, in 2012, we released Heroes of Tang Dynasty II, a comprehensive upgrade that builds on the strong user base of its predecessor, Heroes of Tang Dynasty, which further enhanced our leading position in the 2.5D game market. We also introduced expansion packs for Fantasy Westward Journey, Westward Journey Online II, Tianxia III and Ghost. In addition, we engaged celebrity spokespersons to promote certain of our games in 2012.

Table of Contents

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

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

New technologies in online game programming or operations could render our current online titles or other online games that we develop in the future obsolete or unattractive to our subscribers, thereby limiting our ability to recover development costs and potentially adversely affecting our future revenues and profitability. For example, the online game industry in China is transitioning from 2D to 3D games, with numerous new 2.5D and 3D game titles being launched in the market in recent years. In response to this trend, we have been devoting additional resources to developing or licensing 2.5D and 3D games and software components for such games, and we cannot assure you that such games will be successful. We commercially launched Legend of Fairy in May 2011, Tianxia III in October 2011, Kung Fu Master in July 2012 and Heroes of Tang Dynasty II in November 2012, all of which are 2.5D or 3D games. We have also commercially launched Soul of the Fighter, a 3D action role-playing game, or ARPG, in July 2012, and are currently testing several new types of 2.5D and 3D games. In addition, web-based games, social networking games and mobile games have gained increasing popularity and user base as Internet users in China rely more and more on mobile devices, such as smart phones and tablets, to access the Internet. In response to this trend, we are exploring the possibility of developing games that can be operated on mobile devices. Each of these games has required long periods of time for research and development and testing and also typically experience long ramp-up periods as players become familiar with the games. We are not able to predict if or when we will commercially launch additional new games and whether any of our new games will gain popularity in the Chinese online game market.

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

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

**We may not be able to maintain a stable relationship with Blizzard, and we may experience difficulties in the operation of the online games licensed from it or its affiliates.**

In August 2008 and April 2009, Blizzard agreed to license certain online games developed by it to Shanghai EaseNet Network Technology Co., Ltd., or Shanghai EaseNet, for operation in the PRC, including StarCraft® II: Wings of Liberty® and World of Warcraft. Shanghai EaseNet is a PRC company owned by William Lei Ding, our Chief Executive Officer, director and major shareholder, and has contractual arrangements with us and with the joint venture established between Blizzard and us. Shanghai EaseNet commercially launched World of Warcraft in

September 2009 and StarCraft II: Wings of Liberty in April 2011 after receiving the relevant government authorities' approvals. In March 2012, Blizzard and Shanghai EaseNet agreed to extend the license term of the World of Warcraft license agreement for an additional three years commencing from September 2012. In addition, Blizzard agreed to license another online game, Blizzard All-Stars, to Shanghai EaseNet for operation in the PRC in November 2012. For further details, see Item 4.B. Business Overview - Our Services - Game Licensing and Joint Venture with Blizzard. We have limited experience in licensing online games from third parties and working with Blizzard. If we are unable to maintain a stable relationship with Blizzard, or if Blizzard establishes similar or more favorable relationships with our competitors in violation of its contractual arrangements with us or otherwise, we may not be able to ensure the smooth operation of these licensed online games, and Blizzard could terminate the license and joint venture agreements with us, which in either case could harm our operating results and business. Moreover, the success of our arrangements with Blizzard depends on the popularity of the games licensed by it in the Chinese market, which is affected by, among other things, the frequency and success of upgrades and expansion packs to those games developed by Blizzard over which we have no control. In addition, certain events may limit Blizzard's ability to develop or license online games, such as claims by third parties that Blizzard's online games infringe such third parties' intellectual property rights or Blizzard's inability to acquire or maintain licenses to use another party's intellectual property in its online games. In the case of such events, Blizzard may be unable to continue licensing online games to us or to continue participating in any joint venture with us, regardless of the stability of our relationship with Blizzard.



Table of Contents

Shanghai EaseNet, as licensee of the games, has paid to Blizzard license fees. In addition, the licenses with Blizzard have three-year terms, require Shanghai EaseNet to pay royalties and consultancy fees to Blizzard for the games over the length of the licenses, have a minimum marketing expenditure commitment, and require Shanghai EaseNet to provide funds for hardware to operate the games. We have guaranteed the payment of the foregoing amounts if and to the extent Shanghai EaseNet has insufficient funds to make such payments. We will be entitled to reimbursement of any amounts paid under the guarantee for marketing the licensed games and for hardware support to operate the games from any net profits subsequently generated by Shanghai EaseNet, after the deduction of, among others, various fees and expenses payable to Blizzard, us and our joint venture with Blizzard which will provide technical services to Shanghai EaseNet. See Item 4.B. Business Overview Our Services Game Licensing and Joint Venture with Blizzard. for details about these arrangements.

We believe that our current cash and cash equivalents and cash flow from operations will be sufficient to meet our foregoing obligations. To the extent our obligations exceed our cash resources, we may seek to sell additional equity or debt securities or to obtain a credit facility. The sale of additional equity or convertible debt securities could result in additional dilution to shareholders. The incurrence of indebtedness would result in increased debt service obligations and could result in operating and financial covenants that would restrict operations. Financing may not be available in amounts or on terms acceptable to us, if at all. If we are unable to meet our foregoing obligations, our licensed games operation and financial condition could be adversely affected and our licenses with Blizzard could be terminated.

In addition, we cannot be certain that these licensed online games will be viewed by the regulatory authorities as complying with content restrictions, will be attractive to users or will be able to compete with games operated by our competitors. We may not be able to fully recover the costs associated with licensing these online games if the games are not popular among users in the PRC, and any difficulties in the operation of these licensed games could harm our results of operations and financial condition.

**Any difficulties or delays in receiving approval from the relevant government authorities for the operation of games we license from game developers outside of China or any expansion packs for or material changes to such games could adversely affect such games popularity and profitability.**

Games we license from game developers outside of China require government approvals before operation of such games within China. Moreover, even after licensed games have received government approvals, any expansion packs for or material changes of content to those games may require further government approvals. We cannot be certain of the duration of any necessary approval processes, and any delay in receiving such government approvals may adversely affect the profitability and popularity of such licensed games.

**Future alliances may have an adverse effect on our business.**

Strategic alliances with key players in the online game industry and other related industry sectors form part of our strategy to expand our portfolio of online games. For example, in August 2008, April 2009 and November 2012, Blizzard agreed to license certain online games developed by it to Shanghai EaseNet for operation in the PRC. We have also formed a joint venture with Blizzard to provide technical services to Shanghai EaseNet. However, our ability to grow through future alliances, including through joint ventures, will depend on the availability of suitable partners at reasonable terms, our ability to compete effectively to attract these partners, the availability of financing to complete larger joint ventures, and our ability to obtain any required governmental approvals. Further, the benefits of an alliance may take considerable time to develop, and we cannot be certain that any particular alliance will produce its intended benefits.

## Edgar Filing: NetEase, Inc. - Form 20-F

Future alliances could also expose us to potential risks, including risks associated with the assimilation of new operation technologies and personnel, unforeseen or hidden liabilities, the inability to generate sufficient revenue to offset the costs and expenses of alliances and potential loss of, or harm to, our relationships with employees, customers, licensors and other suppliers as a result of integration of new businesses. Further, we may not be able to maintain a satisfactory relationship with our partners, which could adversely affect our business and results of operations. We have limited experience in identifying, financing or completing strategic alliances. Such transactions and the subsequent integration process would require significant attention from our management. The diversion of our management's attention and any difficulties encountered with respect to the alliances or in the process of integration could have an adverse effect on our ability to manage our business.

**Our new games may attract game players away from our existing games, which may have a material adverse effect on our business, financial condition and results of operations.**

Our new online games may attract game players away from our existing games and shrink the player base of our existing online games, which could in turn make those existing games less attractive to other game players, resulting in decreased revenues from our existing games. Players of our existing games may also spend less money to purchase time or virtual items in our new games than they would have spent if they had continued playing our existing games. In addition, our game players may migrate from our existing games with a higher profit margin to new games with a lower profit margin. The occurrence of any of the foregoing could have a material and adverse effect on our business, financial condition and results of operations.

Table of Contents

**New or changed game features in our online games may not be well received by our game players.**

In the course of launching and operating online games, including the release of updates and expansion packs to existing games, certain game features may periodically be introduced, changed or removed. We cannot assure you that the introduction, change or removal of any game feature will be well received by our game players, who may decide to reduce or eliminate their playing time in response to any such introduction, change or removal. As a result, any introduction, change or removal of game features may adversely impact our business, financial condition and results of operations.

**A prolonged slowdown in the PRC economy may materially and adversely affect our results of operations, financial condition, prospects and future expansion plans.**

Since the second half of 2008, global credit and capital markets, particularly in the United States and Europe, have experienced difficult conditions. These challenging market conditions have resulted in reduced liquidity, greater volatility, widening of credit spreads, lack of price transparency in credit markets, a reduction in available financing and lack of market confidence. These factors, combined with declining business and consumer confidence and increased unemployment in the United States and elsewhere in the world, precipitated a global economic slowdown, including a slowdown in the rate of economic growth in China during several quarters since 2008. Given the dramatic change in the overall credit environment and economy, it is difficult to predict how long these conditions will exist and the extent to which we may be affected. The uncertainty and volatility of credit and capital markets and the overall slowdown in the PRC economy has had and may continue to have an adverse effect on our business. While there have been signs of economic recovery in China and the world's major economies, there can be no assurance that the economic recovery may be sustained. As a result, prolonged disruptions to the global credit and capital markets and the global economy, including as a result of the European debt crisis as discussed in the next risk factor, may materially and adversely affect the Chinese economy, consumer spending in China and our business, results of operations, financial condition, prospects and future expansion plans.

**Our results of operations, liquidity and financial position may be adversely affected by the European debt crisis.**

As part of our efforts to minimize our foreign exchange risk, we keep our liquid assets in bank deposits and short term investments in various currencies, including mainly the US dollar, Euro and RMB. As of December 31, 2012, we had Euro-denominated cash and cash equivalent and time deposits totaling 42.0 million (approximately US\$55.4 million at an exchange rate of US\$1.00: 0.7584 as reported in the H.10 statistical release of the U.S. Federal Reserve Board on December 31, 2012), representing approximately 2.3% of our total cash and cash equivalents and time deposits. Since 2011, the long term structural deficits in numerous European nations coupled with the deterioration of the economic outlook have led the weaker nations to a liquidity and solvency crisis. Eurozone leaders have made numerous attempts to solve this debt crisis; but, to date, a sustainable long term solution has not been implemented and much uncertainty remains.

If the European debt crisis continues or further deteriorates, European banks may face further liquidity problems, and weaker banks could even become insolvent. If the Euro dissolves entirely, the legal and contractual consequences for holders of Euro-denominated obligations would be determined by laws in effect at such time. The European debt crisis could also result in a significant devaluation of the Euro. Any of these conditions could ultimately adversely affect the value of such assets and thus our overall liquidity and financial position.

In addition, ongoing economic problems in Europe as a result of the debt crisis, including possibly a break up of the Eurozone, could be a deeply disruptive global economic event which could adversely affect the growth of China's economy and thus our business, results of operations and financial position.

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

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

Table of Contents

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

There have been a number of incidents in previous years where users, through a variety of methods, were able to modify the rules of our online games. Although these users did not gain unauthorized access to our systems, they were able to modify the rules of our online games during game-play in a manner that allowed them to cheat and disadvantage our other online game users, which often has the effect of causing players to stop using the game and shortening the game's lifecycle. Although we have taken a number of steps to deter our users from engaging in cheating when playing our online games, we cannot assure you that we or the third parties from whom we license some of our online games will be successful or timely in taking corrective steps necessary to prevent users from modifying the rules of our online games.

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

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

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

In our daily supervision of the operation of our online games and portal or during the investigation of users' complaints, we may take actions to regulate the behavior of our users. For example, if we suspect a player of installing cheating programs on our online games, we may freeze that player's game account or even ban the player from logging on to our games and portal. Such regulatory activities are essential to maintain a fair playing environment for our users. However, if any of our regulatory activities are found to be wrongly implemented, our users may institute legal proceedings against us for damages or claims. Our operation, business and financial performance may be materially and adversely affected as a result.

**We expect that a portion of our future revenues will continue to come from our advertising services, which represented approximately 9.4% of our total net revenues for 2012, but we may not be able to compete effectively in this market because it is relatively new and intensely competitive, in which case our ability to generate and maintain advertising revenue in the future could be adversely affected.**

Although we anticipate that the revenues generated by our online games will continue to constitute the major portion of our future revenues, we believe that we will continue to rely on advertising revenues as one of our primary revenue sources for the foreseeable future. The popularity of online advertising in China has been growing quickly in recent years and many of our current and potential advertisers have gained in experience with using the Internet as an advertising medium. Many advertisers, however, still do not devote a significant portion of their advertising expenditures to Internet-based advertising. Some advertisers may also not find the Internet to be effective for promoting their products and services relative to traditional print and broadcast media. Our ability to generate and maintain significant advertising revenue will depend on a number of factors, many of which are beyond our control, including:

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

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

Table of Contents

In addition, competition in the online advertising industry in China is intense with numerous competitors such as Baidu, Inc., or Baidu, Sina Corporation, or Sina, Sohu.com Inc., or Sohu, Tencent Holdings Limited, or Tencent, Alibaba.com Limited, or Alibaba, Youku Tudou Inc., or Youku, as well as other new entrants such as Qihoo 360 Technology Co. Ltd., or Qihu, Phoenix New Media Limited, or iFeng.com, and iQIYI, and other vertical Internet portals. The entry of additional, highly competitive Internet companies, whether domestic or international, into the Chinese market has and may continue to further heighten competition for advertising spending in China.

In 2009, as competition intensified for advertising services, we restructured our portal business operations and launched other new marketing strategies to grow our advertising business and to cater to changes in the needs of our advertising services customers. In particular, we increased our sales staff to support more direct contacts with advertisers. In addition, to increase traffic on the NetEase websites and enhance the websites appeal to advertisers, we have been focusing on high profile sporting events, such as Euro Cup 2012 and the London Olympics, including partnership with China Network Television to broadcast the London Olympic Games and the opening and closing ceremonies on our portal and our mobile news application, NetEase News App. We believe that these efforts, together with other factors, contributed to the growth of our net revenues from advertising services in recent years. We cannot assure you, however, that any of these efforts will continue to be successful in improving the financial results of our advertising business.

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

**If we fail to keep up with rapid changes in technologies and user behavior, our future success may be adversely affected.**

Our future success will depend on our ability to respond to rapidly changing technologies, adapt our products and services to evolving industry standards and improve the performance and reliability of our products and services. Our failure to adapt to such changes could harm our business. In addition, changes in user behavior resulting from technological developments may also adversely affect us. For example, the number of people accessing the Internet through mobile devices, including mobile phones, tablets and other hand-held devices, has increased in recent years, and we expect this trend to continue while 3G and more advanced mobile communications technologies are broadly implemented. If we fail to develop products and technologies that are compatible with all mobile devices, or if the products and services we develop are not widely accepted and used by users of various mobile devices, we may not be able to penetrate the mobile markets. In addition, the widespread adoption of new Internet, networking or telecommunications technologies or other technological changes could require substantial expenditures to modify or integrate our products, services or infrastructure. If we fail to keep up with rapid technological changes to remain competitive, our future success may be adversely affected.

**We experienced a decline in the rate of growth of our online games which appears to be a result of the outbreak of severe acute respiratory syndrome, or SARS, in 2003. Any recurrence of SARS or another widespread public health problem could adversely affect our business and results of operations.**

During April and May 2003, we experienced a decline in the rate of growth of our online game services which we believe resulted from the closure of Internet cafés in Beijing and elsewhere to prevent the spread of SARS. Many users of our online game services can only access those services at Internet cafés.

## Edgar Filing: NetEase, Inc. - Form 20-F

There have been confirmed human cases of the H5N1 strain of influenza virus, commonly referred to as bird flu or avian influenza, in the PRC, Vietnam, Iraq, Thailand, Indonesia, Turkey, Cambodia and other countries, which have proven fatal in some instances. In addition, in April 2009, H1N1, a new strain of the influenza virus commonly referred to as swine flu, was first discovered in North America and quickly spread to other parts of the world, including China. There have also been recent reports of outbreaks of an avian flu caused by the H7N9 virus, or H7N9, including confirmed human cases, in China.

A renewed outbreak of SARS, the spread of H5N1, H1N1 or H7N9, or another widespread public health problem in China, where virtually all of our revenue is derived, or in Beijing, Shanghai, Guangzhou or Hangzhou, where most of our employees are located, could have a negative effect on our business and operations.

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

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



Table of Contents

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

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

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

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

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

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

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

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

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

Table of Contents

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

We believe that online video content is becoming increasingly popular among Internet users in China and that we will need to offer a wide range of video content on the NetEase websites to attract users. Although advances in video compression technology have allowed reductions in the bandwidth required to deliver video content, such content still requires significantly more bandwidth than the other forms of content we offer on the NetEase websites. To enable users to access our video content quickly and reliably and remain competitive with other Internet portals in China and elsewhere, we anticipate that we will be required to invest in new video streaming technologies, including technologies developed by third parties. Currently, we obtain technology service support from certain technology companies in providing video content on our websites in exchange of our advertising services. If we are unable to continue such exchange of services or pass on such increased costs to users, our costs will increase which could materially adversely affect our business and profitability.

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

Guangzhou NetEase and Guangyitong Advertising are owned by shareholders whose interests may differ from ours and those of our shareholders because they own a larger percentage of such companies than of our company. Specifically, the business and operations of Guangzhou NetEase, as the operator of the NetEase websites and a provider of online games, e-mail and wireless value-added and other fee-based premium services, the two majority-owned subsidiaries of Guangzhou NetEase, namely, Beijing NetEase Youdao Computer System Co., Ltd., or Youdao Computer, as a search-related business operator, and Wangyibao Co., Ltd., or Wangyibao, as the operator of our Wangyibao online payment platform, and Guangyitong Advertising, as an advertising firm, are subject to Chinese laws and regulations that differ from the laws and regulations that govern the business and operations of NetEase. For example, Chinese laws and regulations require us to verify the content of third party advertising content we place on the NetEase websites, and we are partly dependent upon the conduct of Guangyitong Advertising, which is not directly subject to those laws and regulations, in order to ensure that we remain compliant with those laws and regulations. Guangzhou NetEase, Guangyitong Advertising or their ultimate shareholders could violate our arrangements with them by, among other things, failing to operate and maintain the NetEase websites or their various businesses in an acceptable manner, failing to remit revenue to us on a timely basis or at all or diverting customers or business opportunities from our company. In addition, the operation of the online games licensed from Blizzard is dependent on Shanghai EaseNet, which is owned by William Lei Ding, our Chief Executive Officer, director and major shareholder, and has contractual arrangements with us and with the joint venture established between Blizzard and us. The interests of Mr. Ding and the joint venture may differ from ours and those of our shareholders. A violation of the foregoing agreements could disrupt our business and adversely affect our reputation in the market. If these companies or their ultimate shareholders violate our agreements with them, we may have to incur substantial costs and expend significant resources to enforce those arrangements and rely on legal remedies under the PRC laws. The PRC laws, rules and regulations are relatively new, and because of the limited volume of published decisions and their non-binding nature, the interpretation and enforcement of these laws, rules and regulations involve substantial uncertainties. These uncertainties may impede our ability to enforce these agreements, or suffer significant delay or other obstacles in the process of enforcing these agreements and may materially and adversely affect our results of operations and financial position.

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

Our current relationship with Guangzhou NetEase, Guangyitong Advertising and their ultimate shareholders is based on a number of contracts, and these affiliated companies are considered our variable interest entities, or VIEs, for accounting purposes. The terms of these agreements are

## Edgar Filing: NetEase, Inc. - Form 20-F

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

Table of Contents

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

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

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

Our operations are currently dependent upon our commercial relationships with Guangzhou NetEase, Guangyitong Advertising and Shanghai EaseNet, and we derive most of our revenues from these companies. If these companies are unwilling or unable to perform the agreements which we have entered into with them, we may not be able to conduct our operations in the manner in which we currently conduct. In addition, Guangzhou NetEase, Guangyitong Advertising and Shanghai EaseNet may seek to renew these agreements on terms that are disadvantageous to us. Although we have entered into a series of agreements that provide us with substantial ability to control these companies, we may not succeed in enforcing our rights under them. If we are unable to renew these agreements on favorable terms, or to enter into similar agreements with other parties, our business may not expand, and our operating expenses may increase.

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

Our founder, Chief Executive Officer and director, William Lei Ding, beneficially owned, as of December 31, 2012, approximately 44.9% of our outstanding ordinary shares and is our largest shareholder. Accordingly, Mr. Ding has significant influence in determining the outcome of any corporate transaction or other matter submitted to the shareholders for approval, including mergers, consolidations, the sale of all or substantially all of our assets, election of directors and other significant corporate actions. He also has significant influence in preventing or causing a change in control. In addition, without the consent of this shareholder, we may be prevented from entering into transactions that could be beneficial to us. The interests of Mr. Ding may differ from the interests of our other shareholders.

**Our corporate structure may restrict our ability to receive dividends from, and transfer funds to, our PRC subsidiaries and variable interest entities, which could restrict our ability to act in response to changing market conditions and reallocate funds internally in a timely manner.**

NetEase, Inc. is a holding company with no significant assets other than cash on hand and its equity interests in its directly and indirectly-owned subsidiaries, including those set forth in the organizational diagram appearing in Item 4.B. Business Overview Our Organizational Structure. As

a result, our primary internal source of funds for our cash and financing requirements is dividend payments and other distributions on equity from our subsidiaries. If these subsidiaries incur debt on their own behalf in the future, the instruments governing the debt may restrict their ability to pay dividends or make other distributions to us, which in turn would limit our ability to pay dividends on our ADSs and service any debt we may incur. PRC tax authorities may also require us to amend our contractual arrangements with Guangzhou NetEase, Guangyitong Advertising, Shanghai EaseNet and their respective shareholders in a manner that would materially and adversely affect the ability of our subsidiaries to pay dividends and other distributions to us. In addition, Chinese legal restrictions permit payment of dividends only out of net income as determined in accordance with Chinese accounting standards and regulations. Under Chinese law, our PRC subsidiaries and variable interest entities are also required to set aside a portion of their net income each year to fund certain reserve funds, except in cases where a company's cumulative appropriations have already reached the statutory limit of 50% of that company's registered capital. These reserves are not distributable as cash dividends. Also see We may be treated as a resident enterprise for PRC tax purposes following the promulgation of the Enterprise Income Tax Law on January 1, 2008, which may subject us to PRC income tax for our global income and result in dividends payable by us to our foreign investors, and gains on the sales of our ordinary shares or ADSs, becoming subject to taxes under PRC tax laws, which may materially reduce the value of your investment. below for further detailsAny limitation on the ability of our PRC subsidiaries and variable interest entities to transfer funds to us in the form of dividends or other distributions could materially and adversely limit our ability to grow, make investments or acquisitions that could be beneficial to our businesses, pay debt or dividends, and otherwise fund and conduct our business.

Table of Contents

In addition, any transfer of funds from us to any of our PRC subsidiaries or variable interest entities, either as a shareholder loan or as an increase in registered capital, is subject to certain statutory limit requirements and registration or approval of the relevant PRC governmental authorities, including the relevant administration of foreign exchange and/or the relevant examining and approval authority. Our PRC subsidiaries and variable interest entities are not permitted under PRC law to directly lend money to one another. Therefore, it is difficult to change our capital expenditure plans once the relevant funds have been remitted from our company to our PRC subsidiaries or variable interest entities. These limitations on the free flow of funds between us and our PRC subsidiaries and variable interest entities could restrict our ability to act in response to changing market conditions and reallocate funds internally in a timely manner.

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

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

**A transfer of shares of Guangzhou NetEase, Guangyitong Advertising or Shanghai EaseNet may trigger tax liability.**

If we need to cause the transfer of shareholdings of Guangzhou NetEase, Guangyitong Advertising or Shanghai EaseNet from their current respective shareholders to any other individual, we may be required to pay individual income tax in the PRC on behalf of the transferring shareholder. Such individual income tax would be based on any gain deemed to have been realized by such shareholder on such transfer, and may be calculated based on a tax rate of 20% applied to the transferring shareholder's interest in net book value of the entity whose shares are being transferred minus the original investment cost. A significant tax obligation arising from any such transfer of shares could materially adversely affect our business and results of operations.

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

Prior to January 1, 2008, foreign invested enterprises were generally subject to a national and local enterprise income tax at statutory rates of 30.0% and 3.0%, respectively, under the previous income tax law. Our subsidiaries, NetEase Information Technology (Beijing) Co., Ltd., or NetEase Beijing, Guangzhou Boguan Telecommunication Technology Co., Ltd., or Boguan, NetEase (Hangzhou) Network Co., Ltd., or NetEase Hangzhou, and NetEase Youdao Information Technology (Beijing) Co., Ltd. (formerly named NetEase Yodao Information Technology (Beijing) Co., Ltd.), or Youdao Information, and our variable interest entity, Guangzhou NetEase, had been granted various preferential tax treatments because the local tax authorities had approved such companies as High and New Technology Enterprises (or HNTes), Software Enterprises, Key Software Enterprises or New Software Enterprises under the then applicable tax rules and regulations.

Effective as of January 1, 2008, the Chinese government adopted the Enterprise Income Tax Law, as further clarified by subsequent tax regulations implementing the new income tax law, which unified the enterprise income tax rates payable by domestic and foreign-invested

## Edgar Filing: NetEase, Inc. - Form 20-F

enterprises at 25.0%. Preferential tax treatments continue to be granted to entities that are classified as HNTEs and conduct business in encouraged sectors, whether such entities are foreign invested enterprises or domestic companies. Pursuant to these policies, qualified enterprises can enjoy a reduced enterprise income tax, or EIT, rate of 15.0%. Under the new income tax law, enterprises that were established and already enjoyed preferential tax treatments before March 16, 2007, other than companies qualifying as HNTEs, continue to enjoy such treatments (i) in the case of preferential tax rates, for a period of five years from January 1, 2008, or (ii) in the case of preferential tax exemption or reduction for a specified term, until the expiration of such term.

A number of our subsidiaries enjoy preferential tax rates by being recognized as a HNTE and/or Key Software Enterprise. For example, for 2010, Boguan was subject to a preferential tax rate of 12.5% as it was recognized as a Software Enterprise in 2006 and subject to a 50% reduction to its EIT rate in 2010. Boguan renewed its recognition as a HNTE in 2011 and enjoys a preferential tax rate of 15% from 2011 to 2013. In addition, Boguan was recognized as a Key Software Enterprise in March 2011 and enjoyed a further reduced preferential tax rate of 10% for 2010. We recorded the resulting income tax reduction in our consolidated financial statements in 2011. NetEase Hangzhou was recognized as a Software Enterprise and HNTE in 2007 and its qualification as a HNTE was renewed in 2011. Accordingly, NetEase Hangzhou enjoyed a preferential tax rate of 12.5% from 2009 to 2011 and enjoys a preferential tax rate of 15% from 2012 to 2013. In addition, certain of our subsidiaries, including Boguan, were recognized as Key Software Enterprises in March 2013 and enjoyed a preferential tax rate of 10% for 2011 and 2012. We will record the resulting income tax reduction in our consolidated financial statements in 2013. See Item 5.A. Operating Results Income Taxes.



Table of Contents

Although we will attempt to obtain or maintain similar preferential tax statuses for our subsidiaries in the future, we cannot assure you that we will obtain or maintain any particular preferential tax status, and typically the relevant government agencies do not confirm that we have obtained or maintained a particular tax status until late in a given tax year or the following tax year. The qualifications for HNTE or Software Enterprise status are subject to an annual assessment by the relevant government authorities in China. Without any preferential tax status, the standard EIT rate is 25.0%. Moreover, if there are further changes to the relevant income tax laws and their implementation, our subsidiaries and variable interest entities may need to pay additional taxes, which could have a material adverse effect on our results of operations.

**We may be treated as a resident enterprise for PRC tax purposes following the promulgation of the Enterprise Income Tax Law on January 1, 2008, which may subject us to PRC income tax for our global income and result in dividends payable by us to our foreign investors, and gains on the sales of our ordinary shares or ADSs, becoming subject to taxes under PRC tax laws, which may materially reduce the value of your investment.**

Under the Enterprise Income Tax Law, enterprises established outside of the PRC whose de facto management bodies are located in the PRC are considered resident enterprises, and will generally be subject to the uniform 25.0% enterprise income tax rate for their global income. Under the implementation rules of the Enterprise Income Tax Law, de facto management body is defined as the body that has material and overall management control over the business, personnel, accounts and properties of the enterprise. In April 2009, the PRC tax authority promulgated a circular to clarify the criteria for determining whether the de facto management bodies are located within the PRC for enterprises established outside of the PRC that are controlled by entities established within the PRC. However the relevant laws and regulations remain unclear regarding treatment of an enterprise established outside the PRC that is controlled by another enterprise established outside the PRC.

Some of our management is currently located in the PRC. Accordingly, we may be considered a resident enterprise and may therefore be subject to the EIT rate of 25.0% of our global income, and as a result, the amount of dividends we can pay to our shareholders could be reduced. We cannot confirm whether we will be considered a resident enterprise because the implementation rules are unclear at this time.

Under the implementation rules of the Enterprise Income Tax Law, dividends paid to non-resident enterprises by resident enterprises on profits earned after January 1, 2008 are regarded as income from sources within the PRC and therefore subject to a 10.0% withholding income tax, while dividends on profits earned before January 1, 2008 are not subject to the withholding income tax. Similarly, gains realized on the transfer of ordinary shares or ADSs by non-resident enterprises are also subject to a 10.0% PRC enterprise income tax if such gains are regarded as income derived from sources within the PRC. A lower withholding income tax rate of 5.0% is applied if the non-resident enterprises are registered in Hong Kong or other jurisdictions that have a favorable tax treaty arrangement with China. Nevertheless, the PRC State Administration of Taxation promulgated a tax notice on October 27, 2009, or Circular 601, which provides that tax treaty benefits will be denied to conduit or shell companies without business substance, and a beneficial ownership analysis will be used based on a substance-over-form principle to determine whether or not to grant tax treaty benefits. It is unclear at this stage whether Circular 601 applies to dividends from our PRC subsidiaries paid to us through our Hong Kong subsidiaries. It is possible that under Circular 601 our Hong Kong subsidiaries would not be considered to be the beneficial owners of any such dividends, and that, if such dividends are subject to withholding, such withholding rate would be 10% rather than the favorable 5% rate generally applicable under the tax treaty between mainland China and Hong Kong.

Because we may be treated as a resident enterprise, any dividends paid to the corporate shareholders or shareholders appearing as corporate entities on the share registers of NetEase, Inc. which are considered non-resident enterprises may be subject to withholding income tax, and gains realized on the transfer of our ordinary shares or ADSs by such shareholders may be subject to PRC income tax, which may adversely and materially affect the value of the investment in our shares or ADSs.

**If we fail to maintain an effective system of internal control over financial reporting, we may lose investor confidence in the reliability of our financial statements which in turn could negatively impact the trading price of our ADSs or otherwise harm our reputation.**

The SEC, as required under Section 404 of the Sarbanes-Oxley Act of 2002, has adopted rules requiring public companies to include a report of management on the effectiveness of such companies' internal control over financial reporting in their respective annual reports. In addition, an independent registered public accounting firm for a public company may be required to issue an attestation report on the effectiveness of such company's internal control over financial reporting.

Our management conducted an evaluation of the effectiveness of our internal control over financial reporting and concluded that our internal control over financial reporting was effective as of December 31, 2012. Our independent registered public accounting firm has issued an attestation report, which has concluded that our internal control over financial reporting was effective in all material aspects as of December 31, 2012. Please refer to Item 15 Controls and Procedures Management's Annual Report on Internal Control over Financial Reporting and Attestation Report of the Registered Public Accounting Firm. However, if we fail to maintain effective internal control over financial reporting in the future, our management and our independent registered public accounting firm may not be able to conclude that we have effective internal control over financial reporting in accordance with the Sarbanes-Oxley Act of 2002. Moreover, effective internal control over financial reporting is necessary for us to produce reliable financial reports. As a result, any failure to maintain effective internal control over financial reporting could result in the loss of investor confidence in the reliability of our financial statements, which in turn could negatively impact the trading price of our ADSs or otherwise harm our reputation. Furthermore, we may need to incur additional costs and use additional management and other resources in an effort to comply with Section 404 of the Sarbanes-Oxley Act of 2002 and other requirements going forward.

Table of Contents

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

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

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

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

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

In addition, fire, floods, droughts, typhoons, earthquakes and other natural disasters could result in material disruptions of our operations and adversely affect our revenues and profit. For example, the PRC government declared April 21, 2010 as a national mourning day for the April 14, 2010 earthquake centered in Qinghai Province. As required by the PRC government, we and the other major online game operators in China suspended our game operations during this national mourning day.

**We may be subject to breaches of our information technology systems, which could materially adversely affect our reputation and our results of operations and financial position and expose us to liability claims.**

Any compromise of the security of our information technology systems could materially adversely affect the operations of the NetEase websites and result in improper disclosure of personal information and other data. We transmit and store over our systems confidential and private information of our users, such as personal information, including names, user IDs and passwords, and payment or transaction related information.

Hackers develop and deploy viruses, worms, and other malicious software programs to attack websites and gain access to networks and data centers, and there have been a number of well-publicized malicious attacks against a variety of companies worldwide to gain access to non-public information. Hackers may also act in a coordinated manner to launch distributed denial of service attacks, or other coordinated attacks, that may cause service outages or other interruptions. Although we believe that we have not experienced any hacking activity that

allowed unauthorized access to any information stored on our information technology systems or caused any loss or corruption of personal information and other data, software or other computer equipment, we have been subject to denial of service attacks that have caused portions of our network to be inaccessible for limited periods of time. Although these are industry wide problems that affect many companies worldwide, we anticipate that we may be subject to additional attacks in the future because of the high profile of our company in the Chinese Internet industry.

We take a number of measures to ensure that our information technology systems are secure, including ensuring that our servers are hosted at physically secure sites and limiting access to server ports. We also use encryption and authentication technologies to secure the transmission and storage of data. These security measures may be compromised as a result of third-party security breaches, employee error, malfeasance, faulty password management, or other irregularities. Third parties may also attempt to fraudulently induce employees or customers into disclosing user names, passwords or other sensitive information, which may in turn be used to access our information technology systems. We expect that we will be required to continue to expend significant resources to system security, data encryption, and other security measures to protect our systems and data, but these security measures cannot provide absolute security. We may experience a breach of our systems and may be unable to protect sensitive data. Moreover, if a computer security breach affects our systems or results in the unauthorized release of personal information and other data of our users, our reputation and brand could be materially damaged and use of the NetEase websites and our services could decrease. We could also be exposed to a risk of loss or litigation and possible liability, which could result in a material adverse effect on our business, results of operations and financial condition.

Table of Contents

**We are subject to a variety of laws and other obligations regarding data protection in China.**

We are subject to laws in China relating to the collection, use, sharing, retention, security and transfer of confidential and private information, such as personal information and other data. These laws apply not only to third-party transactions, but also to transfers of information between our company and our subsidiaries and VIEs, and among our company, our subsidiaries, VIEs and other parties with which we have commercial relations. These laws are continuing to develop, and the PRC government may adopt other rules and restrictions in the future. Complying with emerging and changing requirements may cause us to incur substantial costs or require us to change our business practices. Noncompliance could result in penalties or significant legal liability, including fines and public announcements of misconduct by the relevant telecommunication regulatory authorities.

Our privacy policies and practices concerning the use and disclosure of data are posted on the NetEase websites. Any failure by us, our business partners or other parties with whom we do business to comply with its posted privacy policies or with other applicable privacy-related or data protection laws and regulations could result in proceedings against us by governmental entities or others, which could have a material adverse effect on our business, results of operations and financial condition. In addition, any negative publicity on our website's safety or privacy protection mechanism and policy could have a material and adverse effect on our business, results of operations and financial condition, public image and reputation.

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

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

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

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

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

## Edgar Filing: NetEase, Inc. - Form 20-F

We may face liability for defamation, negligence, copyright, patent or trademark infringement and other claims based on the nature and content of the materials that are published on the NetEase websites. We are involved in several intellectual property infringement claims or actions and are occasionally subject to defamation claims. We believe that the amounts claimed in these actions, in the aggregate, are not material to our business. However, these amounts may be increased for a variety of reasons as the claims progress, and we and our affiliates could be subject to additional defamation or infringement claims which, singly or in the aggregate, could have a material adverse effect on our business and results of operations, if successful. We also could be subject to claims based upon content that is accessible on the NetEase websites such as content and materials posted by users on message boards, online communities, voting systems, e-mail or chat rooms that are offered on the NetEase websites. By providing technology for hypertext links to third-party websites, we may be held liable for copyright or trademark violations by those third party sites. Third parties could assert claims against us for losses incurred in reliance on any erroneous information distributed by us. Moreover, users of the NetEase Web-based e-mail services could seek damages from us for:

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

Table of Contents

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

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

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

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

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

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

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

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

we take will effectively prevent misappropriation of our technology.

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



Table of Contents

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

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

The determination of whether or not we are a PFIC is made on an annual basis and depends on the composition of our income and assets, including goodwill, from time to time. Specifically, we will be classified as a PFIC for U.S. tax purposes for a taxable year if either (a) 75.0% or more of our gross income for such taxable year is passive income, or (b) 50.0% or more of the average percentage of our assets during such taxable year either produce passive income or are held for the production of passive income. For such purposes, if we directly or indirectly own 25.0% or more of the shares of another corporation, we generally will be treated as if we (a) held directly a proportionate share of the other corporation's assets, and (b) received directly a proportionate share of the other corporation's income.

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

If we are a PFIC in any year with respect to a U.S. Holder (as defined below), the U.S. Holder will be required to file an annual information return on IRS Form 8621 regarding distributions received on our shares or ADSs and any gain realized on the disposition of our shares or ADSs. In addition, under recently enacted U.S. tax legislation, if we are a PFIC U.S. Holders will be required to file an annual information return (also on IRS Form 8621) relating to their ownership of our shares or ADSs. Although the IRS has updated Form 8621 to include a new Part I, Summary of Annual Information, to reflect this filing requirement, pursuant to Notice 2011-55 and the instructions to the Revised Form 8621, completion of that part is not required until the underlying Treasury Regulations are published. Prior to filing their annual income tax returns, U.S. Holders should consult their tax advisors regarding whether additional guidance has been issued with respect to this reporting requirement, and if so, how to comply with such guidance.

For further discussion of the adverse U.S. federal income tax consequences of our possible classification as a PFIC, see Item 10.E Additional Information Taxation United States Federal Income Taxation.

**RISKS RELATED TO DOING BUSINESS IN CHINA**

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

## Edgar Filing: NetEase, Inc. - Form 20-F

The Chinese legal system is a civil law system based on written statutes. Unlike common law systems, it is a system in which decided legal cases have little precedential value. In the late 1970s, the Chinese government began to promulgate a comprehensive system of laws and regulations governing economic matters. The overall effect of legislation enacted over the past 30 years has significantly enhanced the protections afforded to foreign invested enterprises in China. However, these laws, regulations and legal requirements are relatively recent and are evolving rapidly, and their interpretation and enforcement involve uncertainties. These uncertainties could limit the legal protections available to foreign investors.

### **Contract drafting, interpretation and enforcement in China involve significant uncertainty.**

We have entered into numerous contracts governed by PRC law, many of which are material to our business. As compared with contracts in the United States, contracts governed by PRC law tend to contain less detail and are not as comprehensive in defining contracting parties' rights and obligations. As a result, contracts in China are more vulnerable to disputes and legal challenges. In addition, contract interpretation and enforcement in China is not as developed as in the United States, and the result of any contract dispute is subject to significant uncertainties. Therefore, we cannot assure you that we will not be subject to disputes under our material contracts, and if such disputes arise, we cannot assure you that we will prevail. Any dispute involving material contracts, even without merit, may materially and adversely affect our reputation and our business operations, and may cause the price of our ADSs to decline.

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

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

Table of Contents

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

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

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

The value of the Renminbi may fluctuate according to a number of factors. From 1995 until July 2005, the People's Bank of China, or PBOC, intervened in the foreign exchange market to maintain an exchange rate of approximately RMB8.28 per U.S. dollar. On July 21, 2005, the PRC government reformed this policy to allow the Renminbi to fluctuate within a narrow and managed band against a basket of certain foreign currencies. There have been a number of changes to the currency policy in the PRC since July 2005, and the Renminbi has appreciated significantly since then. There currently remains significant international pressure on the PRC government to adopt a substantial liberalization of its currency policy, which could result in a further and more significant appreciation in the value of the Renminbi against the U.S. dollar. Our revenues are primarily denominated in Renminbi, and any fluctuation in the exchange rate of Renminbi may affect the value of, and dividends, if any, payable on, our ADSs in foreign currency terms.

**Restrictions on currency exchange may limit our ability to utilize our revenues effectively.**

Most of our revenues and operating expenses are denominated in Renminbi. The Renminbi is currently freely convertible under the current account, which includes dividends, trade and service-related foreign exchange transactions, but not under the capital account, which includes foreign direct investment and loans.

Under existing PRC foreign exchange regulations, payments of current account items, including payment of dividends, interest payments and trade and service-related foreign exchange transactions, can be made in foreign currencies without prior approval of the State Administration of Foreign Exchange, or SAFE, by complying with certain procedural requirements. Our PRC subsidiaries and affiliates may also retain foreign exchange in its current account, subject to a ceiling approved by SAFE, to satisfy foreign exchange liabilities or to pay dividends. However, we cannot assure you that the relevant PRC governmental authorities will not limit or eliminate our ability to purchase and retain foreign currencies in the future.

Since a significant amount of our future revenues will be denominated in Renminbi, the existing and any future restrictions on currency exchange may limit our ability to utilize revenues generated in Renminbi to fund our business activities outside China, if any, or expenditures denominated in foreign currencies.

Foreign exchange transactions under the capital account are subject to limitations and require registration with or approval by the relevant PRC governmental authorities. In particular, any transfer of funds from us to any of our PRC subsidiaries or variable interest entities, either as a shareholder loan or as an increase in registered capital, is subject to certain statutory limit requirements and registration or approval of the relevant PRC governmental authorities, including the relevant administration of foreign exchange and/or the relevant examining and approval authority. Our ability to use the U.S. dollar proceeds of the sale of our equity or debt to finance our business activities conducted through our PRC subsidiaries or variable interest entities will depend on our ability to obtain these governmental registrations or approvals. In addition, because of the regulatory issues related to foreign currency loans to, and foreign investment in, domestic PRC enterprises, we may not be able to finance the operations of our PRC subsidiaries or variable interest entities by loans or capital contributions. We cannot assure you that we can obtain these governmental registrations or approvals on a timely basis, if at all.

Table of Contents

**Failure to comply with PRC regulations regarding the registration requirements for employee equity incentive plans may subject our PRC citizen employees or us to fines and other legal or administrative sanctions.**

On March 28, 2007, SAFE promulgated the Application Procedure of Foreign Exchange Administration for Domestic Individuals Participating in Employee Stock Holding Plan or Share Option Plan of Overseas-Listed Company, or the Share Option Rule. On February 15, 2012, SAFE issued the Notices on Issues Concerning the Foreign Exchange Administration for Domestic Individuals Participating in Stock Incentive Plan of Overseas-Listed Company, or the Stock Incentive Plan Rule, which replaced the Share Option Rule. Under the Stock Incentive Plan Rule, PRC citizens who are granted share options or other employee equity incentive awards by an overseas publicly-listed company are required, through a qualified PRC agent or a PRC subsidiary of such overseas publicly-listed company, to register with SAFE and complete certain other procedures related to the share options or other employee equity incentive plans. We have registered with and obtained approvals from SAFE office in Beijing for the participants of our equity compensation plans who are PRC citizens. Nevertheless, if we or such PRC participants fail to comply with these regulations, we or such PRC participants may be subject to fines and other legal or administrative sanctions.

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

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

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

These regulations may have a significant impact on our present and future structuring and investment. We have requested our shareholders who to our knowledge are PRC residents to make the necessary applications, filings and amendments as required under these regulations. We intend to take all necessary measures for ensuring that all required applications and filings will be duly made and all other requirements will be met. We further intend to structure and execute our future offshore acquisitions in a manner consistent with these regulations and any other relevant legislation. However, because it is presently uncertain how the SAFE regulations, and any future legislation concerning offshore or cross-border transactions, will be interpreted and implemented by the relevant government authorities in connection with our future offshore financings or acquisitions, we cannot provide any assurances that we will be able to comply with, qualify under, or obtain any approvals required by the regulations or other legislation. Furthermore, we cannot assure you that any PRC shareholders of our company or any PRC company into which we invest will be able to comply with those requirements. The inability of our company or any PRC shareholder to secure required approvals or registrations in connection with our future offshore financings or acquisitions may subject us to legal sanctions, restrict our ability to pay dividends from our Chinese subsidiaries to our offshore holding company, and restrict our overseas or cross-border investment activities or affect our ownership structure.

**The audit report included in this annual report has been prepared by an auditor who is not inspected by the U.S. Public Company Accounting Oversight Board (United States) and, as such, you are deprived of the benefits of such inspection.**

Auditors of companies that are registered with the SEC and traded publicly in the United States, including our independent registered public accounting firm, must be registered with the U.S. Public Company Accounting Oversight Board (United States), or the PCAOB, and are required by the laws of the United States to undergo regular inspections by the PCAOB to assess their compliance with the laws of the United States and professional standards. Because our auditor is located in the PRC, a jurisdiction where the PCAOB is currently unable to conduct inspections without the approval of the Chinese authorities, our auditor is not currently inspected by the PCAOB.

Table of Contents

This lack of PCAOB inspections in China prevents the PCAOB from regularly evaluating audits and quality control procedures of any auditors operating in China, including our auditor. As a result, investors may be deprived of the benefits of PCAOB inspections.

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

**We may be adversely affected by the outcome of the administrative proceedings brought by the SEC against five accounting firms in China.**

The SEC has brought administrative proceedings in the U.S. against five accounting firms in China recently, alleging that they refused to produce audit work papers and other documents related to certain China-based companies under investigation by the SEC for potential accounting fraud. We were not and are not subject to any SEC investigations, nor are we involved in the proceedings brought by the SEC against the accounting firms. However, the independent registered public accounting firm that issues the audit reports included in our annual reports filed with the SEC is one of the five accounting firms named in the SEC's proceedings and we may be adversely affected by the outcome of the proceedings, along with other U.S.-listed companies in China audited by these accounting firms. If the SEC prevails in the proceedings, our independent registered public accounting firm and other four accounting firms in China that were named in the proceedings may be barred from practicing before the SEC and hence unable to continue to be the auditors for China-based companies listed in the U.S. like ourselves. If none of the China-based auditors are able to continue to be auditors for China-based companies listed in the U.S., we will not be able to meet the reporting requirements under the Securities Exchange Act of 1934, as amended, or the Exchange Act, which may ultimately result in our deregistration by the SEC and delisting from NASDAQ.

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

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

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

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

The telecommunications industry, including Internet content provider, or ICP, services and online games, is highly regulated by the Chinese government, with the main relevant government authority being the MII. Pursuant to the Administrative Rules for Foreign Investments in Telecommunications Enterprises promulgated by the State Council dated December 5, 2001, foreign investors are allowed to hold in the

## Edgar Filing: NetEase, Inc. - Form 20-F

aggregate up to 50.0% of the total equity in any value-added telecommunications business in China. In addition, foreign and foreign invested enterprises are currently not able to apply for the required licenses for operating online games in China.

To operate the NetEase websites in compliance with all the relevant ICP-related Chinese regulations, Guangzhou NetEase successfully obtained ICP licenses issued by the Guangdong Provincial Telecommunications Bureau in 2000. The ICP license of Guangzhou NetEase issued by the Guangdong Provincial Telecommunications Bureau was replaced by the Value-Added Telecommunication Operating License issued by the MII in 2004, which was further replaced by the Value-Added Telecommunication Operating License issued by the Guangdong Provincial Telecommunications Bureau in 2009. Guangzhou NetEase has also obtained the following licenses and registrations: a website registration with the Guangzhou Municipal Administrative Bureau of Industry and Commerce, an audio-visual product operating license issued by Guangdong Culture Department to sell audio-visual products on the Internet, which was replaced by a publication operating license issued by the Administration of Culture, Radio, Film and Television, Press and Publication of Guangzhou, an Internet publishing license issued by General Administration of Press and Publication, an Internet Culture Operating License issued by the Ministry of Culture, or MOC, a license for online dissemination of drug-related information issued by Guangdong Food and Drug Administration, an Internet news information service license issued by the State Council Information Office, a permit for the Network Transmission of Audiovisual Programs issued by the State Administration of Radio, Film and Television, a permit for the production of audiovisual programs issued by the Radio, Film and Television Administration of Guangdong and a license for the sale of security products for computer information systems issued by the Ministry of Public Security. It has also received approvals for online dissemination of health information from the Department of Health of Guangdong Province and approvals for provision of online education-related information from the Department of Education of Guangdong Province. NetEase, Inc. relies exclusively on contractual arrangements with Guangzhou NetEase and its approvals to operate as an ICP. In addition, to operate the online games licensed from Blizzard in compliance with all the relevant ICP-related Chinese regulations, Shanghai EaseNet obtained a Value-Added Telecommunications Business Operating License issued by the Shanghai Provincial Telecommunications Bureau in October 2008 and an Internet Culture Operating License from MOC in October 2008.



Table of Contents

We cannot be certain, however, that we or our affiliates will be granted any other additional license, permit or clearance we may need now or in the future. Moreover, we cannot be certain that any local or national ICP or telecommunications license requirements will not conflict with one another or that any given license will be deemed sufficient by the relevant governmental authorities for the provision of our services. There are substantial uncertainties regarding the interpretation of current PRC Internet laws and regulations. The PRC government may issue new interpretations of the regulations regarding supervision of the information industry from time to time.

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

**The Chinese government restricts the ability for foreign investors to invest in and operate in the telecommunications and online gaming businesses.**

In July 2006, the MII issued a notice to strengthen management of foreign investment in and operation of value-added telecommunication services. The notice emphasizes that foreign investors who wish to engage in value-added telecommunication services must strictly follow the relevant rules and regulations on foreign investment in telecommunication sectors. The notice also prohibits domestic telecommunication services providers from leasing, transferring or selling telecommunications business operating licenses to any foreign investor in any form, or providing any resources, sites or facilities to any foreign investor for their illegal operation of a telecommunications business in China. According to the notice, either the holder of a value-added telecommunication service license or its shareholders must directly own the domain names and trademarks used by such license holders in their provision of value-added telecommunication services. The notice further requires each license holder to have the necessary facilities, including servers, for its approved business operations and to maintain such facilities in the regions covered by its license. Value-added services license holders are required to evaluate the compliance with the requirements set forth in the notice. To comply with these requirements, Guangzhou NetEase submitted its self-correction report to MII in 2007.

In September 2009, GAPP, together with the National Copyright Administration, and National Office of Combating Pornography and Illegal Publications jointly issued a *Notice on Further Strengthening on the Administration of Pre-examination and Approval of Online Games and the Examination and Approval of Imported Online Games*, or the GAPP Notice. The GAPP Notice restates that foreign investors are not permitted to invest in online game operating businesses in China via wholly-owned, equity joint venture or cooperative joint venture investments and expressly prohibits foreign investors from gaining control over or participating in domestic online game operators through indirect ways such as establishing other joint venture companies, or contractual or technical arrangements. It is unclear whether the authorities will deem our VIE structure as a kind of such indirect ways by foreign investors to gain control over or participate in domestic online game operators. If our VIE structure is deemed as one such indirect way under the GAPP Notice, our VIE structure may be challenged by the authorities and the authorities may require us to restructure our VIE structure and take action to prohibit or restrict our business operations. In such case, we may not be able to operate or control business in the same manner as we currently do and may not be able to consolidate the VIEs. In addition, the authorities would have broad discretion in dealing with such determination which may adversely impact our financial statements, operations and cash flows.



Table of Contents

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

In April 2001, the PRC government began tightening its regulation and supervision of Internet cafés, at which many of our users access the NetEase websites and our services, especially online games. In particular, a large number of unlicensed Internet cafés have been closed. In addition, the PRC government has imposed higher capital and facility requirements for the establishment of Internet cafés. Furthermore, the PRC government's policy, which encourages the development of a limited number of national and regional Internet café chains and discourages the establishment of independent Internet cafés, may slow down the growth of Internet cafés. Moreover, in 2007 the State Administration of Industry and Commerce, one of the government agencies in charge of Internet café licensing, and other government agencies jointly issued a notice temporarily suspending the issuance of new Internet café licenses for a period of six months. In March 2010, the MOC issued a circular to increase the punishment for Internet cafés that allow minors to enter and use the Internet in violation of government regulations. According to this circular, among other things, the government authorities may revoke an Internet café's Internet Culture Operation License if that Internet café allows three or more minors to enter and use the Internet at one time. Governmental authorities may from time to time impose stricter requirements, for example, limiting customer age limits and hours of operation, based on the occurrence and perception of, and the media attention on, gang violence, arson, and other incidents in or associated with Internet cafés.

So long as Internet cafés are one of the primary venues for our users to access the NetEase websites and services, especially online games, any reduction in the number, or any slowdown in the growth, of Internet cafés in China could limit our ability to maintain or increase our revenues and expand our customer base, thereby reducing our profitability and growth prospects.

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

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

In addition, on June 3, 2010, the MOC issued a decree on Interim Measures for the Administration of Online Games, or the Online Games Measures, which will be effective as of August 1, 2010. The Online Games Measures set forth certain requirements regarding online games, including requirements that game operators follow new registration procedures, publicize information about the content and suitability of their games, prevent access by minors to inappropriate games, avoid certain types of content in games targeted to minors, avoid game content that compels players to kill other players, manage virtual currency in certain ways and register users with their real identities. Furthermore, in

## Edgar Filing: NetEase, Inc. - Form 20-F

July 2010 the MOC enacted the Notice on Implementing Interim Measures for the Administration of Online Games, or the Online Games Notice, in which several provisions of the Online Games Measures are supplemented, including the required standard clauses for online games service contracts between game operators and users and the timing for the implementation of a real identity registration system. The Online Games Notice also adopts several new measures, including requirements for the domestic online games joint operation by game developers and operators. Although many of these requirements reflect previously issued government regulations with which we already comply, certain new requirements may cause us to change the way we launch and operate our online games. Because the Online Games Measures and Online Games Notice are relatively new and it is unclear how the MOC will interpret and enforce them, we are unable to fully assess what impact, if any, these new requirements may have on our business.

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

Table of Contents

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

One of the features of our MMORPGs which helps to build a large user base and maintain loyalty is that users can accumulate virtual tools, powers and rankings as they play the games. We believe that these virtual assets are highly valued by our users, particularly long-term users, and are traded among users. However, on occasion, such assets can be lost if, for example, a user's identity is stolen by another user or we experience a system error or crash. The Chinese government has not enacted any laws regarding virtual asset property rights. Accordingly, we have no basis to determine what are the legal rights, if any, associated with virtual assets and what liabilities we could be exposed to for the loss or destruction of virtual assets. We could therefore potentially be held liable for the way in which we handle and protect virtual assets.

**Restrictions on virtual currency may adversely affect our online game revenues.**

Our online game revenues are collected through the sale of physical and virtual prepaid point cards, as described elsewhere on this annual report, including below in the "User Fees" section in Item 4.B of this annual report.

On February 15, 2007, the MOC issued the Notice on the Reinforcement of the Administration of Internet Cafés and Online Games, or the Internet Cafés Notice, which directs the PBOC to strengthen the administration of virtual currency in online games to avoid any adverse impact on the PRC economy and financial system. Under the Internet Cafés Notice, the total amount of virtual currency issued by online game operators and the amount purchased by individual users should be strictly limited, with a clear distinction between virtual transactions and real transactions, so that virtual currency should only be used to purchase virtual items.

On June 4, 2009, the MOC and the Ministry of Commerce jointly issued the Notice on Strengthening the Administration of Online Game Virtual Currency, or the Virtual Currency Notice, which defined "Virtual Currency" as a type of virtual exchange instrument that is issued by online game operators, purchased directly or indirectly by the game user by exchanging legal currency at a certain exchange rate, saved outside the game programs, stored in servers provided by the online game operators in electronic record format and represented by specific numeric units. In addition, the Virtual Currency Notice categorizes companies involved with virtual currency as either issuers or trading platforms and prohibits companies from simultaneously engaging both as issuers and as trading platforms. The Virtual Currency Notice's stated objective is to limit the circulation of virtual currency and thereby reduce concerns that it may impact real world inflation. To accomplish this, the Virtual Currency Notice requires online game operators to report the total amount of their issued virtual currencies on a quarterly basis and to refrain from issuing disproportionate amounts of virtual currencies in order to generate revenues. In addition, the Virtual Currency Notice reiterates that virtual currency can only be provided to users in exchange for an RMB payment and can only be used to pay for virtual goods and services of the issuers. Online game operators are strictly prohibited from conducting lucky draws or lotteries in which participants pay cash or virtual currency to win game items or virtual currency. The Virtual Currency Notice also requires online game operators to keep transaction data records for no less than 180 days and to not provide virtual currency trading services to minors.

In order to comply with the requirements of the Virtual Currency Notice, we may need to change our prepaid point card distribution and database systems, resulting in higher costs of our online game operation, lower sales of our prepaid cards, or other changes in our business model. Such changes may therefore have an adverse effect on our revenues from online games.

**Regulatory restrictions on financial transactions may adversely affect the operation and profitability of our business.**

On April 16, 2009, the PBOC issued a notice, or the PBOC Notice, regarding the regulation of non-financial institutions engaged in the business of effecting payments and settlements. The PBOC Notice requires non-financial institutions established before April 16, 2009 which are engaged in the payment and settlement business to register with the PBOC before July 31, 2009. According to the PBOC Notice, such registration is interpreted as a basis for future policy making rather than a permit. Guangzhou NetEase has finished the required registration with the PBOC. In addition, on June 14, 2010, the PBOC issued the Measures for the Administration of Non-financial Institutions Engaging in Payment and Settlement Services, or the PBOC Measures, which were effective as of September 1, 2010 and require that non-financial institutions engaging in the business of effecting payments and settlements before June 14, 2010 obtain a permit from the PBOC by August 31, 2011 to continue such business. On December 1, 2010, the PBOC issued Detailed Rules for the Implementation of the Administrative Measures for the Payment Services Provided by Non-financial Institutions, which provide, among other things, further explanation for the qualifications of applicants and more detailed description for the application materials.

We currently operate an online payment platform used by both distributors of our prepaid point cards and end users of our online services, which requires a permit under the PBOC Measures. We have obtained such permit from the PBOC. However, as the PBOC Measures are quite new, we cannot be certain how they will be interpreted and enforced by the PBOC and whether we will be able to maintain or renew such permit in the future. An inability to continue operating our current online payment platform would likely materially and adversely affect the operation and profitability of our business.

Table of Contents

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

The Chinese market for Internet content and services is intensely competitive and rapidly changing. Many companies offer competitive products or services including online games, Chinese language-based Web search, retrieval and navigation services, wireless value-added services and extensive Chinese language content, informational and community features, and e-mail.

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

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

**Item 4. Information on the Company**

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

Our business was founded in June 1997, and we began offering search services and free Web-based e-mail starting mid-1997 and early-1998, respectively. In mid-1998, we changed our business model from a software developer to an Internet technology company and commenced developing the NetEase websites. In mid-1999, we established our advertising sales force to sell advertisements on the NetEase websites and also began to offer e-commerce platforms and to provide online shopping mall and other e-commerce services in China. In 2001, we also began focusing on fee-based premium services and online entertainment services, including online games, wireless value-added services, premium e-mail services and other subscription-type services. We developed our own proprietary Internet search engine, Youdao, which was launched in December 2007 and is free of charge to users.

NetEase.com, Inc. was incorporated in the Cayman Islands on July 6, 1999, and it operates under the Cayman Islands Companies Law (2012 Revision). We changed our name from NetEase.com, Inc. to NetEase, Inc. with effect from March 29, 2012 after its approval at our extraordinary general meeting of shareholders held on the same day. We believe that the change of name would more accurately reflect our business operations which encompass an increasingly diversified range of entertainment, community, e-commerce and other services. Our

## Edgar Filing: NetEase, Inc. - Form 20-F

principal executive offices are located at 26/F, SP Tower D, Tsinghua Science Park Building 8, No.1 Zhongguancun East Road, Haidian District, Beijing, People's Republic of China 100084. Our telephone number is (86-10) 8255-8163.

Our principal capital expenditures for 2012 consisted mainly of acquisition of new servers in connection with the operation of our self-developed games, investment in the expansion and upgrade of our mailbox infrastructure, and cost incurred for office renovations, furniture and fixtures, for a total of approximately RMB178.7million (US\$28.7 million). Our principal capital expenditures for 2011 consisted mainly of costs incurred for the construction of a new office building in Beijing, China (including costs for obtaining land use right and preparing the land for future construction), office renovations, furniture and fixtures, the acquisition of new servers in connection with the operation of our self-developed games and Blizzard's World of Warcraft and StarCraft II: Wings of Liberty, as well as an investment in the expansion and upgrade of our mailbox infrastructure, for a total of approximately RMB410.1 million. Our principal capital expenditures for 2010 consisted mainly of costs incurred for the construction of our research and development complex in Hangzhou, China, office renovations, furniture and fixtures, computer equipment, and software costs, as well as the acquisition of new servers in connection with the operation of Blizzard's World of Warcraft and in preparation for the operation of StarCraft II: Wings of Liberty for a total of approximately RMB298.0 million. We substantially completed and moved into our research and development center in Hangzhou in 2010.

In addition, in connection with the licensing of certain online games by Blizzard to Shanghai EaseNet for operation in the PRC, during the three-year terms of the licenses, Shanghai EaseNet as licensee of the games is required to pay royalties and consultancy fees to Blizzard for the games, have a minimum marketing expenditure commitment, and provide funds for hardware to operate the games. For further details, see Item 4.B. Business Overview Our Services Game Licensing and Joint Venture with Blizzard. As of December 31, 2012, we had capital expenditure commitments of RMB87.2 million (US\$14.0 million) for 2013 which primarily consist of commitments made in connection with the construction of a new office building in Beijing and the purchase of computer equipment. Our capital expenditures in 2012 have been, and are expected to continue to be, funded by operating cash flows and our existing capital resources.



Table of Contents

**B. Business Overview**

**OVERVIEW**

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

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

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

**Online Games Services**

Our online games business focuses on offering massively multi-player online games, more specifically role-playing games, to the Chinese market. These MMORPGs, as they are commonly known, are played over the Internet in virtual worlds that exist on networked game servers to which thousands of players simultaneously connect to interact with each other. We develop and operate MMORPGs that are targeted at or localized to the Chinese market, and we strive to provide the highest quality game playing experience to our users. In addition, in August 2008, April 2009 and November 2012, Blizzard agreed to license certain online games to Shanghai EaseNet for operation in the PRC, as discussed below under Our Services Game Licensing and Joint Venture with Blizzard .

We use two revenue models for games: a time-based model, in which players pay for game playing time, and an item-based model, in which players can play the basic features of the game for free and can purchase virtual items that enhance their playing experience. A majority of our revenues come from our in-house games that use the time-based model and from World of Warcraft and StarCraft II: Wings of Liberty, which also use the time-based model. We commercially launched our first item-based online games, Tianxia II and Warsong of Westward Journey (previously named Legend of Westward Journey), in June and September 2008, respectively, and subsequently launched several other item-based MMORPG games, including Tianxia III, Ghost, New Fly for Fun, Kung Fu Master, Legend of Fairy and Heroes of Tang Dynasty II, a comprehensive upgrade of Heroes of Tang Dynasty, as well as Soul of the Fighter, an ARPG. We plan to launch other new games using the item-based revenue model in the future.

To pay for MMORPG playing time or virtual items purchased within a game, players use our proprietary prepaid point system by purchasing physical prepaid point cards or virtual prepaid point cards. We work with a wide range of distributors to distribute our point cards to gamers across China. Physical prepaid point card distribution channels include wholesalers, Internet cafés, software stores, supermarkets, bookstores

## Edgar Filing: NetEase, Inc. - Form 20-F

and newspaper stands, as well as convenience stores mainly in Guangzhou Province, Shanghai, Beijing and in several second tier cities. Virtual prepaid point cards can be purchased online by debit card, credit card or bank transfer using our Wangyibao online payment platform.

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

### **Our Portal**

The NetEase websites provide Internet users with Chinese language online services centered around three core service categories content, community and communication. Our wide range of content appeals to a broad audience group spanning all age groups. However, our services are particularly popular among younger audiences between the ages of 23 and 35. We are continually working to reinforce our leadership position through premium content and service development and innovation.

Table of Contents

*Content*

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

*Community and Communication*

The NetEase websites provide a broad array of free and fee-based community and communication services, including micro-blogging, blogging, photo album, instant messaging, online personal advertisements, open courses (NetEase Open Courses), mobile news applications (NetEase News App), e-reading (EaseRead), matchmaking (Huatian) and community forums.

*Other*

In addition to the services described above, the NetEase websites provide other services to our users, including various search functions, dictionary (Youdao Dictionary) and cloud note-taking application (Youdao Cloudnote). These products are powered by our own proprietary Internet search engine, Youdao, which was developed by us and launched in December 2007 and is free of charge to users.

**Advertising Services**

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

**E-mail, Wireless Value-Added Services and Others**

As one of the largest e-mail services provider in China, we offer free and fee-based premium e-mail services to our individual users and corporate users. We also offer a wide range of wireless value-added services, as well as e-commerce related services, such as Wangyibao, our online payment platform, and Yinxiangpai, our personalized photo-based products, to our users.

## OUR ORGANIZATIONAL STRUCTURE

We conduct our business in China solely through our subsidiaries and VIEs. Under current Chinese regulations, there are restrictions on the percentage interest foreign or foreign-invested companies may have in Chinese companies providing value-added telecommunications services in China, which include the provision of Internet content, online games and e-mail, wireless value-added and other services. In addition, the operation by foreign or foreign-invested companies of advertising businesses in China is subject to government approval. In order to comply with these restrictions and other Chinese rules and regulations, NetEase, Inc. and certain of its subsidiaries have entered into a series of contractual arrangements for the provision of such services with certain affiliated companies, namely Guangzhou NetEase and Guangyitong Advertising. Under the contracts, we provide our Internet, e-mail and wireless value-added applications, services and technologies and advertising services to Guangzhou NetEase and Guangyitong Advertising and they operate the NetEase websites and the online advertising business. Guangzhou NetEase has two majority-owned subsidiaries, Youdao Computer (a search-related business operator) and Wangyibao (the operator of our Wangyibao online payment platform). For more information on these agreements, see Item 7.B. Major Shareholders and Related Party Transactions Related Party Transactions.

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

Guangzhou NetEase is 90% beneficially owned by our founder, Chief Executive Officer and major shareholder, William Lei Ding, and 10% owned by his brother, Bo Ding. Guangyitong Advertising is 80% owned by Guangzhou NetEase and 20% owned by Bo Ding. Youdao Computer is 71.7% owned by Guangzhou NetEase and 28.3% owned by individuals who are employees of Youdao Computer. Wangyibao is 90% owned by Guangzhou NetEase and 10% owned by an individual. We do not have any direct ownership interest in Guangzhou NetEase, Guangyitong Advertising, Youdao Computer or Wangyibao.

As a result of our contractual arrangements with these companies, we bear the risks of, and enjoy the rewards associated with, and therefore are the primary beneficiary of our investments in them. They are therefore considered our variable interest entities, and we consolidate the results of operations of these VIEs and their subsidiaries in our historical consolidated financial statements. See also Item 5 Operating and Financial Review and Prospects. Hangzhou Leihuo Network Co., Ltd. and Ujia E-commerce Co., Ltd., or Ujia E-commerce, are also VIEs of our company, but they have not been fully operational since their formation in April 2009 and August 2011, respectively.

Table of Contents

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

In August 2008, April 2009 and November 2012, Blizzard agreed to license certain online games to Shanghai EaseNet for operation in the PRC. Shanghai EaseNet is a PRC company owned by William Lei Ding, our Chief Executive Officer, director and major shareholder and has contractual arrangements with the joint venture established between, and owned equally by, Blizzard and us, and with us. The joint venture was established concurrently with the licensing of games from Blizzard in August 2008 and provides technical services to Shanghai EaseNet.

Ujia.com, Inc., or Ujia Cayman, Ujia (Hong Kong) Limited, or Ujia Hong Kong, and Lede Technology Co., Ltd., or Lede Technology, were established by us in the second half of 2011. Lede Technology now operates our e-commerce business.

We established Zhejiang Weiyang Technology Co., Ltd., or Zhejiang Weiyang, in March 2010 and its subsidiary, Anji Weiyang Agricultural Development Co., Ltd. in September 2012 to operate a swine raising business in Zhejiang Province, China. We are in the process of constructing the swine farm.

In February 2013, we completed the merger of Guangzhou NetEase Interactive Entertainment Co., Ltd., or Guangzhou Interactive, and Guangzhou NetEase Information Technology Co., Ltd., or Guangzhou Information, into Boguan, with Boguan as the surviving entity.

The following diagram shows the group structure of our principal subsidiaries and affiliated companies, other than our joint venture arrangements with Blizzard, which are described separately in this section.

Table of Contents

**OUR SERVICES**

**Online Games**

*Massively Multi-player Online Role-Playing Games*

We launched our first MMORPG, Westward Journey Online, in December 2001 and began charging users for playing time beginning in January 2002. Subsequently, we launched Westward Journey Online II in August 2002 and our second internally developed MMORPG, Fantasy Westward Journey, in January 2004. We subsequently have launched a number of additional online games, as set forth in the table below.

Our principal internally developed games, in terms of the number of users and revenue generated, are Fantasy Westward Journey, Westward Journey Online II, Tianxia III, Ghost, and Heroes of Tang Dynasty II (a comprehensive upgrade of Heroes of Tang Dynasty). These games are MMORPGs set in classical Chinese-themed fantasy worlds, of which Fantasy Westward Journey and Westward Journey Online II are 2D games, Ghost and Heroes of Tang Dynasty II are 2.5D games and Tianxia III is a 3D game. The following table sets forth these and certain of our other major MMORPG games. In addition, we have also commercially launched Soul of the Fighter, a 3D item-based ARPG, in July 2012, and are currently testing several new types of 2.5D and 3D games.

Table of Contents

| <b>Game</b>   | <b>Genre</b>                                 | <b>Revenue Model</b> | <b>Date of Initial Commercial Launch</b> | <b>Date of Issue of Latest Expansion Pack</b> |
|---|--|----------------------|--|---|
| Westward Journey Online II  | 2D MMORPG,<br>classical Chinese setting      | Time-Based           | August 2002                              | June 2012                                     |
| Fantasy Westward Journey  | 2D MMORPG,<br>classical Chinese setting      | Time-Based           | December 2004                            | September 2012                                |
| Westward Journey Online III   | 2D MMORPG,<br>classical Chinese setting      | Time-Based           | September 2007                           | August 2012                                   |
| Warsong of Westward Journey   | 2D MMORPG,<br>classical Chinese setting      | Item-Based           | September 2008                           | April 2012                                    |
| New Fly for Fun   | 3D MMORPG,<br>cartoon-style flying theme     | Item-Based           | October 2008                             | January 2013                                  |
| Ghost   | 2.5D MMORPG,<br>classical Chinese setting    | Item-Based           | July 2010                                | April 2012                                    |
| Legend of Fairy   | 2.5D MMORPG,<br>European-style fairy setting | Item-Based           | May 2011                                 | December 2012                                 |
| Tianxia III   | 3D MMORPG,<br>classical Chinese setting      | Item-Based           | October 2011                             | September 2012                                |
| Kung Fu Master  | 2.5D MMORPG,<br>classical Chinese setting    | Item-Based           | July 2012                                | October 2012                                  |
| Heroes of Tang Dynasty II (a comprehensive upgrade of Heroes of Tang Dynasty) | 2.5D MMORPG,<br>classical Chinese setting    | Item-Based           | November 2012                            |   |

Our MMORPG titles can be accessed from any location with an Internet connection by registered users of the NetEase websites. Users may enter our network with a password and a user-ID, after downloading our installation software or purchasing such software on a CD-ROM. Players of these games select a specific character to begin play. Over the course of play, these characters build up experience and enhanced game capabilities, wealth, weapons and other possessions, all of which may be carried over into subsequent gaming sessions. In our item-based games, players can also purchase virtual items that enhance their playing experience such as special powers, costumes, weapons and other accessories. We regularly introduce new virtual items or change the features of virtual items based on player feedback, market trends and other factors.

Players develop their characters according to choices they make within the construct of the game. Players also interact with computer operated characters as well as with other players that are playing on the same network server. Players are able to communicate with each other during the game through instant messaging or chatting features, allowing them to coordinate their activities with other players to form groups and achieve collective objectives.

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

We periodically develop and release expansion packs, which expand game content and gameplay features for previously launched games. These periodic expansion packs are designed to retain the interest of existing users and to attract new users. The timing and success of periodic expansion packs have a strong influence on the popularity and profitability of online games.



*Web-based Games*

Web-based games are games that players can easily access and play via the Web without downloading and installing any software. Our principal web-based games, such as Storm of Empires, use an item-based revenue model.

*Casual Games*

Our online casual game platform, iTown, provides various multi-player games such as billiards, card games and mahjong. Casual games are easier to play than MMORPGs and can be played to a conclusion within a short period of time. The basic versions of such games are available free-of-charge, and we sell virtual game enhancements, such as options for changing the appearance of the gameplay or advanced tools, which players can use in the game, utilizing our prepaid point card system. As of December 31, 2012, iTown offered more than 30 casual games to users.

Table of Contents

*Customer Service*

We believe that providing strong, dependable customer support is a key component to success in the online games business. Our customer service center provides 24 hour-a-day, 7 day-a-week customer service and technical support and can be contacted via telephone or e-mail. As of December 31, 2012, our company employed approximately 1,749 personnel in our call center as customer service specialists for our online games as well as for our other services, of which 904 personnel provided customer service support for World of Warcraft.

*User Fees*

Users of Westward Journey Online II, Fantasy Westward Journey and Westward Journey Online III pay fees according to the amount of time they play the games, which was RMB0.40 (US\$0.06) per hour for each game in 2012 and increased to RMB0.60 (US\$0.10) per hour in February 2013. For our item-based games, such as Tianxia III, Heroes of Tang Dynasty II, Warsong of Westward Journey, Ghost, Soul of the Fighter and Kung Fu Master, we charge users a separate fee for each virtual item purchased within the games.

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

Revenues from our online games accounted for 88.1%, 88.4% and 87.8% of our total net revenues in 2010, 2011 and 2012, respectively.

*Mobile Internet Applications*

Web-based games, social networking games and mobile games have gained increasing popularity and user base as Internet users in China rely more and more on mobile devices, such as smart phones and tablets, to access the Internet. In response to this trend, we are exploring the possibility of developing games that can be operated on mobile devices.

*Game Licensing and Joint Venture with Blizzard*

## Edgar Filing: NetEase, Inc. - Form 20-F

In August 2008, Blizzard agreed to license to Shanghai EaseNet on an exclusive basis in China three personal computer strategy games: StarCraft II: Wings of Liberty, a sequel to Blizzard's space-themed strategy game, which was commercially launched in April 2011; Warcraft® III: Reign of Chaos, a fantasy-themed strategy game; and Warcraft III: The Frozen Throne, an expansion pack to Warcraft III: Reign of Chaos. Blizzard also licensed to Shanghai EaseNet on an exclusive basis in China its Battle.net® platform, which enables multiplayer interaction within these games and other online services. The term of the license is three years, with an additional one year extension upon agreement of the parties, commencing from the commercial release of StarCraft II: Wings of Liberty in China. Shanghai EaseNet, as licensee of the games, has paid to Blizzard an aggregate amount of RMB66.8 million (US\$10.0 million) as license fee.

In April 2009, Shanghai EaseNet paid Blizzard a three-year license fee of RMB204.8 million (US\$30 million) for the right to operate World of Warcraft. Shanghai EaseNet commercially launched World of Warcraft (with its first expansion pack, The Burning Crusade®, its second expansion pack, Wrath of the Lich King®, its third expansion pack, Cataclysm®, and its fourth expansion pack, Mists of Pandaria®, in September 2009, August 2010, July 2011 and October 2012, respectively. Shanghai EaseNet's license to operate World of Warcraft in the PRC has a three-year term from September 2009. In March 2012, Blizzard and Shanghai EaseNet agreed to extend the license term for an additional three years commencing from September 2012.

In November 2012, Shanghai EaseNet obtained the right to operate Blizzard All-Stars in China from Blizzard. The term of the license is three years, with an additional one year extension upon agreement of the parties, commencing from the commercial release of such game in China. Blizzard All-Stars has not been commercially launched yet in China.

Table of Contents

With respect to the three license agreements with Blizzard, Shanghai EaseNet is required to pay license fees (except Blizzard All-Stars for which no license fee is required to be paid), royalties and consultancy fees to Blizzard for the games. The license agreements also include minimum marketing expenditure commitments. In sum, the total commitments (including an additional commitment in connection with the three-year extension of the World of Warcraft license) amount to approximately RMB3.9 billion (US\$0.6 billion) over the terms of the agreements. As of December 31, 2012, our outstanding commitments under the license agreements with respect to StarCraft II: Wings of Liberty and World of Warcraft totaled RMB1,123.9 million (US\$180.4 million). We expect to incur a commitment under the license agreement with respect to Blizzard All-Stars totaling approximately RMB375.9 million (US\$60.3 million) after the commercial launch of the game. We have guaranteed the payment of the foregoing amounts if and to the extent Shanghai EaseNet has insufficient funds to make such payments. We will be entitled to reimbursement of any amounts paid for the marketing of the games and hardware support to operate the games under the guarantee from any net profits subsequently generated by Shanghai EaseNet, after the deduction of, among others, various fees and expenses payable to Blizzard, us and our joint venture with Blizzard which will provide technical services to Shanghai EaseNet.

Blizzard has the right to terminate the license of the foregoing games under certain circumstances.

Concurrently with the licensing of games from Blizzard in August 2008, we entered into arrangements to establish a joint venture with Blizzard. The joint venture provides technical services to Shanghai EaseNet in return for a fee. Net profits of the joint venture are shared equally between Blizzard and us, after the deduction of, among others, various fees and expenses payable to Blizzard and us.

**Internet Portal**

Our Internet portal business, which is conducted through the NetEase websites, offers Chinese Internet users a network of Chinese language-based online content channels, community and communication services, including news content, community forums, micro-blogging, blogging, mobile-based applications, open courses (which offer users access to recorded content from classes and lectures) and online video (which is a platform that provides various categories of video products, including news, entertainment, music, sports, financial and life). We also offer other Web-based applications and services, including a full text Chinese language search engine and a Web directory, to enhance their Internet experience. Our Internet services are all designed with user friendly interfaces and easy to understand instructions.

*163.com*

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

The NetEase websites currently include various channels focusing on news, automobile, sports, finance, real estate, entertainment, science and information technology. Our mobile news application, NetEase News App, has achieved over 50 million installations as of December 31, 2012.

## Edgar Filing: NetEase, Inc. - Form 20-F

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

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

### *Community and Communication*

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

Table of Contents

NetEase users can interact through a variety of community services, including:

- *Online Community Forums.* We offer NetEase registered community members a variety of community forums where they can post messages and articles for viewing by other registered community members and other users. The NetEase online communities are hosted by volunteers, who are chosen by us based on their contributions to the communities. The NetEase community volunteers monitor our community forums and select appropriate articles for posting. In addition, these forums are also monitored by NetEase customer service personnel.
- *Micro-blogging.* We offer a micro-blogging service which allows users to exchange small elements of content such as short sentences, images or video links. With this service, registered users can follow the hottest topics being discussed online as well as discussions related to people they know. Our micro-blogging accounts consist of celebrities, commercial enterprises, government entities and grass root Internet users, who may send feeds in the form of text (up to 163 Chinese characters) and multimedia (photo, video and music) content to their opted-in followers. Micro-blogging account users may view feeds from accounts that they follow, via search results or by topical content pages. Micro-blogging services can be a powerful individual distribution media, because it allows users to redistribute a feed to their followers with added commentary. An interesting feed that is redistributed several times enables the original author to virally reach users beyond the author's first degree of followers, leveraging on the network of the author's followers' followers several degrees away. We also offer a traditional blogging service for registered users, which allows the posting of larger messages than micro-blogging.
- *Matchmaking and Others.* We offer a large number of other community services including online matchmaking services, including Huatian, online greeting cards, photo album sharing and diary.

*Youdao*

In addition to the services described above, the NetEase websites provide other services to our users including web search, blog search, image search, news search, online shopping search (Huihui.cn), online dictionary (Youdao Dictionary), toolbar and cloud note-taking application (Youdao Cloudnote), which automatically retrieves syndicated online content and customized sets of search results. Those products are powered by our own proprietary Internet search engine, Youdao, which was officially launched in December 2007 and is free of charge to users. Among these, Youdao Dictionary has become one of the most popular online translation tools among Chinese Internet users, achieving over 275 million installations as of December 31, 2012, and Huihui.cn is an online shopping search engine developed by us and launched in September 2012.

*Mobile Internet Applications*

Many of our services, such as news content (NetEase News App), micro-blogging, open courses (NetEase Open Courses), online dictionary (Youdao Dictionary), cloud note-taking application (Youdao Cloudnote) and e-reading (EaseRead) may be accessed through mobile Internet and mobile applications, such as those operating on iPhone, iPad and Android devices. Designed as multi-device products, our products and services enable Chinese communities to participate in discussions on PCs and mobile devices, including mobile phones, tablets and other hand-held devices, allowing easier and more frequent interactions and elevating the social media and networking experience to a different level.

*Advertising Services on the Websites and Fees and Revenues*

Revenue generated by our Internet portal business consists mainly of fees we receive from the sale of advertising space on the NetEase websites. Our free website content and services attract a large number of visitors who generate page views, which form the audience for us to provide advertising services for advertisers on our websites.

Our advertising services utilize many advertising formats and techniques. These include sponsorships of our channels, advertisements such as animated and interactive banners, floating buttons, text-links, in-stream video and other formats throughout our websites, advertising through interactive media-rich sites and sponsored special events that integrate live events with online promotion and other media.

Furthermore, in compliance with applicable laws and ensuring the confidentiality of the information of our users, we transmit and store over our systems information, such as age, geographic location and interest, of our users and integrate such information to generate comprehensive demographic profiles for individual users, which enable us to better tailor our advertising services.

To increase traffic on the NetEase websites and enhance the websites' appeal to advertisers, we periodically sponsor major events, such as the 2010 Asian Games held in Guangzhou, China. We have also been focusing on high profile sporting events, such as Euro Cup 2012 and the London Olympics, including partnership with China Network Television to broadcast the London Olympic Games and the opening and closing ceremonies on our portal and our mobile news application, NetEase News App.

Table of Contents

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

For our search engine business, Youdao Computer enters into cost per action, or CPA, advertising contracts with advertisers and receives fees when an online user performs a specific action such as purchasing a product from or registering with an advertiser appearing on a search page. Revenue for CPA contracts is recognized when the specific action is completed. Youdao Computer also enters into advertising business contracts which provide priority placements in a search directory and other online marketing services on the Youdao Dictionary service.

Revenues from our Internet portal accounted for 10.4%, 9.9% and 9.4% of our total net revenues in 2010, 2011 and 2012, respectively.

**E-mail, Wireless Value-added Services and Others**

*E-mail*

We provide registered users with free and fee-based premium e-mail services which support both the Chinese and English languages. Registered users can access and send e-mail through their Web browsers, smart phone application or through the POP3 and SMTP standards, which allow users to handle e-mails on their own e-mail applications without opening their browsers. The free e-mail service includes free SPAM filters and anti-virus protection as well as the convenience of an address book to maintain user contact lists online. As of December 31, 2012, we had approximately 530 million registered free e-mail users. We also offer value-added e-mail services for individuals, known as VIP, which provide fee-paying subscribers with the latest anti-virus and anti-SPAM filtering capabilities. The VIP e-mail service also includes enhanced security features as well as several convenient online and offline payment methods and 24-hour customer support. As of December 31, 2012, we had approximately 379,000 active VIP e-mail subscribers. In addition, we also offer fee-based premium e-mail services to corporate users, who could use their corporate name as e-mail address and enjoy our custom-made functions, such as group instant message, push mail service and Internet disk services. As of December 31, 2012, we had approximately 50,000 paid corporate e-mail customers.

During 2012, we invested in significant upgrades to our mailbox infrastructure and engaged in promotional activities, including advertising on a high profile television show collaborating with major mobile phone manufacturers to reinstall our e-mail services on their mobile devices.

*Wireless Value-added Services*

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



## Edgar Filing: NetEase, Inc. - Form 20-F

they have received an e-mail message in our premium VIP e-mail service. For an additional payment, we will also send subscribers the text of the e-mail message to their mobile phone via SMS.

In addition, we offer wireless application protocol, or WAP, services, which provide a browser-based platform to access and use sophisticated wireless value-added services, and multimedia messaging services, or MMS, which provide sophisticated, content-rich mobile messages. Both WAP and MMS services are available to mobile users with phones that are compatible with the 2.5G mobile networks in China. We also offer interactive voice response services, or IVRS. IVRS allows users to access pre-recorded information from their mobile phones or interact with other users through voice chat simply by dialing specially designated IVRS phone numbers and responding to menu options. Our users can also order color ring-back tones, which enable users to customize the ringtone a caller hears. These ringtones can include voice recordings as well as pre-recorded music.

### *Others*

In addition to the services described above, the NetEase websites provide e-commerce related services, such as Wangyibao, our online payment platform, Yinxiangpai, our personalized photo-based products, and game-related accessories, and other services to our users.

Table of Contents

Revenues from e-mail, wireless value-added services and others accounted for 1.5%, 1.7% and 2.8% of total net revenues in 2010, 2011 and 2012, respectively.

**SALES AND MARKETING**

**Sales**

*Online Games*

We sell game playing time to users of the MMORPGs that we operate largely in the form of prepaid point cards. We sell prepaid point cards to end users through over 3,100 distributors as of December 31, 2012. These distributors arrange for our cards to be offered at various retail points in China including, notably, Internet cafés where many of the users of our online games access our system, and to a much lesser extent, directly over the Internet. Historically, we sold prepaid point cards to distributors at a 6.0% - 12.0% discount off of their face value. We reduced the discount to 6.0% - 10.0% in June 2012. For the distributors selling prepaid point cards for use with the games licensed from Blizzard, the discount was 9.0% - 12.0%, which was reduced to 7.0% - 10.0% in December 2011. The discount for each distributor varies based on that distributor's volume of point cards purchased.

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

*Advertising Services*

We believe the growing number of Internet users in China represents an attractive demographic target for advertisers because it represents an affluent, educated and technically sophisticated market. To capitalize on this advertising opportunity, we maintain a dedicated advertising services sales force, which had 285 sales professionals located in Beijing, Shanghai and Guangzhou as of December 31, 2012.

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

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

## Marketing

We employ a variety of traditional and online marketing programs and promotional activities to build our brand as part of our overall marketing strategy. We focus on building brand awareness through proactive public relations and traditional and online advertising. We invest in a series of marketing activities to further strengthen our brand image and continue to grow our user base. Our marketing campaigns consist of corporate branding and announcements about our services through outdoor, print and online advertisements. We also conduct in-game marketing campaigns, visible to users playing our online games, in connection with holiday seasons or the commercial launches of new games or expansion packs throughout the year. In 2012, we continued with efforts in maintaining and/or raising the popularity of our time-based games, such as Fantasy Westward Journey and Westward Journey Online II and III, and our item-based games, such as Tianxia III, Ghost, Heroes of Tang Dynasty II, Soul of the Fighter and Kung Fu Master, through certain new sales and promotional activities such as using product spokespersons. We believe that players' feedback has been positive in response to our recent promotional activities.

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

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

Table of Contents

**RESEARCH AND DEVELOPMENT**

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

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

Our major area of focus is the development of our proprietary online games (including introducing new types of games) and localizing licensed games, and we plan to continue this focus in the future. As of December 31, 2012, we had approximately 2,000 programmers, network engineers and graphic designers dedicated to online game research and development.

We have multiple studios of game developers established to research and develop new games and expansion packs. In developing a new game or expansion pack, game developers create proposals for the game theme and design, and then construct prototypes for management to review and approve. Next, our quality control staff, as well as volunteer players, conduct limited beta testing for the new game designs and expansion packs. Based on analysis of the feedback provided by the quality control staff and volunteer players, our game developers refine the game designs and expansion packs and then initiate unlimited beta testing, in which the game becomes available to the public. For games using the time-based revenue model, no revenue is collected from users during unlimited beta testing until commercial launch of the game. However, for games using the item-based revenue model, users in the unlimited beta testing can purchase in-game items, which allow those games to start generating revenue from the unlimited beta testing phase onwards. Accordingly, for item-based games, the beginning of unlimited beta testing is sometimes considered to be the commercial launch of the game. Our game developers further improve the new game designs and expansion packs as necessary based on user statistics and feedback gathered from unlimited beta testing. User statistics gathered from limited beta and unlimited beta testing results are compared with existing games, which enables us to assess the potential for success of the new games and expansion packs and to plan the network infrastructure and marketing efforts required to support each new game or expansion pack.

In connection with our game development activities, we occasionally license specific game technologies which we incorporate into our internally developed games.

**INFRASTRUCTURE AND TECHNOLOGY**

Our infrastructure and technology have been designed for reliability, scalability and flexibility and are administered by our technical staff. The NetEase websites are made available primarily through network servers co-located in the facilities of China Unicom's Beijing affiliate and China Telecom's Beijing affiliates. As of December 31, 2012, there were approximately 27,500 of such co-located servers, including servers supporting the operation of World of Warcraft and StarCraft II, operating with Web server software from Apache and Netscape and we leased dedicated lines substantially from CERNET and various affiliates of China Unicom and China Telecom.

In addition, we also develop our own systems to facilitate sales planning, targeting, trafficking, inventory management and reporting tools, as well as advertisement and search tracking systems for our advertising and search services.

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

## COMPETITION

A number of companies offer competitive products or services in China, our main operating market. Specifically, we are encountering competition from companies offering MMORPGs and casual games that target the China market, such as Tencent, Changyou.com Limited, Giant Interactive Group Inc., Shanda Games Limited, Perfect World Company Limited, 9you, and Kingsoft Corporation Limited. We also face competition from other websites that offer online content and online community services, including Tencent, Baidu, Alibaba, Sina, Sohu, Qihu, iFeng.com, Youku, Renren Inc. and 263.net. Some of our existing and potential competitors in these areas have significantly greater financial and marketing resources than we do. In addition, we believe that many of our competitors have become more active in both licensing foreign-developed games and developing games in-house.

Table of Contents

We also believe that competition in the online advertising industry in China is intense with numerous competitors such as Baidu, Sina, Sohu, Tencent, Alibaba and Youku, as well as other new entrants such as Qihu, iFeng.com and iQIYI, and other vertical Internet portals. In addition, we face competition from portals operated by multinational Internet companies such as Yahoo! Inc., Microsoft Corporation and Google Inc. which provide Chinese language service offerings. Many of these Internet companies have longer operating histories in the Internet market, greater name and brand recognition, larger customer bases and databases and significantly greater financial, technical and marketing resources than we have. The entry of additional, highly competitive Internet companies into the Chinese market would further heighten competition. Finally, we face competition from websites that operate outside our market and offer content in the English language, which may be attractive to a portion of Chinese Internet users.

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

## **GOVERNMENT REGULATIONS**

### *Overview*

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

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

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

The Circular of the MII on Intensifying the Administration of Foreign Investment in Value-Added Telecommunication Services, or the 2006 MII Circular, was promulgated by MII on July 13, 2006. The 2006 MII Circular provides that (i) any domain name used by a valued added telecom

## Edgar Filing: NetEase, Inc. - Form 20-F

service provider must be legally owned by the service provider or its shareholder(s); (ii) any trademark used by a value-added telecom service provider must be legally owned by the service provider or its shareholder(s); (iii) the operation site and facilities of a value-added telecom service provider must be installed within the scope as prescribed by the operating licenses obtained by the service provider and must correspond to the value-added telecom services that the service provider has been approved to provide; and (iv) a value-added telecom service provider must establish or improve the measures of ensuring information security. Companies which have obtained operating licenses for value-added telecom services are required to conduct a self-examination and self-correction according to the foregoing requirements and report the results of such self-examination and self-correction to MII. To comply with these requirements, Guangzhou NetEase submitted its self-correction report to MII in 2007.

### *Classified Regulations*

### *Internet Information Services*

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

Table of Contents

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

The Provisional Regulations for the Administration of Website Operation of News Publications, which were jointly issued by SCIO and MII on November 6, 2000, stipulate that non-news organizations may not publish news items produced by themselves and require the websites of non-news organizations to be approved by SCIO after securing permission from SCIO at the provincial level. On September 25, 2005, the Regulations for the Administration of Internet News Information Services were promulgated jointly by SCIO and MII. The regulations require that any ICP operator that is a non-news organization but engaged in Internet news information services must obtain approval for those services from SCIO. Guangzhou NetEase has obtained an Internet News Information Service License from SCIO.

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

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

On May 1, 2009, MOH issued the Measures for the Administration of Internet Medical and Healthcare Information Services, or the 2009 MOH Measures, which replaced the previous Measures for the Administration of Internet Medical and Health Information Services issued by the MOH on January 8, 2001. According to the 2009 MOH Measures, entities engaging in medical and health information service must gain approval from local health administrations. Guangzhou NetEase has secured an approval for publishing medical and health information through a formal reply issued by the Guangdong Health Administration.

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

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



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

Table of Contents

On September 3, 2009, the MOC issued its Notice on Strengthening and Improving the Content Censorship of Online Music Content. According to this notice, only entities approved by the Ministry of Culture for an Internet Culture Operating License may engage in the production, release, dissemination (including providing direct links to music products) and importation of online music products. In addition, the notice also requires all domestic music products to be filed with the MOC within 30 days after being publicly available online. Imported music products must be approved by the MOC before being made available online. Guangzhou NetEase, Shanghai EaseNet and Youdao Computer have each obtained an Internet Culture Operating License.

On April 16, 2009, the PBOC issued a notice, or the PBOC Notice, regarding the regulation of non-financial institutions engaged in the business of effecting payments and settlements. The PBOC Notice requires non-financial institutions established before April 16, 2009 which are engaged in the payment and settlement business to register with the PBOC before July 31, 2009. According to the PBOC Notice, such registration is interpreted as a basis for future policy making rather than a permit. Guangzhou NetEase has finished the required registration with the PBOC. In addition, on June 14, 2010, the PBOC issued the Measures for the Administration of Non-financial Institutions Engaging in Payment and Settlement Services, or the PBOC Measures, which became effective as of September 1, 2010 and require that non-financial institutions engaging in the business of effecting payments and settlements before June 14, 2010 obtain a permit, Payment Service Permit, from the PBOC by August 31, 2011 to continue such business. On December 1, 2010, the PBOC issued the Implementation Rules for the Measures for the Administration of Non-financial Institutions Engaging in Payment and Settlement Services, or the Implementation Rules for the PBOC Measures, which contains further elaboration with respect to the application qualification, material and procedure for the Payment Service Permit and further measures aiming at protecting the rights and interests of clients, including prominent disclosure of service rates, prior notice to clients before any modification can be made to the service rates or payment service agreement between a payment service provider and its clients. We have obtained the Payment Service Permit from the PBOC. For other details, see Item 3.D. Risk Factors Risks Related to the Telecommunications and Internet Industries in China Regulatory restrictions on financial transactions may adversely affect the operation and profitability of our business.

On May 31, 2010, SAIC issued the Interim Measures for the Administration of Online Commodities Transaction and Relevant Services, aiming to further regulate online commodities transaction and relevant services and protect rights and interests of consumers through various measures, including requirement for online commodity and service providers to ensure that information they released should be authentic and accurate without false representation, and that their commodities and services should comply with all applicable laws in respect of intellectual property rights protection and anti-unfair competition.

On September 3, 2009, MOC issued the Notice on Strengthening and Improving the Content Review of Online Music, or the Online Music Notice. Among other things, the Online Music Notice requires that only Internet culture operating entities with an Internet Culture Operating License from MOC may engage in the production, release, dissemination (including providing direct links to music products) and importation of online music products. In addition, the Online Music Notice requires any domestic music products to be filed with MOC within 30 days after being made available online and imported music products to be approved by MOC before being made available online. In compliance with such notice, Youdao Computer has obtained an Internet Culture Operating License.

On May 10, 2010, the State Bureau of Surveying and Mapping issued the Notice on Publishing the Professional Standards of Internet Mapping, or the Mapping Standards Notice. Pursuant to the Mapping Standards Notice and other PRC regulations applicable to Internet mapping services, Internet maps mean maps published and transmitted through the Internet and Internet mapping services provider shall apply for a Surveying and Mapping Qualification Certificate for Internet mapping with the competent surveying and mapping bureau. Youdao Computer has obtained a Surveying and Mapping Qualification Certificate.

## Edgar Filing: NetEase, Inc. - Form 20-F

On December 16, 2011, Beijing Municipal Information Office, Public Security Bureau, Communications Administration and Internet Information Office jointly promulgate Certain Provisions on the Administration of Micro-Blogging Development, or Beijing Micro-blogging Provisions. Among other things, Beijing Micro-blogging Provisions requires that any organization or individual that registers a micro-blogging account and produces, reproduces, publishes, or disseminates information content shall use real identity information, and shall not carry out registration by false information or by using other resident's identity information, business registration information, or organization code information. Also, websites that launch micro-blogging services shall ensure the authenticity of such registered user information. In accordance with these provisions, we have required users to provide real identity information in registering micro-blogging accounts.

On December 21, 2011, MII issued Several Provisions on Regulating the Market Order for Internet Information Services, or the Market Order Provisions. According to such provisions, Internet information service providers, or IISPs, are prohibited from a wide range of activities that would infringe upon rights and interests of users or other IISPs, including but not limited to maliciously forcing incompatibility on services and products provided by other IISPs, deceiving, misleading or forcing users to use or not to use services and products provided by other IISPs, changing user's browser configurations or other configurations without notifying and obtaining permission from the users, bundling their terminal software with other software without providing clear notice to the users. Also, IISPs should not collect information that is related to the users and can serve to identify the users' identities solely or in conjunction with other information without the users' consent and should not provide other people with such information, unless otherwise permitted or required under laws or administrative regulations. We believe our current operation is in compliance with the Market Order Provisions.

Table of Contents

*Information Security and Censorship*

Regulations governing information security and censorship include:

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

## Edgar Filing: NetEase, Inc. - Form 20-F

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

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

Table of Contents

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

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

On December 28, 2012, the Standing Committee of the National People's Congress issued the Decision on Strengthening Network Information Protection, or the Information Protection Decision, which provides that electronic information through which a citizen's identity can be identified or in which a citizen's privacy is involved, or Personal Information, is protected and no person shall steal, illegally obtain, sell or illegally provide to others any Personal Information. Also, according to the Information Protection Decision, where the network service providers provide website access service, or handle network access formalities for fixed-line telephones or mobile phones, or provide information publication service for their users, they shall require the users to provide authentic identity information when concluding agreement or confirming provision of such service with the users.

*Online Games*

Effective as of April 10, 2009, the Measures for the Administration of Software Products, originally issued by MII on October 27, 2000, were amended and replaced by a new version issued by the MII in April 2009. According to these regulations, software products developed in the PRC could be registered with the local provincial government authorities in charge of the information industry and filed with the MII. Upon registration, the software products are granted registration certificates. In accordance with this regulation, all of our online games, including Westward Journey Online II, Fantasy Westward Journey, Tianxia III, Westward Journey Online III, Warsong of Westward Journey, Ghost, Legend of Fairy, New Fly For Fun, Legend of Datang, Storm of Empires, Dragon Sword, Kung Fu Master and Popo games have been registered with MII and its offices at the provincial level.

Pursuant to the Provisional Regulations for the Administration of Online Culture promulgated by MOC in May 2003, which were revised in July 2004 and February 2011, online game operators are required to obtain an Internet Culture Operating License from MOC, which Guangzhou NetEase and Shanghai EaseNet have received. In 2004, MOC promulgated the Notice Regarding the Strengthening of Online Games Censorship, which provides that imported online games must be reviewed and approved by MOC before they can be put into public testing or operation. Shanghai EaseNet has obtained MOC approval for World of Warcraft, including its expansion packs, The Burning Crusade, Wrath of the Lich King, Cataclysm and Mists of Pandaria and StarCraft II: Wings of Liberty.

On April 24, 2009, MOC issued a Circular Concerning the Examination and Declaration of Imported Online Game Products. According to this circular, in the event of a change of the operator of an imported online game, the game's existing import approval will be automatically revoked and the new operator must apply to the MOC for a new approval for the same game.

On June 4, 2009, MOC and the Ministry of Commerce jointly issued the Notice on Strengthening Administration on Online Game Virtual Currency, or the Online Game Virtual Currency Notice. According to the Online Game Virtual Currency Notice, online game virtual currency should only be used to exchange virtual services provided by the issuing enterprise for a designated extent and time, and is strictly prohibited from being used to pay for or purchase tangible products or any service or product of another enterprise. Also, the Online Game Virtual Currency Notice obligates the issuing enterprise to give users 60 days prior notice and refund in the form of legal tender or other forms acceptable to users in case it plans to terminate the provision of its products or services. We have implemented measures which we believe are necessary to ensure our compliance of the Online Game Virtual Currency Notice.

In addition, for imported online games, the relevant license agreements for such games are regarded as technology import contracts and, accordingly, must be registered with the Ministry of Commerce. Shanghai EaseNet has registered the license agreements for StarCraft II: Wings of Liberty and World of Warcraft with the local office of the Ministry of Commerce. Such license agreements also need to be registered with the State Copyright Bureau, otherwise the licensee cannot remit licensing fees out of China to the foreign game licensor. Shanghai EaseNet has registered the license agreement for World of Warcraft and StarCraft II: Wings of Liberty with the State Copyright Bureau.

Table of Contents

The publication of online games also requires approval from GAPP in accordance with the Provisional Rules for the Administration of Internet Publishing jointly promulgated by GAPP and MII on June 27, 2002. Guangzhou NetEase has received such approval. In addition, in April 2007, GAPP and several other government authorities jointly promulgated the Notice Concerning the Protection of Minors' Physical and Mental Well-being and Implementation of Anti-addiction System on Online Games (the Anti-Addiction Notice), which confirms the real-name verification scheme and anti-addiction system standard made by GAPP in previous years and requires online game operators to develop and test their anti-addiction systems from April 2007 to July 2007, after which no online games can be registered or operated without an anti-addiction system in accordance with the Anti-Addiction Notice. On July 1, 2011, GAPP and several other government authorities jointly issued the Notice Regarding the Initiation of Work on the Online Games Real-Name Verification System to Prevent Online Gaming Addiction, or the Real-Name Verification Notice, which requires that online game operators be responsible for the data registration and identification of online game users, and that online game operators shall duly file unverified user identification information with the Ministry of Public Security's National Citizen Identity Information Center, or NCIIC, which will be in charge of real-name verification for the national anti-addiction system. In addition, online game operators shall ensure that via the NCIIC real-name verification, users with fraudulent identification data shall be enrolled in the operators' anti-addiction systems. Accordingly, we have implemented our anti-addiction system and taken necessary measures to comply with the Anti-Addiction Notice and the Real-Name Verification Notice. Since their implementation, we have not experienced a significant negative impact of the Anti-Addiction Notice and the Real-Name Verification Notice on our business.

On September 7, 2009, the Office of the Central Institutional Organization Commission issued the Notice on Interpretation of the Office of the Central Institutional Organization Commission on Several Provisions relating to Animation, Online Games and Comprehensive Law Enforcement in the Culture Market in the Three Provisions jointly promulgated by MOC, SARFT and GAPP. According to this notice, GAPP shall be responsible for the examination and approval of those online games made available on the Internet, and once an online game is available on the Internet, it shall be solely and completely administered by MOC. The notice further clarifies that GAPP shall be responsible for the examination and approval of the game publications which are authorized by overseas copyright owners to be made available on the Internet, and all other imported online games shall be examined and approved by MOC.

On September 28, 2009, GAPP, the National Copyright Administration and the National Office of Combating Pornography and Illegal Publications jointly published the Notice on Further Strengthening Pre-examination and Pre-approval of Online Games and Administration of Imported Online Games Approval, or Circular 13. According to Circular 13, no entity should engage in the operation of online games without receiving an Internet Publishing License and the pre-approval from GAPP. Circular 13 expressly prohibits foreign investors from participating in online game operating business via wholly owned, equity joint venture or cooperative joint venture investments in China, and from controlling and participating in such businesses directly or indirectly through contractual or technical support arrangements. Moreover, for online games which have been approved by GAPP, when the operational entity changes, or when new versions, expansion packs or new content is implemented, the operation entity shall once again undertake the same procedures for the examination and approval by GAPP of such changed operation entity, new versions, expansion packs or new content. Shanghai EaseNet has obtained GAPP approval for World of Warcraft, including its expansion packs, The Burning Crusade, Wrath of the Lich King, Cataclysm and Mists of Pandaria, and StarCraft II: Wings of Liberty.

On June 3, 2010, the MOC issued a decree on Interim Measures for the Administration of Online Games, or the Online Games Measures, which became effective as of August 1, 2010. The Online Games Measures set forth certain requirements regarding online games, including requirements that game operators follow new registration procedures, publicize information about the content and suitability of their games, prevent access by minors to inappropriate games, avoid certain types of content in games targeted to minors, avoid game content that compels players to kill other players, manage virtual currency in certain ways and register users with their real identities. Although many of these requirements reflect previously issued government regulations with which we already comply, certain new requirements may cause us to change the way we launch and operate our online games. For other details, see Item 3.D. Risk Factors Risks Related to the Telecommunications and Internet Industries in China. The Chinese government has taken steps to limit online game playing time for all minors and to otherwise control the content and operation of online games. These and any other new restrictions on online games may materially and adversely impact our business and results of operations. On July 30, 2010, the MOC promulgated the Notice on the Implementation of the Interim Measures for the Administration of Online Games, which provides details concerning the scope of online games, the review of online games content by the MOC, the administration of material changes in the content of online games and the implementation of real-name registration of online game users. In



addition, the notice brings in the definition of joint operation of domestic online games and lays out the specific regulations for such joint operation.

On January 15, 2011, the MOC and several other government authorities jointly issued the Notice on Implementation Program of Online Game Monitoring System of the Guardians of Minors, or the Monitoring System Notice, which requires online game operators to adopt various measures to maintain an interactive system for the protection of minors, through communication with the online game operators, to monitor and restrict online game activities by minors, including restriction of playtime or total suspension of the relevant gaming account. We have taken necessary measures in compliance of the Monitoring System Notice.

Table of Contents

On February 18, 1994, the State Council promulgated the Rules of the People's Republic of China for Protecting the Security of Computer Information Systems, which define Security Products for Computer Information Systems as software and hardware products designed for the protection of computer information security and stipulate that a license must be obtained before selling Security Products for Computer Information Systems. The Ministry of Public Security issued the Measures for the Administration of Security Products for Computer Information Systems Examination and Sales License on June 28, 1997 confirming that a license for the sale of security products for computer information systems must be obtained as a precondition for sales of such products. Guangzhou NetEase has developed a technology which is designed to protect the passwords of online game players and falls into the scope of security products for computer information systems which is subject to this license requirement. Guangzhou NetEase has obtained the above-mentioned license from the Ministry of Public Security.

According to the Guidelines for the Filing for Recordation of Domestic Online Games issued by MOC in 2005, domestic online games operating in China must be filed for recordation with MOC within 30 days after they are put into operation. Our internally developed online games, including Westward Journey Online II, Fantasy Westward Journey, Warsong of Westward Journey, Westward Journey III, Tianxia III, Heroes of Tang Dynasty II, New Fly For Fun, Storm of Empires, Legend of Fairy, Ghost, DREAM, Soul of the Fighter, Kung Fu Master and Popo games, have successfully finished the recordation process.

The Regulations for the Administration of Audio and Video Products, which was released by the State Council on December 25, 2001 and further amended in March 2011, require that the publication, production, duplication, importation, wholesale, retail and renting of the audio and video products are subject to a license issued by competent authorities. Guangzhou NetEase has obtained such license from Guangzhou Municipal Administration of Culture, Radio, Film, TV, Press and Publication.

*Online Advertising*

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

On February 9, 2012, SAIC and several other government authorities jointly issued the Rules on Review of Advertisement Release by Public Media, or the Advertisement Review Rule, which, among other things, states that public media (including Internet information service providers) shall have advertisement reviewers, who shall participate in trainings in relation to advertisement laws, regulations and business, and after passing the training should perform works including reviewing of advertisements to be released and management of advertisement review archives. In compliance with the Advertisement Review Rule, several employees of Guangzhou NetEase have obtained the Certificate for Advertisement Reviewer.

*Wireless Value-Added Services*

## Edgar Filing: NetEase, Inc. - Form 20-F

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

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

### **INTELLECTUAL PROPERTY AND PROPRIETARY RIGHTS**

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

Table of Contents

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

- www.netease.com;
- www.163.com;
- www.yeah.net;
- www.126.com;
- www.nease.net; and
- www.188.com

Guangzhou NetEase and NetEase Beijing have successfully registered numerous trademarks with China's Trademark Office, including marks incorporating the words NetEase and Yeah in English and for marks for NetEase as written in Chinese in traditional and simplified Chinese characters. In addition, they have registered trademarks involving Chinese characters and phrases that have meanings relating to our Web pages, products and services, including our dating and friends matching services, chat services, online gaming and our search engine. We have also registered a number of trademarks in Hong Kong incorporating the words NetEase in English and the marks for NetEase as written in Chinese in traditional and simplified Chinese characters. In addition, we have also filed and registered the marks for NetEase in English in the United States.

In addition, we have registered our products, our various self-developed games, including Westward Journey Online II, Fantasy Westward Journey, Heroes of Tang Dynasty II, Westward Journey Online III, Warsong of Westward Journey, Tianxia III, Ghost, Legend of Fairy, Legend of Datang, Soul of the Fighter, Kung Fu Master, Dragon Sword, Heroes of Three Kingdoms and iTown, and other online products, including Wangyibao (our online payment platform), Yinxiangpai, e-mail, photo album and online shopping mall, with the State Copyright Bureau of China. Moreover, we have filed certain patent applications with the State Intellectual Property Office of China and have obtained Certificate of Design Patent for the Password Protection Device and Certificates of Invention Patent for the Password Protection Device and certain other technologies related to our search engine and e-mail from the State Intellectual Property Office.

While we actively take steps to protect our proprietary rights, such steps may not be adequate to prevent the infringement or misappropriation of our intellectual property. Infringement or misappropriation of our intellectual property could materially harm our business. We own the

## Edgar Filing: NetEase, Inc. - Form 20-F

intellectual property (other than the content) relating to the NetEase websites and the technology that enables on-line community, personalization and e-commerce services on those sites. We license content from various freelance providers and other content providers.

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

### **C. Organizational Structure**

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

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

Our principal executive offices are currently located at 26/F, SP Tower D, Tsinghua Science Park Building 8, No.1 Zhongguancun East Road, Haidian District, Beijing, People's Republic of China 100084. As of December 31, 2012, we leased office facilities with a total effective annual rent of RMB56.6 million (US\$9.1 million), including management fees, and an aggregate of approximately 30,128 square meters of space at properties in Beijing, Shanghai, Guangzhou and Hangzhou.

In addition, we also own and occupy a building in Guangzhou with a total floor area of 20,000 square meters, in which our online game developers, sales and marketing, technology and certain management as well as administrative support functions are currently located.

Table of Contents

In 2010, we substantially completed and moved into our research and development center in Hangzhou, China on land with an area of approximately 56,160 square meters. As of December 31, 2012, the accumulated capital expenditures in connection with the construction and renovation of our research and development center were RMB431.9 million (US\$69.3 million), excluding payment for the land use right. Amortization and depreciation of the relevant capitalized assets began in January 2011. We do not expect to incur material costs for the completion of certain parts of the building which remained unfurnished and unused as of December 31, 2012.

We are in the process of constructing a new office building in Beijing on land with an area of approximately 25,400 square meters. As of December 31, 2012, we had incurred construction in progress cost of RMB112.0 million (US\$18.0 million) in connection with the construction of this new office building, primarily including costs for obtaining land use right and preparing the land for future construction.

We continue to assess our needs with respect to office space and may, in the future, vacate or add additional facilities. We believe that our current facilities are adequate for our needs in the immediate and foreseeable future.

As of December 31, 2012, we leased dedicated lines substantially from various affiliates of China Unicom, China Telecom and CERNET. We lease such capacity pursuant to short term contracts. Our server custody fees were approximately RMB256.0 million (US\$41.1 million) for the year ended December 31, 2012, of which approximately 42% was related to the operations of World of Warcraft and StarCraft II: Wings of Liberty.

**Item 4A. Unresolved Staff Comments**

Not applicable.

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

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

**A. OPERATING RESULTS**

## Overview

NetEase is a leading Internet technology company in China. Our innovative online games, communities and personalized premium services, which allow registered users to interact with other community members, have established a large and stable user base for the NetEase websites which are operated by our affiliate. As of December 31, 2012, we had approximately 610 million accumulated registered accounts for our in-house MMORPGs and a total of approximately 1.9 billion accumulated registered accounts for our other online services.

For the year ended December 31, 2012, we continued to develop our online games and advertising business. We also provide e-mail, wireless value-added and other fee-based premium services, but we expect that revenue from such services will remain a relatively small part of our total revenue for the foreseeable future. In addition, in August 2008, April 2009 and November 2012, Blizzard agreed to license certain online games to Shanghai EaseNet for operation in the PRC.

We achieved a net profit of RMB3,637.5 million (US\$583.9 million) for 2012 and generated positive operating cash flows of RMB4,224.3 million (US\$678.0 million) during the year. We recorded retained earnings of RMB8,565.4 million, RMB11,649.1 million and RMB14,309.6 million (US\$2,296.9 million) as of December 31, 2010, 2011 and 2012, respectively.

## Our Corporate Structure

NetEase.com, Inc. was incorporated in the Cayman Islands on July 6, 1999 as an Internet technology company in China. We changed our name from NetEase.com, Inc. to NetEase, Inc. with effect from March 29, 2012 after its approval at our extraordinary general meeting of shareholders held on the same day. We believe that the change of name would more accurately reflect our business operations which encompass an increasingly diversified range of entertainment, community, e-commerce and other services.

Table of Contents

In 2007, we established two intermediate holding companies, namely NetEase (Hong Kong) Limited, or NetEase Hong Kong, and Hong Kong NetEase Interactive Entertainment Limited, or Hong Kong NetEase Interactive. Guangzhou Interactive and NetEase Hangzhou became wholly owned subsidiaries of Hong Kong NetEase Interactive in December 2007 and January 2008, respectively. NetEase Beijing, Boguan and Youdao Information became subsidiaries of NetEase Hong Kong in December 2007.

NetEase Beijing, Guangzhou Interactive, Boguan, Youdao Information, NetEase Hangzhou, Guangzhou Information, Hangzhou Langhe Technology Co., Ltd., or Hangzhou Langhe, and Zhejiang Weiyang were established in China in August 1999, October 2002, December 2003, March 2006, June 2006, June 2008, July 2009 and March 2010, respectively. In February 2013, we completed the merger of Guangzhou Interactive and Guangzhou Information into Boguan, with Boguan as the surviving entity. We also established Ujia Cayman, Ujia Hong Kong and Lede Technology in the second half of 2011. Lede Technology now operates our e-commerce business.

NetEase, Inc. conducts its business in China through its subsidiaries and VIEs. Under current Chinese regulations, there are restrictions on the percentage interest foreign or foreign-invested companies may have in Chinese companies providing value-added telecommunications services in China, which include the provision of Internet content, online games and wireless value-added services such as SMS. In addition, the operation by foreign or foreign-invested companies of advertising businesses in China is subject to government approval. In order to comply with these restrictions and other Chinese rules and regulations, NetEase, Inc. and certain of its subsidiaries have entered into a series of contractual arrangements for the provision of such services with certain affiliated companies, namely Guangzhou NetEase, Guangyitong Advertising and Shanghai EaseNet. These affiliated companies are considered variable interest entities for accounting purposes (see Basis of Presentation below), and are referred to collectively in this section as VIEs. The revenue earned by the VIEs largely flows through to NetEase, Inc. and its subsidiaries pursuant to such contractual arrangements. Based on these agreements, NetEase Beijing, NetEase Hangzhou, Boguan and Hangzhou Langhe provide technical consulting and related services to the VIEs. In addition, Guangzhou NetEase has two majority-owned subsidiaries, Youdao Computer (a search-related business operator) and Wangyibao (the operator of our Wangyibao online payment platform). Please also see Item 4.B. Business Overview Our Organizational Structure.

As of December 31, 2012, the total assets of all the consolidated VIEs of our company were RMB1.7 billion (US\$0.3 billion), mainly comprising cash and cash equivalents, time deposits, accounts receivable, prepayments and other current assets and fixed assets. As of December 31, 2012, the total liabilities of the consolidated VIEs were RMB1.6 billion (US\$0.3 billion), mainly comprising accounts payable, deferred revenue, accrued liabilities and other payables. As of December 31, 2012, the total assets of our company and all of our consolidated subsidiaries were RMB17.7 billion (US\$2.8 billion), mainly comprising cash and cash equivalents, time deposits, restricted cash, accounts receivable, short-term investments, prepayments and other current assets and fixed assets. As of December 31, 2012, the total liabilities of our company and all of our consolidated subsidiaries were RMB2.1 billion (US\$0.3 billion), mainly comprising accounts payable, salary and welfare payables, dividend payable, tax payable, deferred revenue, accrued liabilities and other payables. Substantially all of our revenues are directly or indirectly generated through our consolidated VIEs.

We believe that our present operations are structured to comply with the relevant Chinese laws. However, many Chinese regulations are subject to extensive interpretive powers of governmental agencies and commissions. We cannot be certain that the Chinese government will not take action to prohibit or restrict our business activities.

Future changes in Chinese government policies affecting the provision of information services, including the provision of online services, Internet access, e-commerce services, online advertising and online payment services, may impose additional regulatory requirements on us or our service providers or otherwise harm our business.



**Basis of Presentation**

On January 17, 2003, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 46: Consolidation of Variable Interest Entities, an interpretation of ARB 51, or FIN 46, which was subsequently amended by a revised interpretation, or FIN 46-R, or ASC 810. These interpretations address financial reporting for entities over which control is achieved through a means other than voting rights. According to the requirements of FIN 46 and FIN 46-R, we have evaluated our relationships with Guangzhou NetEase and Guangyitong Advertising and have concluded that they are VIEs and NetEase, Inc. is the primary beneficiary of these affiliated companies. Accordingly, we consolidate Guangzhou NetEase (including its subsidiaries) and Guangyitong Advertising into our financial statements. In addition, according to the assessment under FIN 46-R, we have concluded that Shanghai EaseNet is also our VIE and have consolidated Shanghai EaseNet into our financial statements since its formation. Also, NetEase, Inc. is the primary beneficiary of the companies comprising our joint venture with Blizzard, namely, StormNet Information Technology (Hong Kong) Limited, or StormNet IT HK, and StormNet Information Technology (Shanghai) Co., Ltd., or StormNet IT SH. Accordingly, we have consolidated these two companies into our financial statements starting in 2009.

Table of Contents

In June 2009, the FASB also issued an amendment to the accounting and disclosure requirements for the consolidation of VIEs. The elimination of the concept of a Qualifying Special Purpose Entity removes the exception from the consolidation guidance within this amendment. This amendment requires an enterprise to perform a qualitative analysis when determining whether or not it must consolidate a VIE. The amendment also requires an enterprise to continuously reassess whether it must consolidate a VIE. Additionally, the amendment requires enhanced disclosures about an enterprise's involvement with VIEs and any significant change in risk exposure due to that involvement, as well as how its involvement with VIEs impacts the enterprise's financial statements. Finally, an enterprise will be required to disclose significant judgments and assumptions used to determine whether or not to consolidate a VIE. This amendment is effective for financial statements issued for fiscal years beginning after November 15, 2009. The adoption of this new accounting standard did not result in a material impact on our consolidated financial statements.

**Revenues**

We generate our revenues from the provision of online games services, advertising services and e-mail, wireless value-added services and others.

No customer individually accounted for greater than 10.0% of our total revenues for the years ended December 31, 2010, 2011 and 2012.

*Online Games Services*

We derive all our online game services revenues from customers through their use of prepaid point cards. Customers can purchase physical prepaid point cards in different locations in China, including Internet cafés, software stores, convenience stores and bookstores, or from vendors who register the points in our system. Customers can also purchase virtual prepaid cards online by debit card, credit card or bank transfer, and receive the prepaid point information over the Internet. Customers can use the points to play our online games, either to pay for playing time or to purchase virtual items within the games, and use our other fee-based services.

In August 2008, April 2009 and November 2012, Blizzard agreed to license certain online games to Shanghai EaseNet for operation in the PRC as discussed in *Business Overview* *Our Services* *Game Licensing and Joint Venture with Blizzard*. One of these games, *World of Warcraft*, was commercially launched by Shanghai EaseNet and commenced generating revenue from September 2009. The second licensed game, *StarCraft II: Wings of Liberty*, was commercially launched and commenced generating revenue in April 2011.

We expect that we will face increasing competition as online game providers in China and abroad expand their presence in the Chinese market or enter it for the first time.

*Advertising Services*

## Edgar Filing: NetEase, Inc. - Form 20-F

We derive most of our advertising services revenue from fees we earn from advertisements placed on the NetEase websites. Approximately 94.8%, 92.0% and 90.0% of our total advertising revenue was derived from brand advertising for the years ended December 31, 2010, 2011 and 2012, respectively, with the remainder generated from advertisers in our search engine business.

We expect that the online advertising market in China will continue to grow as Internet usage in China increases and as more companies, in particular China-based companies in a variety of industries, accept the Internet as an effective advertising medium. Moreover, we expect that as the e-commerce industry further develops in China, there will be more small- to medium-size online businesses using paid search services to advertise or market their businesses and products. Accordingly, we believe that the growth rate of paid search-related advertising in China may increase at a faster rate than that of online brand advertising. We expect that such advertising will become an important advertising sector in China and competition in this area will be intense.

### *E-mail, Wireless Value-Added Services and Others*

We derive our e-mail, wireless value-added services and others revenues primarily from providing to our customers fee-based premium services, online payment platform services (Wangyibao) and e-commerce services. Our online fee-based premium services, supplied to registered users of the NetEase websites, include premium e-mail and wireless value-added services. In February 2009 we launched our Wangyibao online payment platform, through which users registered for Wangyibao operations can deposit money in their accounts and use the accounts to pay for game point cards and other fee-based services and products offered by us. Account holders are charged a service fee when they withdraw cash from their Wangyibao accounts or make a payment to a third party (for example, to purchase goods online from a third party) in accordance with their service agreements with us. We recognize revenue upon services rendered. No fees are imposed when account holders use money in their accounts to pay us for goods or services.

Table of Contents

We also generate revenue from personalized photo-based products, game-related accessories and other e-commerce related services, and revenue is recognized when the titles of such products are transferred to the customers or the services are rendered and collections are reasonably assured.

*Seasonality of Revenues*

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

**Cost of Revenues**

*Online Games Services*

Cost of revenues for our online games services consist primarily of sales tax on intra-group revenues, staff costs (in particular remuneration to employees who maintain game software and employees known as the "Game Masters" who are responsible for the daily co-ordination and regulation of the activities inside our games' virtual worlds), service fee paid to Internet data centers, or IDC, for the rental of servers, and printing costs for our prepaid point cards.

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

The cost of revenues for the games licensed from Blizzard also includes royalties and license and consulting fees paid to Blizzard. We started amortizing the prepayment for the license rights for World of Warcraft over the license term from September 2009, when that game was commercially re-launched. We also started amortizing the prepaid license fee for StarCraft II: Wings of Liberty over the license term from April 2011, when that game was commercially released. As of December 31, 2011, based on an assessment of the unamortized portion of license right for StarCraft II: Wings of Liberty, an impairment charge was provided and recorded in operating expenses.

*Advertising Services*

## Edgar Filing: NetEase, Inc. - Form 20-F

Cost of revenues related to our advertising services consists primarily of sales tax on intra-group revenues, staff costs for editors of the various content channels for the NetEase websites and content fees paid to content providers for the NetEase websites as well as that portion of bandwidth and server custody fees, depreciation and amortization of computers and software which are attributable to the provision of advertising services.

### *E-mail, Wireless Value-Added Services and Others*

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

### **Operating Expenses**

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

Table of Contents

*Selling and Marketing Expenses*

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

*General and Administrative Expenses*

General and administrative expenses consist primarily of salary and welfare expenses, compensation costs for our general administrative and management staff, office rental, legal, professional and consultancy fees, bad debt expenses, recruiting expenses, travel expenses and depreciation charges, as well as a one-off impairment provision with respect to the license fee for StarCraft II: Wings of Liberty in 2011.

*Research and Development Expenses*

Research and development expenses consist principally of salary and welfare expenses and compensation costs for our research and development professionals.

**Share-Based Compensation Cost**

Under our 2000 Stock Incentive Plan, which expired in February 2010, we granted options to our employees, directors, consultants and certain members of our senior management under that plan. The vesting periods for these options generally ranged from two years to four years. In addition, certain of the options granted were cancelled as a result of the resignation of these personnel.

In November 2009, we adopted a restricted share unit plan for our employees, directors and consultants. We have reserved 323,694,050 ordinary shares for issuance under this plan. This plan was adopted by a resolution of the board of directors on November 17, 2009 and became effective for a term of ten years unless sooner terminated.

For the years ended December 31, 2010, 2011 and 2012, we recorded share-based compensation cost of approximately RMB102.4 million, RMB122.0 million and RMB203.0 million (US\$32.6 million), respectively. This cost has been allocated to (i) cost of revenues, (ii) selling and marketing expenses, (iii) general and administrative expenses and (iv) research and development expenses, depending on the responsibilities of the relevant employees.

## Edgar Filing: NetEase, Inc. - Form 20-F

As of December 31, 2012, total unrecognized compensation cost related to unvested awards granted under the 2000 Stock Incentive Plan, adjusted for estimated forfeitures, was RMB0.6 million (US\$0.1 million) and is expected to be recognized through the remaining vesting period of each grant. As of December 31, 2012, the weighted average remaining vesting period was 0.88 years. As of December 31, 2012, total unrecognized compensation cost related to unvested awards granted under the RSU Plan, adjusted for estimated forfeitures, was RMB355.9 million (US\$57.1 million) and is expected to be recognized through the remaining vesting period of each grant. As of December 31, 2012, the weighted average remaining vesting period was 2.90 years.

### **Income Taxes**

#### *Cayman Islands*

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

#### *British Virgin Islands ( BVI )*

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

#### *Hong Kong*

Hong Kong NetEase Interactive, NetEase Hong Kong, Ujia Hong Kong and StormNet IT HK are subject to 16.5% income tax on their taxable income generated from operations in Hong Kong. No significant taxable income was generated by these companies in 2010, 2011 and 2012. The payments of dividends by Hong Kong NetEase Interactive, NetEase Hong Kong, Ujia Hong Kong and StormNet IT HK to us are not subject to any Hong Kong withholding tax.

Table of Contents

*China*

In accordance with the Income Tax Law of the People's Republic of China concerning Foreign Invested Enterprises and Foreign Enterprises and local income tax laws (the previous income tax laws) prevailing prior to January 1, 2008, foreign invested enterprises were generally subject to a national and local enterprise income tax (EIT) at the statutory rates of 30% and 3%, respectively.

On March 16, 2007, the National People's Congress of PRC enacted the Enterprise Income Tax Law, under which Foreign Invested Enterprises (FIEs) and domestic companies would be subject to EIT at a uniform rate of 25%. Preferential tax treatments will continue to be granted to FIEs or domestic companies which conduct businesses in certain encouraged sectors and to entities otherwise classified as Software Enterprises and/or High and New Technology Enterprises (HNTE). The Enterprise Income Tax Law became effective on January 1, 2008.

The Enterprise Income Tax Law provides a five-year transition period for FIEs to gradually increase their tax rates to the uniform tax rate of 25% for those entities established before March 16, 2007, which enjoyed a favorable income tax rate of less than 25% under the previous income tax laws. In addition, the Enterprise Income Tax Law provides grandfather treatment for enterprises which were qualified as HNTEs under the previous income tax laws and were established before March 16, 2007, if they continue to be recognized as HNTEs under the Enterprise Income Tax Law. The grandfather provision allows these enterprises to continue to enjoy their unexpired tax holiday provided by the previous income tax laws.

NetEase Beijing was recognized as a HNTE under the Enterprise Income Tax Law in 2008, which qualification was renewed in 2011, and enjoys a preferential tax rate of 15% from 2008 to 2013. In March 2011, NetEase Beijing was also recognized as a Key Software Enterprise and enjoyed a further reduced preferential tax rate of 10% for 2010. We recorded the resulting income tax reduction in our consolidated financial statements in 2011.

For 2010, Boguan was subject to a preferential tax rate of 12.5% as it was recognized as a Software Enterprise in 2006 and subject to a 50% reduction to its EIT rate in 2010. Boguan renewed its recognition as a HNTE in 2011 and enjoys a preferential tax rate of 15% from 2011 to 2013. In addition, Boguan was recognized as a Key Software Enterprise in March 2011 and enjoyed a further reduced preferential tax rate of 10% for 2010. We recorded the resulting income tax reduction in our consolidated financial statements in 2011.

NetEase Hangzhou was recognized as a Software Enterprise and HNTE in 2007 and its qualification as a HNTE was renewed in 2011. Accordingly, NetEase Hangzhou enjoyed a preferential tax rate of 12.5% from 2009 to 2011 and enjoys a preferential tax rate of 15% from 2012 to 2013.

Hangzhou Langhe was recognized as a Software Enterprise in 2010. As 2010 was the first year Hangzhou Langhe incurred taxable profit, it was exempt from EIT for 2010 and 2011 and subject to a 50% reduction in its EIT rate from 2012 to 2014.



## Edgar Filing: NetEase, Inc. - Form 20-F

Guangzhou Interactive was recognized as a HNTTE under the Enterprise Income Tax Law in 2008, which qualification was renewed in 2011, and enjoyed a preferential tax rate of 15% from 2010 to 2012.

Guangzhou Information was recognized as a Software Enterprise in 2009. As 2010 was the first year Guangzhou Information incurred taxable profit, it was exempt from EIT for 2010 and 2011 and subject to a 50% reduction in its EIT rate in 2012.

In addition, certain of our subsidiaries, including Boguan, were recognized as Key Software Enterprises in March 2013 and enjoyed a preferential tax rate of 10% for 2011 and 2012. We will record the resulting income tax reduction in our consolidated financial statements in 2013.

The foregoing preferential income tax rates, however, are subject to periodic review and renewal by PRC authorities.

### **Sales Tax and Cultural Development Fee**

Sales tax includes business tax and value-added tax. In China, business taxes are imposed by the government on the revenues reported by the selling entities for the provision of taxable services in China, transfer of intangible assets and the sale of immovable properties in China. The business tax rate varies depending on the nature of the revenues. The applicable business tax rate for our revenues generally ranges from 3% to 5%.

In November 2011, the PRC Ministry of Finance and the State Administration of Taxation jointly issued two circulars setting out the details of a pilot value-added tax reform program, which change the charge of sales tax from business tax to value-added tax for certain pilot industries, including research, development and technological industries, information technology industries and cultural innovation industries. The pilot value-added tax reform program initially applied only to the pilot industries in Shanghai commencing from January 1, 2012, and has been expanded to eight additional regions, including, among others, Beijing, Zhejiang province and Guangdong province, during 2012. The pilot program will also be expanded nationwide when conditions permit. As a result, most of our subsidiaries and VIEs are subject to 6% value-added tax which replaced the original 5% business tax.

Table of Contents

We are also subject to a cultural development fee on the provision of advertising services in China. The applicable tax rate is 3% of the advertising services revenue.

**Urban Maintenance and Construction Tax and Education Surcharge**

From December 1, 2010, the urban maintenance and construction tax and education surcharge that were only applicable to pure PRC domestic enterprises and individuals previously, began to apply to foreign-invested enterprises, foreign enterprises and individuals as well. Any entity, foreign-invested or purely domestic, or individual that is subject to consumption tax, value-added tax and business tax is also required to pay urban maintenance and construction tax. The rates of urban maintenance and construction tax are 7%, 5% or 1% of the amount of consumption tax, value-added tax and business tax actually paid depending on where the taxpayer is located. All entities and individuals who pay consumption tax, value-added tax and business tax are also required to pay an education surcharge at a rate of 3% and local education surcharge at a rate of 2% of the amount of value-added tax, business tax and consumption tax actually paid. As a result, the rate for urban maintenance and construction tax, education surcharge and local education surcharge applicable to our foreign-invested enterprises is 12%.

**Critical Accounting Policies and Estimates**

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

We believe that the following are some of the more critical judgment areas in the application of our accounting policies that affect our financial condition and results of operation. We do not have significant change in accounting estimates during the year.

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

***Revenue Recognition***

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectability is reasonably assured.

## Edgar Filing: NetEase, Inc. - Form 20-F

Net revenues presented in the consolidated statements of operations and comprehensive income represent revenues from online game services, advertising services, e-mail, wireless value-added services and others recognized net of sales discount, sales tax and related surcharges.

### *Online Games Services*

We provide online games services through Guangzhou NetEase and Shanghai EaseNet. Regarding the revenue recognition for our online games, we sell prepaid point cards and online points to the end users who may use the points on such cards for online game services provided by us. Proceeds received from the sales of prepaid point cards and online points are initially recorded as deferred revenue.

We earn revenue through providing online game services to players under two types of revenue models: a time-based revenue model and an item-based revenue model. For the time-based model, revenue is recognized based upon the actual usage of game playing time by players. For the item-based model, the basic gameplay functions are free of charge, and players are charged for purchases of in-game items. Revenues from the sales of in-game items are recognized when the items are consumed by the customers or over the estimated lives of the in-game items. In-game items have different life patterns: one-time use, limited life and permanent life. Revenues from the sales of one-time use in-game items are recognized upon consumption. Limited life items are either limited by the number of uses (for example, 10 times) or limited by time (for example, three months). Revenues from the sales of limited life in-game items are recognized ratably based on the extent of time passed or expired or when the items are fully used. Players are allowed to use permanent life in-game items without any use or time limits. Revenues from the sales of permanent life in-game items are recognized based on the estimated lives of the in-game items. We consider the average period that players typically play the games and other game player behavior patterns, as well as various other factors, including the acceptance and popularity of expansion packs, promotional events launched and market conditions to arrive at the best estimates for the estimated lives of the permanent life in-game items. However, given the relatively short operating history of our item-based games, our estimate of the period that game players typically play our games may not accurately reflect the estimated lives of the permanent life in-game items. We have adopted a policy of assessing the estimated lives of the permanent life in-game items on a quarterly basis. All paying users' data collected since the launch of the games are used to perform the relevant assessments. Historical behavior patterns of these paying users during the period between their first log-on date and last log-on date are used to estimate the lives of the permanent life in-game items.

Table of Contents

While we believe our estimates to be reasonable based on available game player information, we may revise such estimates in the future as we continue to gain more operating history and data of our item-based games. Any adjustments arising from changes in estimates of the lives of the permanent in-game items will be applied prospectively as such changes are resulted from new information indicating a change in the game player behavior patterns. Any changes in our estimate of lives of the permanent in-game items may result in our revenues being recognized on a basis different from prior periods and may cause our operating results to fluctuate.

Unused online points in an inactive personal game account are recognized as revenue when the likelihood that we would provide further online games services with respect to such online points is remote. Based on our current policies, we periodically review activity in users' accounts each year and will cancel online points and recognize revenue with respect to such points for accounts which have been inactive for 540 days or more.

*Advertising Services*

We derive advertising fees principally from short-term advertising contracts. Advertising service contracts may consist of multiple elements and typically have a term of three months to one year. Before 2011, we did not establish vendor-specific objective evidence of fair value for the multiple components and, as a result, with respect to advertising contracts that did not include a fixed delivery pattern for various types of advertising services, recognition of revenues was deferred until completion of the contract. For the advertising contracts with a fixed delivery pattern, revenues were recognized ratably over the period in which the advertisement was displayed and only if collection of the resulting receivables was probable. We adopted ASU No.2009-13 Revenue Recognition - Multiple-Deliverable Revenue Arrangements, or ASU No.2009-13, and began on January 1, 2011 to treat advertising contracts with multiple deliverable elements as separate units of accounting for revenue recognition purposes and recognize revenue on a periodic basis during the contract when each deliverable service is provided. Since the contract price is for all deliverables, we allocate the arrangement consideration to all deliverables at the inception of the arrangement on the basis of their relative selling price according to the selling price hierarchy established by ASU No.2009-13. We use vendor-specific objective evidence of selling price, if it exists, otherwise, third-party evidence of selling price. If neither of those types of evidence exists, we will use our management's best estimate of the selling price for that deliverable. Such adoption did not have a material impact on our consolidated financial statements.

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

*E-mail, Wireless Value-Added Services and Others*

E-mail, wireless value-added services and others revenue includes revenue generated from activities related to e-mail and other fee-based premium services, Wangyibao online payment platform services and e-commerce services. We recognize revenue when services are rendered.

*Other Critical Accounting Policies and Estimates*

*Research and Development Costs*

Research and development costs mainly consist of personnel-related expenses and technology service costs incurred for the development of online games prior to the establishment of technological feasibility and costs associated with new product development. We did not capitalize costs incurred for the development of online game products for the years ended December 31, 2010, 2011 and 2012 because the period after the date technical feasibility is reached and the time when the game is marketed have been short historically and the development costs incurred in the period are insignificant.

Table of Contents

*Depreciation*

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

Management's judgment is required in the assessment of the useful lives of long-lived assets, and is required in the measurement of impairment. Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. The estimation of future cash flows requires significant management judgment based on our historical results and anticipated results and is subject to many factors. Measurement of any impairment loss for long-lived assets is based on the amount by which the carrying value exceeds the fair value of the asset.

*Allowances for Doubtful Accounts*

We maintain allowances for doubtful accounts receivable based on various information, including aging analysis of accounts receivable balances, historical bad debt rates, repayment patterns and credit worthiness of customers, industry trend analysis and general and industry-specific economic and market conditions. We have adopted a general provisioning policy for doubtful debts for our trade receivable balances. We provide for 50.0%, in the case of direct customers, and 30.0% in the case of advertising agents, of the outstanding trade receivable balances overdue for more than 180 days and provide for 80.0%, in the case of direct customers, and 50.0% in the case of advertising agents, of the outstanding trade receivable balances overdue for more than 270 days. We provide for 100.0% in the case of all parties for outstanding trade receivable balances overdue for more than one year. In addition to the general provisions for trade receivables, we also make specific bad debt provisions for bad debts if there is strong evidence showing that the debts are likely to be irrecoverable.

*Short-term Investments*

Short-term investments include investments in financial instruments with a variable interest rate indexed to performance of underlying assets and investments that we have positive intent and ability to hold to maturity.

In accordance with ASC 825, for investments in financial instruments with a variable interest rate indexed to performance of underlying assets, we elected the fair value method at the date of initial recognition and carried these investments at fair value. Changes in the fair value are reflected in the consolidated statements of operations and comprehensive income as other income/(expense). Fair value is estimated based on quoted prices of similar products provided by banks at the end of each period. We classify the valuation techniques that use these inputs as Level 2 of fair value measurements.

The investments that we have positive intent and ability to hold to maturity are classified as held-to-maturity investments and stated at amortized cost. For individual investments classified as held-to-maturity investments, we evaluate whether a decline in fair value below the amortized cost basis is other than temporary in accordance to our policy and ASC 320-10. If we conclude that we do not intend or are not required to sell an impaired debt investment before the recovery of its amortized cost basis, the impairment is considered temporary and the held-to-maturity investment continues to be recognized at the amortized cost.

*Impairment of Long-Lived Assets*

The carrying values of long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Based on the existence of one or more indicators of impairment, we measure any impairment of long-lived assets using the projected discounted cash flow method. The estimation of future cash flows requires significant management judgment based on our historical results and anticipated results and is subject to many factors. The discount rate that is commensurate with the risk inherent in our business model is determined by our management.

An impairment loss would be recorded if we determined that the carrying value of long-lived assets may not be recoverable. The impairment to be recognized is measured by the amount by which the carrying values of the assets exceed the fair value of the assets.

Table of Contents

*Share-Based Compensation Expense*

For awards of stock options, effective January 1, 2006, we measure the cost of employee services received in exchange for the award, measured at the grant date fair value of the award. We recognize the share-based compensation costs, net of a forfeiture rate, on a straight-line basis over the requisite service period of the award, which is the vesting term (generally three to four years for stock options). We use the Black-Scholes option pricing model to determine the fair value of stock options and account for share-based compensation cost using an estimated forfeiture rate at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Under our RSU Plan, we issue restricted share units, or RSUs, to our employees, directors and consultants with performance conditions and service vesting periods ranging from one year to five years. Some of the RSUs issued are to be settled, at our discretion, in shares or cash upon vesting based on the share price at grant date. At each reporting period, we evaluate the likelihood of performance conditions being met. Share-based compensation costs are then recorded for the number of RSUs expected to vest on a graded-vesting basis, net of estimated forfeitures, over the requisite service period. The compensation cost of the RSUs to be settled in shares only is measured based on the fair value of shares when all conditions to establish the grant date have been met. The compensation cost of RSUs to be settled either in shares or cash at our discretion is remeasured until the date when settlement in shares or cash is determined by us.

We record share-based compensation on our consolidated statements of operations and comprehensive income with the corresponding credit to the additional paid-in-capital for share options and RSUs to the extent that such awards are to be settled only in shares. On the other hand, for RSUs which will either be settled in shares or cash as discussed above, we continue to mark to market such awards and, in accordance with the vesting schedules of such awards, record the resulting potential liabilities under other long-term payables and accrued liabilities (which totaled RMB99.8 million (US\$16.0 million) and RMB75.6 million (US\$12.1 million), respectively, as of December 31, 2012).

Forfeitures were estimated based on our weighted average historical forfeiture rate of the past five years. Differences between actual and estimated forfeitures are expensed in the period that the differences occur.

Our assumptions are based on our historical experience and expectation of future development. The assumptions used in calculating the fair value of share-based awards and related share-based compensation expenses represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change or different assumptions are used, particularly with respect to the volatility of our shares, our share-based compensation expense could be materially different for any period.

**Consolidated Results of Operations**

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

**For the Year Ended December 31,**



Edgar Filing: NetEase, Inc. - Form 20-F

|   | 2010        |        | 2011        |        | 2012        |        |
|---|-------------|--------|-------------|--------|-------------|--------|
|   | RMB 000     | %      | RMB 000     | %      | RMB 000     | %      |
| <b>Statement of Operations Data:</b>                              |             |        |             |        |             |        |
| Revenues:   |             |        |             |        |             |        |
| Online game services  | 4,944,439   | 87.4   | 6,552,431   | 87.7   | 7,287,063   | 87.0   |
| Advertising services  | 633,209     | 11.2   | 795,422     | 10.6   | 850,157     | 10.1   |
| E-mail, wireless value-added services and others                  | 82,141      | 1.5    | 124,898     | 1.7    | 242,741     | 2.9    |
| Total revenues  | 5,659,789   | 100.0  | 7,472,751   | 100.0  | 8,379,961   | 100.0  |
| Sales tax expense   | (152,120)   | (2.7)  | (182,099)   | (2.4)  | (179,005)   | (2.1)  |
| Net revenues  | 5,507,669   | 97.3   | 7,290,652   | 97.6   | 8,200,956   | 97.9   |
| Cost of revenues:   |             |        |             |        |             |        |
| Online game services  | (1,378,018) | (24.3) | (1,859,176) | (24.9) | (1,872,734) | (22.3) |
| Advertising services  | (312,921)   | (5.5)  | (380,201)   | (5.1)  | (474,165)   | (5.7)  |
| E-mail, wireless value-added services and others                  | (107,902)   | (1.9)  | (132,911)   | (1.8)  | (231,168)   | (2.8)  |
| Total cost of revenues  | (1,798,841) | (31.8) | (2,372,288) | (31.8) | (2,578,067) | (30.8) |
| Gross profit  | 3,708,828   | 65.5   | 4,918,364   | 65.8   | 5,622,889   | 67.1   |
| Operating expenses:   |             |        |             |        |             |        |
| Selling and marketing expenses                                    | (656,976)   | (11.6) | (849,205)   | (11.4) | (906,707)   | (10.8) |
| General and administrative expenses                               | (189,621)   | (3.4)  | (280,227)   | (3.7)  | (286,223)   | (3.4)  |
| Research and development expenses                                 | (317,929)   | (5.6)  | (465,490)   | (6.2)  | (718,315)   | (8.6)  |
| Total operating expenses  | (1,164,526) | (20.6) | (1,594,922) | (21.3) | (1,911,245) | (22.8) |
| Operating profit  | 2,544,302   | 45.0   | 3,323,442   | 44.5   | 3,711,644   | 44.3   |
| Other income (expenses):  |             |        |             |        |             |        |
| Investment income   | 290         | 0.0    | 14,128      | 0.2    | 43,770      | 0.5    |
| Interest income   | 141,001     | 2.5    | 258,053     | 3.5    | 423,634     | 5.1    |
| Exchange losses   | (89,488)    | (1.6)  | (79,058)    | (1.1)  | (554)       | (0.0)  |
| Other, net  | (19,634)    | (0.3)  | 99,164      | 1.3    | 99,718      | 1.2    |
| Income before tax   | 2,576,471   | 45.5   | 3,615,729   | 48.4   | 4,278,212   | 51.1   |
| Income tax  | (344,446)   | (6.1)  | (392,756)   | (5.3)  | (691,642)   | (8.3)  |
| Net income  | 2,232,025   | 39.4   | 3,222,973   | 43.1   | 3,586,570   | 42.8   |
| Net loss attributable to noncontrolling interests                 | 3,747       | 0.1    | 11,291      | 0.2    | 50,882      | 0.6    |
| Net income attributable to NetEase, Inc. s shareholders           | 2,235,772   | 39.5   | 3,234,264   | 43.3   | 3,637,452   | 43.4   |
| Comprehensive income  | 2,232,025   | 39.4   | 3,222,973   | 43.1   | 3,586,570   | 42.8   |
| Add: Comprehensive loss attributable to noncontrolling interests  | 3,747       | 0.1    | 11,291      | 0.2    | 50,882      | 0.6    |
| Comprehensive income attributable to NetEase, Inc. s shareholders | 2,235,772   | 39.5   | 3,234,264   | 43.3   | 3,637,452   | 43.4   |
| Share-based compensation cost included in:                        |             |        |             |        |             |        |
| Cost of revenues  | 37,342      | 0.7    | 57,318      | 0.8    | 100,540     | 1.2    |
| Selling and marketing expenses                                    | 8,123       | 0.1    | 11,357      | 0.2    | 13,368      | 0.2    |
| General and administrative expenses                               | 31,580      | 0.6    | 17,897      | 0.2    | 33,374      | 0.4    |
| Research and development expenses                                 | 25,361      | 0.4    | 35,460      | 0.5    | 55,736      | 0.7    |

Table of Contents

**Year Ended December 31, 2012 Compared to Year Ended December 31, 2011**

**Revenues**

Total net revenues increased by 12.5% to RMB8,201.0 million (US\$1,316.3 million) in 2012 from RMB7,290.7 million in 2011. Net revenues from online games services, advertising services, and e-mail, wireless value-added services and others constituted 87.8%, 9.4% and 2.8%, respectively, of our total net revenues in 2012. This compares with 88.4%, 9.9% and 1.7%, respectively, in 2011. Revenue generated from game licensing represented 14.3% and 21.4% of our total net revenues in 2012 and 2011, respectively.

*Online Games Services*

Net revenues from online games services increased by 11.7% to RMB7,200.6 million (US\$1,155.8 million) in 2012 from RMB6,448.6 million in 2011. The increase was principally attributable to increased revenues from our self-developed games such as Fantasy Westward Journey, Ghost, Tianxia III, Kung Fu Master and Westward Journey Online II, which was partially offset by decreased revenues from games licensed from Blizzard.

Fantasy Westward Journey and Westward Journey Online II performed well during 2012, and both games reached record high PCU levels in August 2012. The continued growth in popularity of these two games throughout 2012 was mainly attributable to the launch of new expansion packs during the year, the implementation of successful promotional activities and introduction of other value-added services to the games in 2012. Ghost and Tianxia III also delivered solid performance in 2012. Since the commencement of its beta testing in September 2011 Ghost has become one of the most popular 2.5D MMORPGs in China. The growth of Tianxia III mainly resulted from the rapid adaption of the game by the existing strong Tianxia II user base and its innovative game play mode. Kung Fu Master, our newly launched self-developed 2.5D MMORPG, has also been well received by players since the commencement of its beta testing in October 2012. On the other hand, revenue from World of Warcraft decreased in 2012 due to the life cycle of its expansion packs.

*Advertising Services*

Net revenues from advertising services increased by 6.6% to RMB767.5 million (US\$123.2 million) in 2012 from RMB720.1 million in 2011. The increase in advertising services revenue in 2012 was attributable to a combination of factors, including growth in the Chinese online advertising market and increasing appeal of NetEase websites to users, which improved portal and search traffic on those websites.

Average net revenue per traditional advertiser (i.e., customers which do not advertise through our search services), which provide the substantial portion of our advertising revenue, increased to approximately RMB1,010,000 (US\$162,000) in 2012 from RMB930,000 in 2011. The number of traditional advertisers using the NetEase websites decreased to 682 in 2012 from 713 in 2011, with revenues from our top ten advertisers

comprising 19.3% of our total advertising services revenues in 2012 as compared to 17.2% in 2011.

Table of Contents

*E-mail, Wireless Value-Added Services and Others*

Net revenues from the e-mail, wireless value-added services and others segment increased by 90.9% to RMB232.9 million (US\$37.4 million) in 2012 from RMB122.0 million in 2011. The increase mainly resulted from increased revenue from e-commerce related services, e-mail services and the sale of game-related accessories, such as limited edition packages of several online games in 2012.

**Cost of Revenues**

Our cost of revenues increased by 8.7% to RMB2,578.1 million (US\$413.8 million) in 2012 from RMB2,372.3 million in 2011. The year-over-year increase was mainly due to an increase in staff-related cost, content cost and sales tax on intra-group revenue, which was partially offset by a decrease in royalty and consulting fees and depreciation and amortization expenses related to World of Warcraft. In 2012, costs relating to online games services, advertising services and e-mail, wireless value-added services and others represented 72.6%, 18.4% and 9.0% of total cost of revenues, respectively, as compared with 78.4%, 16.0% and 5.6% of the cost of revenues, respectively, in 2011.

*Online Games Services*

Cost of revenues from our online games services increased slightly to RMB1,872.7 million (US\$300.6 million) in 2012 from RMB1,859.2 million in 2011. The increase in cost of revenues in 2012 was primarily due to a combination of the following factors:

- Staff-related costs increased by RMB120.0 million (US\$19.3 million) to RMB518.0 million (US\$83.1 million) in 2012 from RMB398.0 million in 2011, mainly as a result of an increase in the level of salaries and bonuses and an increase in the number of employees. The number of full time employees in our online games business increased to 3,645 as of December 31, 2012 from 3,188 as of December 31, 2011, including 904 employees in the customer service function to support the operation of World of Warcraft.
- Sales tax on intra-group revenues related to online games increased by RMB54.5 million (US\$8.75 million) to RMB352.4 million (US\$56.6 million) in 2012 from RMB297.9 million in 2011 primarily due to growth in the popularity of Fantasy Westward Journey, Ghost, Tianxia III and Westward Journey Online II. In addition, sales tax expenses of RMB18.0 million (US\$2.9 million) were recorded for technical consultancy service fees received from our joint venture with Blizzard in 2012, compared to RMB26.4 million in 2011.

The foregoing increase was partially offset by the following factors:

## Edgar Filing: NetEase, Inc. - Form 20-F

- Technology costs decreased by RMB105.9 million (US\$17.0 million) to RMB785.4 million (US\$126.1 million) in 2012 from RMB891.3 million in 2011, mainly due to a decrease in royalties of RMB105.8 million (US\$17.0 million) in line with the decrease of revenue from World of Warcraft.
- Depreciation and amortization costs decreased by RMB66.8 million (US\$10.7 million) to RMB139.4 million (US\$22.4 million) in 2012 from RMB206.2 million in 2011, mainly as a result of a decrease in server depreciation cost of RMB34.2 million (US\$5.5 million) and a decrease in amortization of license fees of RMB35.7 million (US\$5.7 million) associated with the operation of Blizzard licensed games.

### *Advertising Services*

Cost of revenues from our advertising services increased by 24.7% to RMB474.2 million (US\$76.1 million) in 2012 from RMB380.2 million in 2011. The increase in cost of revenues in 2012 was primarily due to a combination of the following factors:

- Information costs increased by RMB52.1 million (US\$8.4 million) to RMB93.8 million (US\$15.1 million) in 2012 from RMB41.7 million in 2011, mainly due to an increase in content costs incurred for certain major events in 2012 such as Euro Cup 2012 and the London Olympics.
- Staff-related costs increased by RM38.2 million (US\$6.1 million) to RMB222.0 million (US\$35.6 million) in 2012 from RMB183.8 million in 2011, mainly as a result of an increase in salaries and other compensation payments, such as bonuses and welfare benefits, and also due to an expansion of the business.

Table of Contents

*E-mail, Wireless Value-Added Services and Others*

Cost of revenues from our e-mail, wireless value-added services and others increased by 74.0% to RMB231.2 million (US\$37.1 million) in 2012 from RMB132.9 million in 2011. The increase in cost of revenues in 2012 was primarily due to a combination of the following factors:

- Staff-related cost increased by RMB31.6 million (US\$5.1 million) to RMB60.2 million (US\$9.7 million) in 2012 from RMB28.6 million in 2011, mainly as a result of an increase in salaries and bonuses and an increase in the number of employees.
- E-commerce related costs such as costs associated with producing personalized photo-based products and purchasing game-related accessories increased by RMB28.4 million (US\$4.6 million) to RMB30.7 million (US\$4.9 million) in 2012 from RMB2.3 million in 2011, which was in line with the increase in their revenues.
- Technology service cost such as bandwidth and server custody fees increased by RMB25.6 million (US\$4.1 million) to RMB83.6 million (US\$13.4 million) in 2012 from RMB58.0 million in 2011, mainly as a result of an increase in bandwidth usage by our e-mail, e-commerce related services and other value added services in 2012.
- Depreciation and amortization costs increased by RMB7.2 million (US\$1.2 million) to RMB36.0 million (US\$5.8 million) in 2012 from RMB28.8 million in 2011, mainly as a result of an increase in server depreciation cost.

**Gross Profit**

Our gross profit increased by 14.3% to RMB5,622.9 million (US\$902.5 million) in 2012 from RMB4,918.4 million in 2011.

The following table sets forth the consolidated gross profits and gross profit margins of our business activities for the periods indicated as derived from our audited financial statements. The gross profit margins in 2011 and 2012 were calculated by dividing our gross profits over our net revenues for the corresponding type of services. The net revenues are before netting-off the sales tax payable by us on intra-group revenues from our VIEs, which are recorded under cost of revenues.

|                             | For the Year Ended December 31, |         |          |
|-----------------------------|---------------------------------|---------|----------|
|                             | 2011                            | 2012    | 2012     |
|                             | RMB 000                         | RMB 000 | US\$ 000 |
| <b>Gross profit (loss):</b> |                                 |         |          |

Edgar Filing: NetEase, Inc. - Form 20-F

|  |           |           |         |
|--|-----------|-----------|---------|
| Online game services                             | 4,589,431 | 5,327,851 | 855,179 |
| Advertising services                             | 339,872   | 293,312   | 47,080  |
| E-mail, wireless value-added services and others | (10,939)  | 1,726     | 278     |
| Total gross profit                               | 4,918,364 | 5,622,889 | 902,537 |

**Gross profit (loss) margin:**

|  |        |       |       |
|--|--------|-------|-------|
| Online game services                             | 71.2%  | 74.0% | 74.0% |
| Advertising services                             | 47.2%  | 38.2% | 38.2% |
| E-mail, wireless value-added services and others | (9.0)% | 0.7%  | 0.7%  |
| Total gross profit margin                        | 67.5%  | 68.6% | 68.6% |

Gross profit margin for online game services remained relatively stable between 2011 and 2012. The decrease in gross profit margin for advertising services was mainly due to increased headcount-related costs and content costs. The improvement in gross profit margin for e-mail, wireless value-added services and others business was mainly due to increased revenues from our e-commerce business and e-mail service, as well as the sale of game-related accessories.

**Operating Expenses**

Total operating expenses increased by 19.8% to RMB1,911.2 million (US\$306.8 million) in 2012 from RMB1,594.9 million in 2011, mainly driven by the increase in selling and marketing expenses, general and administrative expenses and research and development expenses.

Selling and marketing expenses increased by 6.8% to RMB906.7 million (US\$145.5 million) in 2012 from RMB849.2 million in 2011, primarily due to a combination of the following factors:

Table of Contents

- An increase in marketing costs of approximately RMB24.5 million (US\$3.9 million) in 2012 resulting from increased advertising and marketing promotional activities related to various games, including Kung Fu Master, Soul of the Fighter, World of Warcraft: Mists of Pandaria, and increased marketing spending on media and outdoor branding promotion for our portal and e-commerce businesses, partially offset by reduced promotional activities related to several of our other online games.
- An increase in staff-related costs of our sales team of approximately RMB19.3 million (US\$3.1 million) in 2012, primarily driven by higher compensation levels and performance-related bonus accruals for our online game promotion team.
- An increase in other miscellaneous cost of approximately RMB9.5 million (US\$1.5 million) in 2012 primarily driven by increased business expansion costs related to our portal business.

General and administrative expenses increased by 2.1% to RMB286.2 million (US\$45.9 million) in 2012 from RMB280.2 million in 2011, primarily due to a combination of the following factors:

- An increase in staff-related costs of approximately RMB38.1 million (US\$6.1 million) in 2012 primarily driven by increased headcount, higher compensation levels and increased share based compensation.
- An increase in other miscellaneous cost of approximately RMB17.2 million (US\$2.8 million) which included conference fees, entertainment cost, property tax, labor cost and other office supplies cost driven by our business expansion in 2012.

In addition, in 2011 we recorded a one-off impairment provision of RMB50.3 million with respect to the license fee for StarCraft II: Wing of Liberty which was recognized as intangible assets. There was no such impairment provision in 2012.

Research and development expenses increased by 54.3% to RMB718.3 million (US\$115.3 million) in 2012 from RMB465.5 million in 2011, primarily due to a combination of the following factors:

- An increase in staff-related costs of approximately RMB181.2 million (US\$29.1 million) in 2012, mainly as a result of increased headcount of program developers in our research and development center and game studio in Hangzhou and higher salaries and other benefits paid to our research and development team during 2012.
- An increase in game content design costs of approximately RMB54.5 million (US\$8.7 million).



### **Allowances for Doubtful Accounts**

As of December 31, 2012, the gross accounts receivable balance before any allowance for bad and doubtful accounts was RMB279.9 million (US\$44.9 million). After providing for doubtful accounts in the amount of RMB10.4 million (US\$1.7 million), the net balance of accounts receivable was RMB269.5 million (US\$43.2 million) as of December 31, 2012. The allowances for doubtful accounts represented the general provisions of RMB8.0 million (US\$1.3 million) and a special provision of RMB2.4 million (US\$0.4 million) as of December 31, 2012, as compared to the general provision of RMB8.0 million as of December 31, 2011.

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

As discussed above under **Consolidated Results of Operations – Year Ended December 31, 2012 Compared to Year Ended December 31, 2011** Operating Expenses, no significant allowance for bad and doubtful accounts was provided in 2012, and the allowances for bad and doubtful accounts as of December 31, 2012 was similar to that as of December 31, 2011. As of December 31, 2012, we did not have any customer with a receivable balance exceeding 10.0% of the total accounts receivable balance.

### **Other Income (Expenses)**

Other income in 2012 mainly consisted of interest income, investment income related to short-term investments and government incentives, offset in part by a foreign exchange loss. Interest income increased to RMB423.6 million (US\$68.0 million) in 2012 from RMB258.1 million in 2011, primarily due to an increase in our total cash and cash equivalents and time deposit balance which increased by 27.7% to RMB15.2 billion (US\$2.4 billion) as of December 31, 2012 from RMB11.9 billion as of December 31, 2011. We did not incur interest expense in 2012 and 2011. Investment income related to short-term investments, which consisted of held-to-maturity investments of fixed-rate corporate bonds and other short-term investments of financial products issued by commercial banks with a maturity date within one year when purchased, was RMB42.9 million (US\$6.89 million) in 2012, compared to RMB13.1 million in 2011. As of December 31, 2012, our held-to-maturity investments and other short-term investments totaled approximately RMB1,073.5 million (US\$172.3 million), compared to RMB993.6 million as of December 31, 2011. In 2012, we also received and recognized unconditional government incentives of RMB92.4 million (US\$14.8 million), compared to RMB89.8 million in 2011. In 2012, we reported a net foreign exchange loss of RMB0.6 million (US\$0.1 million), compared to a net foreign exchange loss of RMB79.1 million in 2011, which is primarily due to the translation loss arising from our Euro-denominated bank deposit balances as the exchange rate of the Euro against the Renminbi fluctuated over these periods.

Table of Contents

**Income Tax**

Income tax increased to RMB691.6 million (US\$111.0 million) in 2012 from RMB392.8 million in 2011. Our effective tax rate in 2012 was 16.2%, compared with 10.9% in 2011, which was primarily due to the expiration of tax exemption periods for certain subsidiaries in 2012, a one-time accrued withholding tax of RMB40.0 million (US\$6.4 million) in 2012 and a tax refund of RMB47.1 million that was received in 2011.

**Net Income**

As a result of the foregoing, net profit increased by 12.5% to RMB3,637.5 million (US\$583.9 million) in 2012 from RMB3,234.3 million in 2011.

**Year Ended December 31, 2011 Compared to Year Ended December 31, 2010**

**Revenues**

Total net revenues increased by 32.4% to RMB7,290.7 million in 2011 from RMB5,507.7 million in 2010. Net revenues from online games services, advertising services, and e-mail, wireless value-added services and others constituted 88.4%, 9.9% and 1.7%, respectively, of our total net revenues in 2011. This compares with 88.1%, 10.4% and 1.5%, respectively, in 2010. Revenue generated from game licensing represented 21.4 % and 25.6% of our total net revenues in 2011 and 2010, respectively.

*Online Games Services*

Net revenues from online games services increased by 32.8% to RMB6,448.6 million in 2011 from RMB4,854.5 million in 2010. The significant increase was principally attributable to increased revenues from our self-developed games such as Ghost, Fantasy Westward Journey, Heroes of Tang Dynasty, Tianxia III and Westward Journey Online II, as well as increased revenues from World of Warcraft and its expansion packs licensed from Blizzard.

Both Fantasy Westward Journey and Westward Journey Online II delivered solid performance during 2011. Their continued growth in popularity throughout 2011 was mainly attributable to new expansion packs launched during the year, together with the successful launch of a series of in-game marketing events in the year, which led to their record high revenue in 2011. Tianxia III is a comprehensive upgrade that builds on the strong user base of its predecessor, Tianxia II, and demonstrated rapid growth since its launch. Ghost, which was launched in

## Edgar Filing: NetEase, Inc. - Form 20-F

July 2010, was also well received by players in China, becoming one of the most popular 2.5D MMORPGs of 2011 in China. In addition, revenue and users of Heroes of Tang Dynasty grew steadily mainly resulted from the launch of beta testing and a new expansion pack in 2011, as well as successful promotional activities. Revenue generated from World of Warcraft, a game licensed from Blizzard, also continued to grow in 2011.

### *Advertising Services*

Net revenues from advertising services increased by 25.7% to RMB720.1 million in 2011 from RMB572.7 million in 2010. The increase in advertising services revenue in 2011 was attributable to a combination of factors, including growth in the Chinese online advertising market and increasing appeal of NetEase websites to users, which improved portal and search traffic on those websites.

Average net revenue per traditional advertiser (i.e., customers which do not advertise through our search services), which provide the substantial portion of our advertising revenue, increased to approximately RMB930,000 in 2011 from RMB715,000 in 2010. The number of traditional advertisers using the NetEase websites decreased to 713 in 2011 from 759 in 2010, with revenues from our top ten advertisers comprising 17.2% of our total advertising services revenues in 2011 as compared to 19.7% in 2010.

Table of Contents

*E-mail, Wireless Value-Added Services and Others*

Net revenues from the e-mail, wireless value-added services and others segment increased by 51.5% to RMB122.0 million in 2011 from RMB80.5 million in 2010. The increase mainly resulted from increased revenue from corporate e-mails, payment platform services and e-commerce related services in 2011.

**Cost of Revenues**

Our cost of revenues increased by 31.9% to RMB2,372.3 million in 2011 from RMB1,798.8 million in 2010. The year-over-year increase was mainly due to an increase in technology cost, staff-related cost, depreciation cost and sales tax on intra-group revenue. In 2011, costs relating to online games services, advertising services and e-mail, wireless value-added services and others represented 78.4%, 16.0% and 5.6% of total cost of revenues, respectively, as compared with 76.6%, 17.4% and 6.0% of the cost of revenues, respectively, in 2010.

*Online Games Services*

Cost of revenues from our online games services increased by 34.9% to RMB1,859.2 million in 2011 from RMB1,378.0 million in 2010. The increase in cost of revenues in 2011 was primarily due to a combination of the following factors:

- Technology costs increased by RMB213.4 million to RMB891.3 million in 2011 from RMB677.9 million in 2010, mainly consisting of an increase in royalties of RMB637.6 million and technical consultancy service fees of RMB91.6 million associated with the operation of World of Warcraft and its expansion packs and StarCraft II: Wings of Liberty licensed from Blizzard, and an increase in custody fees of RMB115.1 million, in line with the increased revenue in both our self-developed games and Blizzard licensed games.
- Staff-related costs increased by RMB136.1 million to RMB398.0 million in 2011 from RMB267.2 million in 2010, mainly as a result of an increase in the level of salaries and bonuses and an increase in the number of employees. The number of full time employees in our online games business increased to 3,188 as of December 31, 2011 from 2,789 as of December 31, 2010, including 878 employees in the customer service function to support the operation of World of Warcraft.
- Depreciation and amortization costs increased by RMB43.1 million to RMB206.2 million in 2011 from RMB163.1 million in 2010, mainly as a result of an increase in server depreciation cost of RMB26.7 million and an increase in amortization of license fees of RMB16.4 million associated with the operation of Blizzard licensed games. As of December 31, 2011, an impairment of license fee for StarCraft II: Wings of Liberty of RMB50.3 million was provided in operating expenses, which led to a decrease in amortization of license fees of RMB22.2 million (US\$3.6 million) in 2012 and will lead to a decrease in amortization of license fees of RMB22.2 million and RMB5.9

million in 2013 and 2014, respectively.

- Sales tax on intra-group revenues related to online games increased by RMB99.2 million to RMB297.9 million in 2011 from RMB198.7 million in 2010 primarily due to growth in the popularity of Ghost, Fantasy Westward Journey, Heroes of Tang Dynasty, Tianxia III and Westward Journey Online II. In addition, sales tax of RMB26.4 million was recorded for technical consultancy service fees received from our joint venture with Blizzard in 2011, compared to RMB21.6 million in 2010.

#### *Advertising Services*

Cost of revenues from our advertising services increased by 21.5% to RMB380.2 million in 2011 from RMB312.9 million in 2010. The increase in cost of revenues in 2011 was primarily due to a combination of the following factors:

- Staff-related costs increased by RMB40.0 million to RMB183.8 million in 2011 from RMB143.8 million in 2010, mainly as a result of an increase in salaries and other compensation payments, such as bonuses and welfare benefits, and also due to an expansion of the number of editors of the various content channels for the NetEase websites to 931 as of December 31, 2011 from 706 as of December 31, 2010.
- Searching engine related cost increased by RMB20.3 million to RMB27.2 million in 2011 from RMB6.9 million in 2010, mainly as a result of the expansion of this business.
- Miscellaneous costs increased by RMB7.9 million to RMB36.5 million in 2011 from RMB28.6 million in 2010, mainly consisting of increased office charges, telephone usage fees, consumable costs, meeting expenses, labor costs, and other costs resulting from the expansion of our portal business.

Table of Contents

The foregoing increase was partially offset by a decrease in information costs by RMB11.7 million to RMB41.7 million in 2011 from RMB53.4 million in 2010, mainly due to a decrease in major events in 2011. Major events in 2010 included the 2010 FIFA World Cup, Expo 2010 in Shanghai and the 2010 Asian Games.

*E-mail, Wireless Value-Added Services and Others*

Cost of revenues from our e-mail, wireless value-added services and others increased by 23.2% to RMB132.9 million in 2011 from RMB107.9 million in 2010. The increase in cost of revenues in 2011 was primarily due to a combination of the following factors:

- Staff-related cost increased by RMB9.5 million to RMB28.6 million in 2011 from RMB19.1 million in 2010, mainly as a result of an increase in salaries and bonuses and an increase in the number of employees.
- Depreciation and amortization costs increased by RMB6.0 million to RMB28.8 million in 2011 from RMB22.8 million in 2010, mainly as a result of an increase in server depreciation cost.
- Technology service cost such as bandwidth and server custody fees increased by RMB7.3 million to RMB51.8 million in 2011 from RMB44.5 million in 2010, mainly as a result of an increase in bandwidth usage by our e-mail, blog, e-commerce related services and other value-added services in 2011.

**Gross Profit**

Our gross profit increased by 32.6% to RMB4,918.4 million in 2011 from RMB3,708.8 million in 2010.

The following table sets forth the consolidated gross profits and gross profit margins of our business activities for the periods indicated as derived from our audited financial statements. The gross profit margins in 2010 and 2011 were calculated by dividing our gross profits over our net revenues for the corresponding type of services. The net revenues are before netting-off the sales tax payable by us on intra-group revenues from our VIEs, which are recorded under cost of revenues.

|                             | For the Year Ended December 31, |                 |
|-----------------------------|---------------------------------|-----------------|
|                             | 2010<br>RMB 000                 | 2011<br>RMB 000 |
| <b>Gross profit (loss):</b> |                                 |                 |
| Online game services        | 3,476,484                       | 4,589,431       |

Edgar Filing: NetEase, Inc. - Form 20-F

|  |           |           |
|--|-----------|-----------|
| Advertising services                             | 259,737   | 339,872   |
| E-mail, wireless value-added services and others | (27,393)  | (10,939)  |
| Total gross profit                               | 3,708,828 | 4,918,364 |

**Gross profit (loss) margin:**

|  |         |        |
|--|---------|--------|
| Online game services                             | 71.6%   | 71.2%  |
| Advertising services                             | 45.4%   | 47.2%  |
| E-mail, wireless value-added services and others | (34.0)% | (9.0)% |
| Total gross profit margin                        | 67.3%   | 67.5%  |

Gross profit margin for online game services remained relatively stable between 2010 and 2011. The increase in gross profit margin for advertising services was mainly due to economies of scale as advertising revenue increased in 2011 without a corresponding increase in costs. The improvement in gross loss margin for e-mail, wireless value-added services and others business was mainly due to increased revenues from our e-commerce business and e-mail service.

**Operating Expenses**

Total operating expenses increased by 37.0% to RMB1,594.9 million in 2011 from RMB1,164.5 million in 2010, mainly driven by the increase in selling and marketing expenses, general and administrative expenses and research and development expenses.

Table of Contents

Selling and marketing expenses increased by 29.3% to RMB849.2 million in 2011 from RMB657.0 million in 2010, primarily due to a combination of the following factors:

- An increase in marketing costs of approximately RMB143.3 million in 2011 resulting from increased advertising and marketing promotional activities related to Ghost, Heroes of Tang Dynasty and Blizzard's World of Warcraft and StarCraft II: Wings of Liberty, partially offset by reduced promotional activities related to Fantasy Westward Journey. In addition, we also increased marketing spending on media and outdoor branding promotion for our search engine business.
- An increase in staff-related costs of our sales team of approximately RMB38.9 million in 2011 primarily driven by performance-related bonus accruals for our advertising sales and marketing team and online game promotion team.

General and administrative expenses increased by 47.8% to RMB280.2 million in 2011 from RMB189.6 million in 2010, primarily due to a combination of the following factors:

- The recording of a one-off impairment provision of RMB50.3 million with respect to the license fee for StarCraft II: Wing of Liberty which was recognized as intangible assets in 2011.
- An increase in allowance for bad and doubtful debts of approximately RMB20.4 million in 2011. We provided a specific provision for a long-outstanding debt owed by a large customer which debt was subject to litigation in 2009. In 2010, we released the provision after the litigation was settled and the debt was collected. In 2011, no significant allowance for bad and doubtful debts was provided.
- An increase in depreciation cost of approximately RMB17.8 million in 2011 primarily due to increased depreciation in connection with our research and development center in Hangzhou, China. We substantially completed and moved into our research and development center in Hangzhou in 2010. Amortization and depreciation of the relevant capitalized assets began in January 2011.
- An increase in staff-related costs of approximately RMB7.4 million in 2011 primarily driven by increased headcount, higher compensation levels and increased share based compensation.
- An increase in other miscellaneous cost of approximately RMB9.5 million which included conference fees, entertainment cost, labor cost and other office supplies cost driven by our business expansion in 2011.



Research and development expenses increased by 46.4% to RMB465.5 million in 2011 from RMB317.9 million in 2010, primarily due to an increase in staff-related costs of approximately RMB135.0 million in 2011, mainly as a result of increased headcount of program developers in our research and development center and game studio in Hangzhou and higher salaries and other benefits paid to our research and development team during 2011.

#### **Allowances for Doubtful Accounts**

As of December 31, 2011, the gross accounts receivable balance before any allowance for bad and doubtful accounts was RMB238.0 million. After providing for doubtful accounts in the amount of RMB8.0 million, the net balance of accounts receivable was RMB230.0 million as of December 31, 2011. The allowances for doubtful accounts represented the general provisions of RMB8.0 million, and there was no specific provision as of December 31, 2011.

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

As discussed above under **Consolidated Results of Operations** Year Ended December 31, 2011 Compared to Year Ended December 31, 2010 **Operating Expenses**, no significant allowance for bad and doubtful accounts was provided in 2011, and the allowances for bad and doubtful accounts as of December 31, 2011 was similar to that as of December 31, 2010. As of December 31, 2011, we did not have any customer with a receivable balance exceeding 10.0% of the total accounts receivable balance.

Table of Contents

**Other Income (Expenses)**

Other income in 2011 mainly consisted of interest income, investment income related to short-term investments and government incentives, offset in part by a foreign exchange loss. Interest income increased to RMB258.1 million in 2011 from RMB141.0 million in 2010, primarily due to an increase in our total cash and cash equivalents and time deposit balance which increased by 25.3% to RMB11.9 billion as of December 31, 2011 from RMB9.5 billion as of December 31, 2010. We did not incur interest expense in 2011 and 2010. Investment income related to short-term investments, which were fixed-rate corporate bonds with a maturity date within one year when purchased, was RMB13.1 million in 2011. As of December 31, 2011, our short-term investments totaled approximately RMB993.6 million. We did not have short-term investments in 2010. In 2011, we also received and recognized unconditional government incentives of RMB89.8 million, compared to RMB15.2 million in 2010. In 2011, we reported a net foreign exchange loss of RMB79.1 million, compared to a net foreign exchange loss of RMB89.5 million in 2010, which is primarily due to the translation loss arising from our Euro-denominated bank deposit balances as of December 31, 2011 as the exchange rate of the Euro against the Renminbi fluctuated during the year.

**Income Tax**

Income tax increased to RMB392.8 million in 2011 from RMB344.4 million in 2010. Our effective tax rate in 2011 was 10.9%, compared with 13.4% in 2010, which was primarily due to the recognition in 2011 of a tax benefit of approximately RMB47.1 million upon the recognition of certain of our subsidiaries as Key Software Enterprises in 2011.

**Net Income**

As a result of the foregoing, net profit increased by 44.7% to RMB3,234.3 million in 2011 from RMB2,235.8 million in 2010.

**B. LIQUIDITY AND CAPITAL RESOURCES**

To date, we have financed our operations primarily through operating cash flows and existing capital resources. As of December 31, 2012, we had RMB1,590.8 million (US\$255.3 million) in cash and cash equivalents.

We believe that our current levels of cash and cash equivalents, cash flows from operations and short-term investments will be sufficient to meet our anticipated cash needs for at least the next 12 months. However, we may need additional cash resources if we experience changed business conditions or other developments. We may also need additional cash resources if we find and wish to pursue opportunities for investment, acquisition, strategic cooperation or other similar action. If we determine that our cash requirements exceed our amounts of cash and cash equivalents on hand, we may seek to issue debt or equity securities or obtain a credit facility. Any issuance of equity securities could cause dilution for our shareholders. Any incurrence of indebtedness could increase our debt service obligations and cause us to be subject to restrictive operating and finance covenants. It is possible that, when we need additional cash resources, financing will only be available to us in amounts or

on terms that would not be acceptable to us or financing will not be available at all.

## Cash Flows

### *Operating Activities*

Cash provided by operating activities was RMB4,224.3 million (US\$ 678.0 million), RMB4,072.9 million and RMB2,855.0 million for the years ended December 31, 2012, 2011 and 2010, respectively.

For the year ended December 31, 2012, cash provided by operating activities consisted primarily of (i) our net income of RMB3,586.6 million (US\$575.7 million), (ii) depreciation and amortization charges of RMB233.5 million (US\$37.5 million), (iii) an increase in accounts payable and other liabilities of RMB207.7 million (US\$33.3 million), such as content fees, bandwidth cost, bonus, marketing expenses and sales of game cards, (iv) share-based compensation cost of RMB203.0 million (US\$32.6 million) and (v) an increase in deferred revenue of RMB145.9 million (US\$23.4 million), partially offset by (A) an increase in accounts receivable, prepayments and other current assets of RMB139.1 million (US\$22.3 million), (B) taxes payable of RMB34.4 million (US\$5.5 million) and (C) deferred income taxes of RMB31.6 million (US\$5.1 million).

For the year ended December 31, 2011, cash provided by operating activities consisted primarily of (i) our net income of RMB3,223.0 million, (ii) depreciation and amortization charges of RMB293.2 million, (iii) an increase in deferred revenue of RMB240.1 million, (iv) an increase in accounts payable and other liabilities of RMB194.2 million, such as content fees, bandwidth cost, bonus, marketing expenses and sales of game cards, (v) share-based compensation cost of RMB122.0 million and (vi) unrealized exchange losses of RMB76.3 million, partially offset by (A) an increase in prepayments and other current assets of RMB83.5 million and (B) deferred income taxes of RMB42.4 million.

Table of Contents

For the year ended December 31, 2010, cash provided by operating activities consisted primarily of (i) our net income of RMB2,232.0 million, (ii) depreciation and amortization charges of RMB232.2 million, (iii) an increase in deferred revenue of RMB190.5 million, (iv) share-based compensation cost of RMB102.4 million, (v) unrealized exchange losses of RMB100.2 million and (vi) an increase in accounts payable and other liabilities of RMB83.1 million, such as content fees, bandwidth cost, bonus, marketing expenses and sales of game cards, partially offset by an increase in accounts receivable of RMB90.0 million.

*Investing Activities*

Cash used in investing activities was RMB4,454.0 million (US\$714.9 million), RMB3,208.2 million and RMB2,621.2 million for the years ended December 31, 2012, 2011 and 2010, respectively.

For the year ended December 31, 2012, cash used in investing activities mainly consisted of (i) placement/rollover of matured time deposits of RMB16,393.6 million (US\$2,631.4 million), (ii) purchase of short-term investments of RMB1,101.7 million (US\$176.8 million) and (iii) transfer of cash deposited by customers with our Wangyibao online payment platform of RMB251.8 million (US\$40.4 million) to restricted cash pursuant to relevant PBOC regulations, partially offset by (A) proceeds from maturity of time deposits of RMB11,626.6 million (US\$1,866.2 million), (B) proceeds from maturity of short-term investments of RMB1,120.0 million (US\$179.8 million) and (C) net change in time deposits with terms of three months of RMB889.4 million (US\$142.8 million).

For the year ended December 31, 2011, cash used in investing activities mainly consisted of (i) placement/rollover of matured time deposits of RMB10,861.5 million, (ii) purchase of short-term investments of RMB1,001.0 million, (iii) purchase of property, equipment and software of RMB410.1 million and (iv) net change in time deposits with terms of three months of RMB318.9 million, partially offset by proceeds from maturity of time deposits of RMB9,598.5 million.

For the year ended December 31, 2010, cash used in investing activities mainly consisted of (i) placement/rollover of matured time deposits of RMB10,402.8 million, (ii) net change in time deposits with terms of three months of RMB338.6 million and (iii) purchase of property, equipment and software of RMB298.0 million, partially offset by proceeds from maturity of time deposits of RMB8,443.8 million.

*Financing Activities*

Cash used in financing activities was RMB390.2 million (US\$62.6 million) for the year ended December 31, 2012 and cash provided by financing activities was RMB73.5 million and RMB24.1 million for the years ended December 31, 2011 and 2010, respectively.

For the year ended December 31, 2012, cash used in financing activities resulted from open market purchases of our ADSs in the amount of RMB414.9 million (US\$66.6 million), partially offset by proceeds from the issuance of shares on the exercise of employee stock options of

RMB24.7 million (US\$4.0 million).

For the year ended December 31, 2011, cash provided by financing activities mainly resulted from proceeds from the issuance of shares on the exercise of employee stock options of RMB73.3 million.

For the year ended December 31, 2010, cash provided by financing activities mainly resulted from proceeds from the issuance of shares on the exercise of employee stock options of RMB24.1 million.

### **Management of Capital Resources**

In managing our capital, we seek to maintain a reasonable amount of liquidity to support new business growth and maximize returns on our capital resources, while at the same time focusing on the preservation of capital and complying with applicable legal requirements. Our capital resources include primarily cash on hand, demand deposits and time deposits placed with banks in Hong Kong and China and short-term investments. Although we consolidate the results of our subsidiaries and variable interest entities in our consolidated financial statements, we do not have direct access to the cash and cash equivalents or future earnings of our subsidiaries and variable interest entities. As of December 31, 2012, these subsidiaries and variable interest entities had RMB15.0 billion (US\$2.4 billion) in cash and cash equivalents, demand deposits and short-term and long-term time deposits. Our cash and cash equivalents, demand deposits, time deposits and short-term investments held outside of China are mainly denominated in U.S. dollars, Renminbi and Euro.

To fund any cash requirements we may have, we may need to rely on dividends and other distributions on equity paid by our subsidiaries. Since substantially all of our operations are conducted through our PRC subsidiaries and variable interest entities, our subsidiaries may need to rely on dividends, loans or advances made by another PRC subsidiary or variable interest entity. Certain of these payments are subject to PRC taxes, including sales taxes, which effectively reduce the received amount. In addition, the PRC government could impose restrictions on such payments or change the tax rates applicable to such payments. For all our PRC subsidiaries and variable interest entities, we did not recognize deferred tax liabilities as of December 31, 2012 in respect of the retained earnings of these subsidiaries and variable interest entities after January 1, 2008, except for an amount of RMB800.0 million (US\$128.4 million) which was subsequently used to settle substantially all of a US\$130.8 million special cash dividend which we declared to our shareholders in November 2012, as we expect that these PRC subsidiaries and variable interest entities will indefinitely reinvest all the remaining earnings accumulated after January 1, 2008.

Table of Contents

In addition, the payment of dividends by entities established in the PRC is subject to limitations. Regulations in the PRC currently permit payment of dividends only out of accumulated profits as determined in accordance with accounting standards and regulations in the PRC. Each of our PRC subsidiaries that is a domestic company is also required to set aside at least 10.0% of its after-tax profit based on PRC accounting standards each year to its general reserves or statutory capital reserve fund until the accumulative amount of such reserves reach 50.0% of its respective registered capital. These restricted reserves are not distributable as cash dividends. As a result of these and other restrictions under PRC laws and regulations, our PRC subsidiaries and VIEs are restricted in their ability to transfer a portion of their net assets to us either in the form of dividends, loans or advances, which restricted portion amounted to approximately RMB2.6 billion or 17% of our total consolidated net assets as of December 31, 2012. In addition, if any of our PRC subsidiaries incurs debt on its own behalf in the future, the instruments governing the debt may restrict its ability to pay dividends or make other distributions to us.

Furthermore, any transfer of funds from us to any of our PRC subsidiaries or variable interest entities, either as a shareholder loan or as an increase in registered capital, is subject to certain statutory limit requirements and registration or approval of the relevant PRC governmental authorities, including the relevant administration of foreign exchange and/or the relevant examining and approval authority. Our PRC subsidiaries and variable interest entities are not permitted under PRC law to directly lend money to one another. Therefore, it is difficult to change our capital expenditure plans once the relevant funds have been remitted from our company to our PRC subsidiaries or variable interest entities. These limitations on the free flow of funds between us and our PRC subsidiaries and variable interest entities could restrict our ability to act in response to changing market conditions and reallocate funds internally in a timely manner.

For additional information, see Item 3.D. Risk Factors Risks Related to Our Company Our corporate structure may restrict our ability to receive dividends from, and transfer funds to, our PRC subsidiaries and variable interest entities, which could restrict our ability to act in response to changing market conditions and reallocate funds internally in a timely manner. and Risk Factors Risks Related to Doing Business in China Restrictions on currency exchange may limit our ability to utilize our revenues effectively. ~~and~~ Item 10D. Exchange Controls.

**Capital Expenditures**

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, office renovations and construction of a new office building in Beijing.

**C. RESEARCH AND DEVELOPMENT, PATENTS AND LICENSES, ETC.**

## Edgar Filing: NetEase, Inc. - Form 20-F

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

We have utilized and will continue to utilize the products and services of third parties to enhance our platform of technologies and services to provide competitive and diverse Internet and wireless services to our users. In addition, we plan to continue to expand our technologies, products and services and registered user base through diverse online community products and services developed internally, particularly with respect to our online game services. We will seek to continually improve and enhance our existing services to respond to rapidly evolving competitive and technological conditions. For the years 2012, 2011 and 2010, we spent RMB718.3 million (US\$115.3 million), RMB465.5 million and RMB317.9 million, respectively, on research and development activities.

Table of Contents

**D. TREND INFORMATION**

Other than as described elsewhere in this annual report, we are not aware of any trends, uncertainties, demands, commitments or events that are reasonably likely to have a material adverse effect on our revenue, income from continuing operations, profitability, liquidity or capital resources, or that would cause our reported financial information not necessarily to be indicative of future operation results or financial condition.

**E. OFF-BALANCE SHEET ARRANGEMENTS**

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

**F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS**

We have entered into leasing arrangements relating to our office premises. We also have contractual obligations in respect of server custody fees and capital expenditures related to the construction of a new office building in Beijing and computer equipment. In addition, we have contractual obligations in connection with the licensing of World of Warcraft, StarCraft II: Wings of Liberty and Blizzard All-Stars from Blizzard, as described below. The following sets forth our contractual obligations for operating leases, server custody fees, long-term payables, capital expenditures, office machine and other obligations related to content and services purchase, other than our obligations in connection with the online games licensed by Blizzard, as of December 31, 2012:

|             | Rental commitments<br>RMB | Server custody fee commitments<br>RMB | Long-term payables<br>RMB | Capital commitments<br>RMB | Office machine and other commitments<br>RMB | Total<br>RMB |
|-------------|---------------------------|---------------------------------------|---------------------------|----------------------------|---|--------------|
|             |                           |                                       |                           | (in thousands)             |   |              |
| 2013        | 47,193                    | 24,003                                |                           | 87,197                     | 51,524                                      | 209,917      |
| 2014        | 16,188                    | 1,544                                 | 46,430                    |                            | 5,015                                       | 69,177       |
| 2015        | 4,134                     | 289                                   | 33,025                    |                            | 1,078                                       | 38,526       |
| 2016        | 2,162                     | 289                                   | 13,928                    |                            | 997   | 17,376       |
| Beyond 2016 | 14,295                    | 96                                    | 6,585                     |                            | 837   | 21,813       |
|             | 83,972                    | 26,221                                | 99,968                    | 87,197                     | 59,451                                      | 356,809      |

Under the three license agreements entered into in 2008, 2009 and 2012 pursuant to which Blizzard licensed to Shanghai EaseNet the exclusive right to operate StarCraft II: Wings of Liberty, World of Warcraft and Blizzard All-Stars in the PRC for a period of three years from each game commercial release, Shanghai EaseNet is required to pay license fees (except Blizzard All-Stars for which no license fee is required to be paid), royalties and consultancy fees to Blizzard for the games, and it also has a minimum marketing expenditure commitment. The commercial launches of World of Warcraft and StarCraft II: Wings of Liberty occurred in September 2009 and April 2011, respectively. Blizzard All-Stars has not been commercially launched yet in China. In March 2012, Blizzard and Shanghai EaseNet agreed to extend the license term of the



## Edgar Filing: NetEase, Inc. - Form 20-F

World of Warcraft license agreement for an additional three years commencing from September 2012. In accordance with such license agreements, we have incurred an overall commitment totaling approximately RMB3.9 billion (US\$0.6 billion).

As of December 31, 2012, our outstanding commitments under the license agreements with respect to StarCraft II: Wings of Liberty and World of Warcraft totaled RMB1,123.9 million (US\$180.4 million) which can be summarized as follows:

|       | RMB (in millions) |
|-------|-------------------|
| 2013  | 636.7             |
| 2014  | 401.9             |
| 2015  | 85.3              |
| Total | 1,123.9           |

We expect to incur a commitment under the license agreement with respect to Blizzard All-Stars totaling approximately RMB375.9 million (US\$60.3 million) after the commercial launch of the game.

In addition, Shanghai EaseNet is obligated to purchase or lease certain prescribed hardware and then make such prescribed hardware available to fulfill its obligations under the three license agreements with Blizzard in the aggregate amount of up to approximately RMB218.0 million (US\$35.0 million) over the remaining term of each license as of December 31, 2012. This amount represents the maximum expenditure Shanghai EaseNet would have to make for the prescribed hardware, but it may not be required to spend this amount in order to satisfy its obligations with respect to such hardware. With respect to the above commitment related to Blizzard licensed games, we have guaranteed the foregoing amounts if and to the extent Shanghai EaseNet has insufficient funds to make such payments. We will be entitled to reimbursement of any amounts paid for the marketing of the games and for hardware support to operate the games under the guarantee from any net profits subsequently generated by Shanghai EaseNet, after the deduction of, among other things, various fees and expenses payable to Blizzard, our company and the joint venture with Blizzard which provides technical services to Shanghai EaseNet.

Table of Contents

Please refer to Item 4.B. Business Overview Our Services Game Licensing and Joint Venture with Blizzard for further details.

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

**Quantitative and Qualitative Disclosures About Market Risk**

*Interest Rate Risk*

Our exposure to market rate risk for changes in interest rates relates primarily to the interest income generated by excess cash invested in fixed-rate corporate bonds of well-known Chinese companies and financial products issued by commercial banks in China. 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. Based on our interest earning instruments in 2012, a 10% change in the interest rate would result in an increase or decrease of RMB42.4 million (US\$6.8 million) of our total amount of interest income or of RMB4.4 million (US\$0.7 million) of our total amount of investment income in 2012.

*Foreign Currency Risk*

Substantially all our revenues and expenses are denominated in Renminbi, but as noted above, certain portion of our cash is kept in U.S. dollars and Euro. Although we believe that, in general, our exposure to foreign exchange risks should be limited, the value of our ADSs will be affected by the foreign exchange rate between U.S. dollars, Euro and Renminbi. For example, to the extent that we need to convert U.S. dollars or Euro into Renminbi for our operational needs and the Renminbi appreciates against the U.S. dollars or Euro 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 or Euro appreciates against the Renminbi, the U.S. dollar equivalent of our earnings from our subsidiaries and controlled entities in China would be reduced.

In July 2005, the Chinese government announced that it is pegging the exchange rate of the Chinese Renminbi against a number of currencies, rather than just the US dollar. This change in policy has resulted in an appreciation in the value of the Renminbi against the US dollar. Although we generate substantially all of our revenues in Renminbi which has become more valuable in US dollar terms, we translate our monetary assets and liabilities which are denominated in currencies other than Renminbi into Renminbi as of each accounting period end, in accordance with applicable accounting standards. As a result of this foreign currency translation, we reported a net foreign exchange loss of RMB0.6 million (US\$0.1 million) in 2012, compared to a net foreign exchange loss of RMB79.1 million in 2011. We have not engaged in any hedging activities, and we may experience additional economic loss as a result of any foreign currency exchange rate fluctuations. In addition, we cannot predict at this time what will be the long-term effect of the Chinese government's decision to tie the Renminbi to a basket of currencies, rather than just to the U.S. dollar.

## Recent Accounting Pronouncements

In July 2012, the FASB issued ASU 2012-02, Intangibles—Goodwill and Other: Testing Indefinite Lived Intangible Assets for Impairment, or the Update. The Update applies to all entities, both public and nonpublic, that have indefinite-lived intangible assets, other than goodwill, reported in their financial statements. Per the Update, an entity has the option first to assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the indefinite-lived intangible asset is impaired. If, after assessing the totality of events and circumstances, an entity concludes that it is not more likely than not that the indefinite-lived intangible asset is impaired, then the entity is not required to take further action. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted, including for annual and interim impairment tests performed as of a date before July 27, 2012, if financial statements for the most recent annual or interim period have not yet been issued. This revised guidance will not have a material impact on our consolidated financial statements.

In February 2013, the FASB issued revised guidance on Comprehensive Income: Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. This revised guidance does not change the current requirements for reporting net income or other comprehensive income in financial statements. However, this revised guidance requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. This revised guidance is effective prospectively for reporting periods beginning after December 15, 2012 for public entities. This revised guidance will not have a material impact on our consolidated financial statements.

Table of Contents**Item 6. Directors, Senior Management and Employees****A. Directors and Senior Management**

The names of our directors and executive officers, their ages as of April 1, 2013 and the principal positions with NetEase held by them are as follows:

| <b>Name</b>       | <b>Age</b> | <b>Position</b>                      |
|-------------------|------------|--------------------------------------|
| William Lei Ding  | 41         | Director and Chief Executive Officer |
| Onward Choi       | 42         | Acting Chief Financial Officer       |
| Alice Cheng (1)   | 51         | Director                             |
| Denny Lee         | 45         | Director                             |
| Joseph Tong (1)   | 50         | Director                             |
| Lun Feng          | 53         | Director                             |
| Michael Leung (1) | 59         | Director                             |
| Michael Tong      | 41         | Director                             |

---

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

**Biographical Information**

*William Lei Ding*, our founder, has served as a director since July 1999 and as our Chief Executive Officer since November 2005. From March 2001 until November 2005, Mr. Ding served as our Chief Architect, and, from June 2001 until September 2001, he served as our Acting Chief Executive Officer and Acting Chief Operating Officer. Mr. Ding stepped down as Chairman of the board of directors in September 2001 (we currently have no permanently appointed Chairman). From July 1999 until March 2001, Mr. Ding served as Co-Chief Technology Officer, and from July 1999 until April 2000, he also served as our interim Chief Executive Officer. Mr. Ding established Guangzhou NetEase and Shanghai EaseNet, our affiliates, in May 1997 and January 2008. Mr. Ding holds a Bachelor of Science degree in Communication Technology from the University of Electronic Science and Technology of China.

*Onward Choi* has served as our Acting Chief Financial Officer since July 2007. Mr. Choi previously served as our Financial Controller from January 2005 to June 2007 and as our Corporate Finance Director from November 2003 to December 2004. Prior to joining our company, Mr. Choi worked in the Beijing office of Ernst & Young, the Hong Kong Trade Development Council and the Hong Kong office of KPMG for over ten years. Mr. Choi currently serves as the chairman of the audit committee and the independent non-executive director for Beijing Jingkelong Company Limited and China ITS (Holdings) Co., Ltd., which are listed on the Stock Exchange of Hong Kong Limited. Mr. Choi is a member of the Institute of Chartered Accountants in England and Wales, a fellow member of the Association of Chartered Certified Accountants, a fellow member of the CPA Australia, a fellow member of the Hong Kong Institute of Certified Public Accountants and a registered practicing Certified Public Accountant in Hong Kong. Mr. Choi holds a Bachelor of Arts degree in accountancy with honors from the Hong Kong Polytechnic University.

*Alice Cheng* has served as a director since June 2007. Ms. Cheng has been the Chief Financial Officer of BBK Electronics Corp., Ltd., a PRC-based manufacturer of audio/visual equipment, since May 2005. From October 2010 to April 2013, she served as a supervisor of Wistron Information Technology Corporation in Taiwan, an information technology company with operations in Taiwan, China and Japan. From January 2002 to April 2005, she served as Financial Controller of Wistron Corporation, a Taiwanese original design manufacturer of notebook computers and other electronics. Prior to that, she held various positions with Acer Inc., a Taiwanese computer manufacturer, culminating in the position of Financial Controller. Ms. Cheng received a Bachelor of Accounting from the Chinese Culture University in Taiwan in 1983 and a Masters of Business Administration from the Thunderbird School of Global Management in Arizona in 2003. She is licensed as a certified public accountant in Taiwan and the PRC.

Table of Contents

*Denny Lee* has served as a director since April 2002. Mr. Lee previously served as our Chief Financial Officer from April 2002 until June 2007 and as our Financial Controller from November 2001 until April 2002. Prior to joining our company, Mr. Lee worked in the Hong Kong office of KPMG for more than ten years. Mr. Lee graduated from the Hong Kong Polytechnic University majoring in accounting and is a member of the Hong Kong Institute of Certified Public Accountants and the Association of Chartered Certified Accountants. Mr. Lee currently serves as the chairman of the audit committees and the independent non-executive director on the boards of New Oriental Education & Technology Group Inc. and Concord Medical Services Holdings Limited, all of which are listed on the New York Stock Exchange.

*Joseph Tong* has been a director of Parworld Investment Management Limited, which provides financial and investment advisory services, since April 2004. From December 2002 until April 2004, Mr. Tong was engaged in establishing offices and operations in Hong Kong and China, setting up accounting and internal control policies and overseeing the overall operations for TLM Apparel Co., Ltd., a garment trading company operating in Hong Kong and China which he co-founded. Prior to that, from September 2000 to September 2002, he was the e-Commerce Director of the Asia Region for Universal Music Limited where he was responsible for forming e-business development strategies and overseeing new promotional opportunities. Mr. Tong currently serves as the chairman of the audit committee, a member of the nominating and remuneration committees and an independent director of Crosby Capital Limited, which is listed on the Stock Exchange of Hong Kong Limited. Mr. Tong received a Bachelor of Social Science degree with honors in Accounting and Statistics from the University of Southampton, England. He is a member of the American Institute of Certified Public Accountants and has served as a director since March 2003.

*Lun Feng* has served as a director since July 2005. He has been the Chairman of Vantone Holdings Co., Ltd., a private real estate investment company in China, since 1993. Mr. Feng has a Juris Doctor from the Chinese Academy of Social Sciences, a Masters of Law degree from the Party School of the Chinese Communist Party and a Bachelor of Arts in Economics from Northwest University.

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

*Michael Tong* has served as a director of our company since December 1999. He joined our company as an executive in May 2003 and later served as our Co-Chief Operating Officer from July 2004 to March 2009. Before joining our company as an executive, Mr. Tong had approximately seven years of experience in the investment industry working in several venture capital and private equity firms, including techpacific.com Venture Capital Limited, Softbank China Venture Investments Limited and Nomura China Venture Investment Limited. Mr. Tong also served as a director for Qunar.com, a Chinese travel website, from October 2007 to June 2011. Mr. Tong graduated with a Bachelor of Business Administration from the University of Wisconsin, Madison with a major in Accounting and an extra concentration in Computer Science in 1993.

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

## Edgar Filing: NetEase, Inc. - Form 20-F

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

### **B. Compensation**

#### **Director Compensation**

In 2012, we paid an aggregate amount of RMB1.5 million (US\$0.2 million) in compensation for the services of our independent non-executive directors. On February 21, 2012, we also granted restricted share unit awards to each of our independent non-executive directors which vested on March 1, 2013. ADRs, representing less than 1% of our total outstanding ordinary shares, were given to the directors in settlement of such awards upon vesting.

Table of Contents

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

We do not have service contracts with any of our directors which provide for benefits upon termination.

**Executive Officer Compensation**

In 2012, we paid our executive officers aggregate cash compensation of RMB6.1 million (US\$1.0 million).

**Employment Agreements**

We have entered into employment and related agreements with each of our executive officers. These agreements include: (i) a covenant that prohibits the executive officer from engaging in any activities that compete with our business during and for one to two years after their employment with us, (ii) a requirement that executive officers assign all rights in company-related inventions to us and to keep our proprietary information confidential, and (iii) provisions for severance payments in the event the executive officer is terminated without cause or resigns for good reason.

**Amended and Restated 2000 Stock Incentive Plan**

**General**

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

The purpose of the Amended Plan is to attract and retain the best available personnel, to provide additional incentive to employees, directors and consultants and to promote the success of our business. The Amended Plan provides for the granting of incentive awards of our ordinary shares, options to purchase our ordinary shares and any other securities the value of which is derived from the value of our ordinary shares.



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

#### **Plan Administration**

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

#### **Acceleration of Awards**

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

#### **Eligibility**

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

Table of Contents

**Awards under the Plan**

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

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

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

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

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

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

**Termination of Service**

Under the Amended Plan, if the employment, director or consultant relationship of a grantee with us terminates for cause, the grantee's right to exercise the option will expire upon the termination of such relationship. If the employment, director or consultant relationship of a grantee with us terminates without cause, all options then exercisable may be exercised within six months of the date of such termination or such shorter period as may be specified in the award agreement. Any ISO granted under the Amended Plan, if not exercised within the time period provided

by law for the exercise of ISOs following the termination of a grantee's employment with us, shall automatically convert to a NQSO thereafter. If the termination of a grantee's employment, director or consultant relationship with us is (i) by reason of death or (ii) by reason of disability, all options then exercisable may be exercised by such grantee, such grantee's estate or by a person who acquired the right of exercise of such options by bequest or inheritance or otherwise by reason of death or disability of such grantee, at any time within a period not less than 12 months (but in no event later than the expiration date of the options) after the date of such termination.

**Amendment; Termination**

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

Table of Contents

**2009 Restricted Share Unit Plan**

**General**

Our board approved the NetEase.com, Inc. 2009 Restricted Share Unit Plan, or the RSU Plan, in November 2009. The RSU Plan was adopted by our board as a replacement for the Amended Plan which expired in February 2010 under its terms.

The purpose of the RSU Plan is to attract and retain the best available personnel, to provide additional incentive to employees, directors and consultants and to promote the success of our business. The RSU Plan provides for the granting of incentive awards of restricted share units, which may or may not be granted with dividend equivalent rights. Participants under the RSU Plan will not receive any account status reports.

The RSU Plan is not subject to the Employee Retirement Income Security Act of 1974, as amended, nor is the RSU Plan a qualified plan within the meaning of Section 401(a) of the Internal Revenue Code of 1986, as amended.

**Plan Administration**

Our board has designated our compensation committee to administer the RSU Plan, and it may designate one or more of our officers to exercise its authority thereunder from time to time.

**Securities Subject to the RSU Plan**

The maximum aggregate number of our ordinary shares which may be issued pursuant to all awards under the RSU Plan is 323,694,050 ordinary shares. Such ordinary shares may, in whole or in part, be authorized but unissued shares or shares that will have been or may be reacquired by us. It is anticipated that all future awards to our employees, directors and consultants will be granted pursuant to the RSU Plan or any other future plan adopted by our board and, if appropriate, our shareholders.

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

## **Eligibility**

Under the RSU Plan, awards can be issued to participants in the RSU Plan, which include employees, directors or consultants of us, our subsidiaries or our variable interest entities.

## **Awards under the RSU Plan**

Awards under the RSU Plan are evidenced by an award agreement which contains, among other things, such provisions concerning how the restricted share unit may be settled upon vesting and forfeiture upon termination of employment or the consulting arrangement (by reason of death, disability, retirement or otherwise) as have been determined by our board.

Restricted share units do not represent any actual ownership interest in us. The units granted correspond in number and value to a specified number of our ordinary shares. No actual shares are issued. Instead, the units are tracked in a bookkeeping account. The units may be subject to forfeiture provisions to replicate the treatment of restricted shares. The purchase price, if any, for an award shall be determined by our board. The units can ultimately be paid in cash or ordinary shares, as our board determines. Dividend equivalents may be paid on the restricted share units. A dividend equivalent right entitles the participant to receive cash compensation measured by the dividends paid with respect to our ordinary shares. The dividend equivalents may be paid out at the time of the dividend or may be credited to the participant's account and converted to additional units.

## **Conditions of Awards**

Our board, either acting directly or through our compensation committee or one or more of our officers, is authorized to determine the provisions, terms and conditions of each award, including without limitation, the award vesting schedule, repurchase provisions, rights of first refusal, forfeiture provisions, settlement of the award, payment contingencies and satisfaction of any performance criteria established by our board. Partial achievement of the specified criteria may result in a payment or vesting corresponding to the degree of achievement as specified in the award agreement.

Table of Contents

**Termination of Service**

In the event of the termination of the participant's employment or service with us for any reason prior to the vesting of any restricted share units, such unvested units held by the participant shall be automatically forfeited as of the date of termination. Neither the participant nor any of the participant's successors, heirs, assigns or personal representatives shall have any rights or interests in any restricted share units that are so forfeited.

**Amendment; Termination**

Under the RSU Plan, our board may at any time terminate, suspend, or amend the RSU Plan in any respect, except that no termination, suspension or amendment will be effective without shareholder approval if such approval is required to comply with any law, regulation or stock exchange rule and no such change may adversely affect any award previously granted without the written consent of the recipient. The RSU Plan will expire in November 2019.

**Non-transferability of Awards**

Under the RSU Plan, awards may not be sold, assigned, transferred, pledged, hypothecated or otherwise disposed of, except by will or by the laws of descent and distribution and during the lifetime of the participants, to the extent and in the manner provided in the award agreement. The RSU Plan permits the designation of beneficiaries by holders of awards in the event of the participant's death. After any such transfer, the original recipient shall continue to remain subject to the withholding tax requirements described below.

**Payment of Taxes**

No ordinary shares shall be delivered under the RSU Plan to any participant or other person until such participant or other person has made arrangements acceptable to us regarding payment of Chinese, Cayman Islands, U.S. and any other federal, state, provincial, local or other taxes required by law. Alternatively, we will withhold or collect from the participant an amount sufficient to satisfy such tax obligations.

**C. Board Practices**

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

Directors and Senior Management. We have no specific policy with respect to director attendance at our annual general meetings of shareholders, and no director attended the annual general meeting of shareholders held on September 6, 2012.

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

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

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

Table of Contents

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

The audit, compensation and nominating committees are composed solely of non-employee directors, as such term is defined in Rule 16b-3 under the Exchange Act and the board of directors has determined that all such members are independent as that term is defined in NASDAQ Marketplace Rule 5605(a)(2).

**Compensation Committee Interlocks**

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

**D. Employees**

As of December 31, 2010, 2011 and 2012, we had 5,254, 6,160 and 7,098 full-time employees, respectively.

The following table sets forth information regarding our staff as of December 31, 2012:

|                     |       |
|---------------------|-------|
| Online game         | 2,003 |
| Customer service    | 1,749 |
| Content             | 973   |
| Search engine       | 484   |
| Product development | 527   |
| Advertising sales   | 285   |
| E-mail              | 255   |
| E-commerce          | 208   |
| Technology services | 185   |
| Finance and Legal   | 99    |
| Administration      | 83    |
| Wireless            | 38    |
| Marketing           | 78    |
| Human resources     | 31    |
| Other               | 100   |
|                     | 7,098 |

In addition, as of December 31, 2012, we had 570 part-time employees.



None of our employees are represented by a labor union.

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

**E. Share Ownership**

The table in this section sets forth certain information known to us with respect to the beneficial ownership as of December 31, 2012 (unless otherwise indicated) by:

- all persons who are beneficial owners of five percent or more of our ordinary shares,
- each of our directors,
- our Chief Executive Officer and Acting Chief Financial Officer, and
- all current directors and executive officers as a group.

Table of Contents

As of December 31, 2012, 3,246,041,681 of our ordinary shares were outstanding. The amounts and percentages of ordinary shares beneficially owned are reported on the basis of regulations of the SEC governing the determination of beneficial ownership of securities. Under the rules of the SEC, a person is deemed to be a beneficial owner of a security if that person has or shares voting power, which includes the power to vote or to direct the voting of such security, or investment power, which includes the power to dispose of or to direct the disposition of such security. A person is also deemed to be a beneficial owner of any securities of which that person has a right to acquire beneficial ownership within 60 days. Under these rules, more than one person may be deemed a beneficial owner of securities as to which such person has no economic interest. The shareholders listed below do not have different voting rights.

|   | Number of Shares<br>Beneficially Owned |            |
|---|--|------------|
|   | Number                                 | Percentage |
| <b>5% Shareholder</b>   |  |            |
| Shining Globe International Limited/William Lei Ding (1)  |  |            |
| c/o NetEase, Inc., 26/F, SP Tower D, Tsinghua Science Park Building 8, No. 1 Zhongguancun East Road, Haidian District, Beijing, People's Republic of China 100084 | 1,456,000,000                          | 44.9%      |
| Orbis Investment Management Limited (2)   | 503,305,725                            | 15.5%      |
| Capital Research Global Investors (3)   | 320,330,075                            | 9.9%       |

|   | Number of Shares<br>Beneficially Owned |            |
|---|--|------------|
|   | Number                                 | Percentage |
| <b>Executive Officers and Directors (4)</b>                             |  |            |
| Onward Choi   | *                                      | *          |
| Alice Cheng   | *                                      | *          |
| Denny Lee   | *                                      | *          |
| Joseph Tong   | *                                      | *          |
| Lun Feng  | *                                      | *          |
| Michael Leung   | *                                      | *          |
| Michael Tong  | *                                      | *          |
| All current directors and executive officers as a group (8 persons) (5) | 1,457,539,000                          | 44.9%      |

\* less than 1%

(1) Shining Globe International Limited is 100% owned by William Lei Ding, our founder, Chief Executive Officer and a director. Holdings consist of 1,406,000,000 ordinary shares and 2,000,000 ADSs.

(2) Based solely upon information contained in the Schedule 13G/A filed by Orbis Investment Management Limited with the SEC on February 14, 2013. The percentage of beneficial ownership was calculated based on the total number of our ordinary shares outstanding as of December 31, 2012. The address of the principal business office of the Orbis Investment Management Limited is Orbis House, 25 Front Street, Hamilton HM 11, Bermuda.

(3) Based solely upon information contained in the Schedule 13G/A filed by Capital Research Global Investors, a division of Capital Research and Management Company, with the SEC on February 13, 2013. The percentage of beneficial ownership was calculated based on the total number of our ordinary shares outstanding as of December 31, 2012. The address of the principal business office of Capital Research

## Edgar Filing: NetEase, Inc. - Form 20-F

Global Investors is 333 South Hope Street, 55th Floor, Los Angeles, California 90071-1447.

(4) The address of our current executive officers and directors is c/o NetEase, Inc., 26/F, SP Tower D, Tsinghua Science Park Building 8, No. 1 Zhongguancun East Road, Haidian District, Beijing, the People's Republic of China 100084.

(5) Shares owned by all of our current directors and executive officers as a group includes shares beneficially owned by William Lei Ding. Such amount includes ordinary shares and ordinary shares issuable upon vesting of RSUs held by our directors and executive officers as a group.

As of December 31, 2012, based on public filings with the SEC, there are no major shareholders holding 5% or more of our ordinary shares or ADSs representing ordinary shares, except as described above.

As of December 31, 2012, there were five ordinary shareholders of record with an address in the United States, including The Bank of New York Mellon, depository of our ADS program, which held 1,884,340,840 ordinary shares as of that date.

Table of Contents

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

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

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

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

**A. Major Shareholders**

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

**B. Related Party Transactions**

NetEase, Inc. and certain of its wholly owned subsidiaries have entered into a series of agreements with Guangzhou NetEase, Guangyitong Advertising and the shareholders of Guangzhou NetEase and Guangyitong Advertising under which we provide our Internet and e-commerce applications, services and technologies and advertising services to Guangzhou NetEase and Guangyitong Advertising, and Guangzhou NetEase and Guangyitong Advertising operate the NetEase websites and our online advertising business. We believe that the terms of each agreement are no less favorable than the terms that we could obtain from disinterested third parties and that the shareholders of Guangzhou NetEase and Guangyitong Advertising will not receive material benefits from these agreements except as shareholders of NetEase. These agreements are described below.

- *Domain Name License Agreement between NetEase and Guangzhou NetEase.* NetEase granted Guangzhou NetEase the right to use the domain names netease.com, 163.com, 126.com, yeah.net and nease.net on the NetEase websites in China for license fees of RMB10,000 per year. NetEase may waive this fee at any time.

- *Copyright License Agreement between NetEase Beijing and Guangzhou NetEase.* NetEase Beijing granted Guangzhou NetEase the right to use NetEase Beijing's web page layout in China for a royalty of RMB10,000 per year. NetEase Beijing may waive this fee at any time.

## Edgar Filing: NetEase, Inc. - Form 20-F

- *Trademark License Agreement between NetEase Beijing and Guangzhou NetEase.* NetEase Beijing granted Guangzhou NetEase a license to use NetEase Beijing's registered trademarks on the NetEase websites in China for license fees of RMB10,000 per year. NetEase Beijing may waive this fee at any time.
  
  - *Cooperative Agreements.* Certain of our subsidiaries and Guangzhou NetEase and Guangyitong Advertising had entered into a series of cooperative agreements pursuant to which such subsidiaries provided technical support and consulting services to Guangzhou NetEase and Guangyitong Advertising in exchange for fees in accordance with a formula based on its expenses incurred. Such cooperative agreements included agreements between (i) Guangzhou NetEase and NetEase Hangzhou, (ii) Guangzhou NetEase and Boguan, (iii) Guangzhou NetEase and Guangzhou Information, (iv) Guangzhou NetEase, Guangzhou Interactive and NetEase Beijing and (v) NetEase Beijing and Guangyitong Advertising. In 2012, we replaced these agreements with the following new cooperative agreements to reflect a change in the tax rules in China which resulted in our business in China becoming subject to a value-added tax instead of a business tax. See Item 5.A. Operating Results - Sales Tax and Cultural Development Fee.
  
  - *Cooperative Agreements with Guangzhou NetEase.* Guangzhou NetEase has entered into cooperative agreements with each of NetEase Beijing, Boguan and NetEase Hangzhou pursuant to which such subsidiaries have agreed to provide the following services:
    - research and development of computer software (including but not limited to online games software) and technical support and maintenance for the operation of computer software;
  
    - technical service for Internet portal, including but not limited to server maintenance and development, update and upgrade of relevant application software; and
  
    - research and development of electronic publishing technology and relevant technical assistance and support.
-

Table of Contents

Guangzhou NetEase has agreed to pay a monthly service fee to each such subsidiary in accordance with a formula based on their respective expenses incurred. The cooperative agreements with each of NetEase Beijing, Boguan and NetEase Hangzhou were effective from September 1, November 1, and December 1, 2012, respectively, and each will continue to be effective unless any one of the two respective parties objects.

- *Cooperative Agreement between NetEase Beijing and Guangyitong Advertising.* Under this cooperative agreement, NetEase Beijing has agreed to provide the following services:

- research and development of computer software (including but not limited to the production, distribution, monitoring and management software of online advertisement) and technical support and maintenance for the operation of computer software;

- design, development, update and upgrade of advertisement distribution platform;

- technical service for Internet portal, including but not limited to server maintenance and development, update and upgrade of relevant application software; and

- research and development of electronic publishing technology and relevant technical assistance and support.

Guangyitong Advertising has agreed to pay a monthly service fee to NetEase Beijing in accordance with a formula based on its expenses incurred. This agreement was effective from April 1, 2012 and will continue to be effective unless any one of the two parties objects.

- *Exclusive Advertising Agency Agreement between NetEase and Guangzhou NetEase.* Guangzhou NetEase appointed NetEase as its advertising agent to solicit advertising customers on behalf of Guangzhou NetEase in markets outside of China. NetEase pays Guangzhou NetEase 10% of the total advertising revenue under this agreement per month.

- *Online Advertising Agreement between Guangzhou NetEase and Guangyitong Advertising.* Guangzhou NetEase sells all of the banner space on the NetEase websites to Guangyitong Advertising and publishes the advertisements provided by Guangyitong Advertising on the banner space purchased by Guangyitong Advertising. Guangyitong Advertising pays Guangzhou NetEase RMB10,000 per year. Guangzhou NetEase may waive this fee at any time.

By supplemental agreements entered into between the relevant parties in August 2005, the respective terms of the foregoing two agreements are automatically renewable for successive one year terms, unless, in the case of the Exclusive Advertising Agency Agreement, NetEase, or in the case of the Online Advertising Agreement, Guangzhou NetEase, objects to such renewal.

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

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

Table of Contents

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

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

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

- *Shareholder Voting Rights Trust Agreement among William Lei Ding, Bo Ding and NetEase Beijing.* Bo Ding irrevocably appoints NetEase Beijing to represent him to exercise all the voting rights to which he is entitled as a shareholder of Guangyitong Advertising and William Lei Ding and Bo Ding agree to cause Guangzhou NetEase to irrevocably appoint NetEase Beijing to represent Guangzhou NetEase to exercise all the voting rights to which Guangzhou NetEase is entitled as a shareholder of Guangyitong Advertising. The term of this agreement was ten years from May 12, 2000, which was extended on June 10, 2011 with a term of 20 years from May 12, 2010.
- *Agreement between NetEase Beijing and Guangzhou NetEase.* NetEase Beijing agrees to pay the operating costs of Guangzhou NetEase.
- *Letter of Agreement.* Each of William Lei Ding and Bo Ding have agreed that any amendments to be made to the Exclusive Consulting and Services Agreement, the Shareholder Voting Rights Trust Agreement, and the Operating Agreement, as well as all other agreements to which Guangzhou NetEase, Guangyitong Advertising and/or William Lei Ding and Bo Ding are parties, shall be subject to the approval by the vote of a majority of our board, excluding the vote of William Lei Ding. Messrs. Ding have also agreed that, if any amendments to the above mentioned agreements require a vote of the shareholders of NetEase, Guangzhou NetEase or Guangyitong Advertising, as applicable, both of them will vote in their capacity as direct or indirect shareholders of these companies to act based upon the instructions of our board. The term of this agreement is 20 years from June 6, 2000.

In addition, in connection with the licensing of certain online games by Blizzard to Shanghai EaseNet for operation in the PRC in August 2008, April 2009 and November 2012, there are certain contractual arrangements among Shanghai EaseNet, the joint venture established between Blizzard and us, and us. As a result of these arrangements, Shanghai EaseNet is a controlled variable interest entity, and William Lei Ding, our Chief Executive Officer, director and major shareholder, does not receive any benefits in his capacity as the shareholder of Shanghai EaseNet or exercise any personal control over it. We have consolidated Shanghai EaseNet into our financial statements as of and for the years ended December 31, 2010, 2011 and 2012 as discussed in Item 5.A. Operating Results Basis of Presentation. Mr. Ding's role as the shareholder of Shanghai EaseNet is designed to address Chinese regulations which place restrictions on the percentage interest foreign or foreign-invested companies may have in Chinese companies providing value-added telecommunications services in China, which include the provision of online games. See Item 5.A Operating Results Our Corporate Structure.

**C. Interests of Experts and Counsel**



Not applicable.

**Item 8. Financial Information**

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

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

**A.7 Legal Proceedings**

There are no material legal proceedings pending or, to our knowledge, threatened against us.

From time to time we become subject to legal proceedings and claims in the ordinary course of our business, including claims of alleged infringement of trademarks, copyrights and other intellectual property rights, and a variety of claims arising in connection with our e-mail, message boards and other communications and community features, such as claims alleging defamation or invasion of privacy. However, such legal proceedings or claims, even if not meritorious, could result in the expenditure of significant financial and management resources.

Table of Contents

**A.8 Dividend Policy**

In November 2012, our board of directors declared a special cash dividend to our shareholders in the amount of US\$130.8 million, which has been paid to holders of ordinary shares and ADSs. Any future determination to pay cash dividends will be at the discretion of the board of directors and will be dependent upon our financial condition, operating results, capital requirements, regulatory limitations on the ability of our subsidiaries and VIEs to distribute dividends to us and such other factors as the board of directors deems relevant.

We are a holding company incorporated in the Cayman Islands, and our ability to pay dividends to our shareholders depends upon dividends that we receive from our subsidiaries and VIEs. Please refer to Item 3.D. Risk Factors Risks Related to Our Company Our corporate structure may restrict our ability to receive dividends from, and transfer funds to, our PRC subsidiaries and variable interest entities, which could restrict our ability to act in response to changing market conditions and reallocate funds internally in a timely manner.

Holders of our ADSs will be entitled to receive dividends, if any, subject to the terms of the deposit agreement (including the fees and expenses payable thereunder), to the same extent as the holders of our ordinary shares. Cash dividends will be paid to the depositary in U.S. dollars, which will distribute them to the holders of ADSs according to the terms of the deposit agreement. Other distributions, if any, will be paid by the depositary to the holders of ADSs in any means it deems legal, fair and practical.

**B. Significant Changes**

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

**Item 9. The Offer and Listing**

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

Our ADSs have been listed on the NASDAQ Global Select Market (formerly the NASDAQ National Market) since June 30, 2000. Our ADSs trade under the symbol NTES.

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

Edgar Filing: NetEase, Inc. - Form 20-F

|                                    | Sales Price |          |
|------------------------------------|-------------|----------|
|                                    | High        | Low      |
| <b>Annual highs and lows</b>       |             |          |
| 2008                               | \$ 27.16    | \$ 15.00 |
| 2009                               | \$ 48.50    | \$ 16.61 |
| 2010                               | \$ 43.66    | \$ 26.16 |
| 2011                               | \$ 55.00    | \$ 35.74 |
| 2012                               | \$ 63.81    | \$ 37.15 |
| <b>Quarterly highs and lows</b>    |             |          |
| First Quarter 2011                 | \$ 49.56    | \$ 36.20 |
| Second Quarter 2011                | \$ 55.00    | \$ 40.48 |
| Third Quarter 2011                 | \$ 52.25    | \$ 37.26 |
| Fourth Quarter 2011                | \$ 50.99    | \$ 35.74 |
| First Quarter 2012                 | \$ 60.47    | \$ 42.02 |
| Second Quarter 2012                | \$ 63.81    | \$ 55.58 |
| Third Quarter 2012                 | \$ 61.38    | \$ 48.20 |
| Fourth Quarter 2012                | \$ 56.02    | \$ 37.15 |
| First Quarter 2013                 | \$ 55.12    | \$ 42.41 |
| <b>Monthly highs and lows</b>      |             |          |
| October 2012                       | \$ 55.78    | \$ 51.95 |
| November 2012                      | \$ 56.02    | \$ 43.15 |
| December 2012                      | \$ 43.72    | \$ 37.15 |
| January 2013                       | \$ 47.42    | \$ 42.41 |
| February 2013                      | \$ 53.22    | \$ 45.63 |
| March 2013                         | \$ 55.12    | \$ 50.65 |
| April 2013 (through April 8, 2013) | \$ 55.70    | \$ 54.33 |

Table of Contents

**Item 10. Additional Information**

**A. Share Capital**

Not applicable.

**B. Memorandum and Articles of Association**

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

*General*

We were incorporated in the Cayman Islands on July 6, 1999 and operate under the Cayman Islands Companies Law (2012 Revision), as revised and amended from time to time, or the Companies Law. Our corporate objectives and purpose are unrestricted.

*Directors*

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

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

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

## Edgar Filing: NetEase, Inc. - Form 20-F

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

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

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

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

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

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

Table of Contents

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

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

*Variations of Rights of Shares*

The rights attached to any class of shares (unless otherwise provided by the terms of issue of the shares of that class) may, subject to the provisions of the Companies Law, be varied either with the consent in writing of the holders of three-fourths of the issued shares of that class or with the sanction of a special resolution passed at a general meeting of the holders of the shares of that class.

*General Meetings of Shareholders*

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

*Limitations on the Right to Own Shares*

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

*Limitations on Transfer of Shares*

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

*Disclosure of Shareholder Ownership*

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

*Changes in Capital*

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

- (a) consolidate and divide all or any of our share capital into shares of larger amount than our existing shares;
- (b) sub-divide our existing shares, or any of them into shares of smaller amount than is fixed by our restated memorandum of association, subject nevertheless to the provisions of Section 13 of the Companies Law; and
- (c) cancel any shares which, at the date of the passing of the resolution, have not been taken or agreed to be taken by any person.

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

Table of Contents

*Differences in Corporate Law*

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

*Mergers and Similar Arrangements.* The Companies Law permits mergers and consolidations between Cayman Islands companies and between Cayman Islands companies and non-Cayman Islands companies. For these purposes, (a) *merger* means the merging of two or more constituent companies and the vesting of their undertaking, property and liabilities in one of such companies as the surviving company and (b) a *consolidation* means the combination of two or more constituent companies into a consolidated company and the vesting of the undertaking, property and liabilities of such companies to the consolidated company. In order to effect such a merger or consolidation, the directors of each constituent company must approve a written plan of merger or consolidation (a *Plan*), which must then be authorized by each constituent company by way of (a) a special resolution of each such constituent company; and (b) such other authorization, if any, as may be specified in such constituent company's articles of association. The consent of each holder of a fixed or floating security interest of a Cayman Islands constituent company must be obtained, unless the Grand Court of the Cayman Islands waives such requirement. The Plan must be filed with the Registrar of Companies together with, among other documents, a director's declaration as to the solvency of the constituent company and of the consolidated or surviving company, a director's declaration of the assets and liabilities of each constituent company and an undertaking that a copy of the certificate of merger or consolidation will be given to the members and creditors of each constituent company and published in the Cayman Islands Gazette. Dissenting shareholders have the right to be paid the fair value of their shares (which, if not agreed between the parties, will be determined by the Grand Court of the Cayman Islands) if they follow the required procedures, subject to certain exceptions. Court approval is not required for a merger or consolidation which is effected in compliance with these statutory procedures.

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

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



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

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

*Shareholders Suits.* The Cayman Islands courts can be expected to follow English case law precedents. The common law principles (namely the rule in *Foss v. Harbottle* and the exceptions thereto) which permit a minority shareholder to commence a class action against or derivative actions in the name of the company to challenge (a) an act which is ultra vires the company or illegal, (b) an act which constitutes a fraud against the minority where the wrongdoers are themselves in control of the company, and (c) an action which requires a resolution with a qualified (or special) majority which has not been obtained have been applied and followed by the courts in the Cayman Islands.

Table of Contents

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

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

**C. Material Contracts**

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

**D. Exchange Controls**

Foreign currency exchange in the PRC is primarily governed by the Foreign Exchange Administration Rules issued by the State Council on January 29, 1996 and effective as of April 1, 1996 (and amended on January 14, 1997 and August 1, 2008) and the Regulations of Settlement, Sale and Payment of Foreign Exchange which came into effect on July 1, 1996.

Under the Foreign Exchange Administration Rules, Renminbi is freely convertible for current account items, including the distribution of dividends payments, interest payments, trade and service-related foreign exchange transactions. Conversion of Renminbi for capital account items, such as direct investment, loans, securities investment and repatriation of investment, however, is still generally subject to the approval or verification of SAFE.

Under the Regulations of Settlement, Sale and Payment of Foreign Exchange, foreign invested enterprises including wholly foreign owned enterprises, may buy, sell or remit foreign currencies only at those banks that are authorized to conduct foreign exchange business after providing such banks with valid commercial supporting documents and, in the case of capital account item transactions, after obtaining approvals from SAFE. Capital investments by foreign invested enterprises outside the PRC are also subject to limitations, which include approvals by the Ministry of Commerce, SAFE and the National Development and Reform Commission.

On August 29, 2008, SAFE promulgated the Circular on Issues Relating to the Improvement of Business Operation With Respect to the Administration of Foreign Exchange Capital Payment and Settlement of Foreign Invested Enterprises, or Circular 142, which stipulates that the registered capital of an foreign invested enterprises may only be used for the purpose within its approved business scope and shall not be used for equity investment within the PRC. Violations of Circular 142 may result in penalties, including fines as set forth in the Foreign Exchange

Administration Rules.

In addition, the payment of dividends by entities established in the PRC is subject to limitations. Regulations in the PRC currently permit payment of dividends only out of accumulated profits as determined in accordance with accounting standards and regulations in the PRC. Each of our PRC subsidiaries that is a domestic company is also required to set aside at least 10.0% of its after-tax profit based on PRC accounting standards each year to its general reserves or statutory capital reserve fund until the accumulative amount of such reserves reach 50.0% of its respective registered capital. These restricted reserves are not distributable as cash dividends. In addition, if any of our PRC subsidiaries incurs debt on its own behalf in the future, the instruments governing the debt may restrict its ability to pay dividends or make other distributions to us.

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

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

Table of Contents

For more information about foreign exchange control, see Item 3.D. **Risk Factors** **Risks Related to Our Company** Our corporate structure may restrict our ability to receive dividends from, and transfer funds to, our PRC subsidiaries and variable interest entities, which could restrict our ability to act in response to changing market conditions and reallocate funds internally in a timely manner. and **Risk Factors** **Risks Related to Doing Business in China** Restrictions on currency exchange may limit our ability to utilize our revenues effectively.

**E. Taxation**

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

**Cayman Islands Taxation**

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

**United States Federal Income Taxation**

The following discussion is a summary of certain United States federal income tax considerations applicable to the ownership and disposition of shares or ADSs by a U.S. Holder (as defined below) who holds such shares or ADSs as capital assets as defined under the Internal Revenue Code of 1986, as amended (the Code). This summary does not purport to be a complete analysis of all potential United States federal income tax effects. This summary is based on the Code, United States Treasury regulations promulgated thereunder, Internal Revenue Service (IRS) rulings and judicial decisions in effect on the date hereof. All of these are subject to change, possibly with retroactive effect, or different interpretations. Such change could materially and adversely affect the tax consequences described below. No assurance can be given that the IRS would not assert, or that a court would not sustain, a position contrary to any of the tax consequences described below.

This summary does not address all aspects of United States federal income taxation that may be relevant to particular U.S. Holders in light of their specific circumstances (for example, U.S. Holders subject to the alternative minimum tax provisions of the Code) or to holders that may be subject to special rules under United States federal income tax law, including:

- dealers in stocks, securities or currencies;

- securities traders that use a mark-to-market accounting method;
- banks and financial institutions;
- insurance companies;
- regulated investment companies;
- real estate investment trusts;
- tax-exempt organizations;
- persons holding shares or ADSs as part of a hedging or conversion transaction or a straddle;
- persons deemed to sell shares or ADSs under the constructive sale provisions of the Code;
- persons who or that are, or may become, subject to the expatriation provisions of the Code;
- persons whose functional currency is not the United States dollar; and
- direct, indirect or constructive owners of 10% or more of the total combined voting power of all classes of our voting stock.

Table of Contents

This summary also does not discuss any aspect of state, local or foreign law, or United States federal estate or gift tax law as applicable to U.S. Holders. Prospective purchasers are urged to consult their tax advisors about the United States federal, state and local tax consequences to them of the purchase, ownership and disposition of shares or ADSs.

For purposes of this summary, U.S. Holder means a beneficial holder of shares or ADSs who or that for United States federal income tax purposes is:

- an individual citizen or resident of the United States;
  
- a corporation or other entity classified as a corporation for United States federal income tax purposes created or organized in or under the laws of the United States, any state thereof or the District of Columbia;
  
- an estate, the income of which is subject to United States federal income taxation regardless of its source; or
  
- a trust, if a court within the United States is able to exercise primary supervision over the administration of such trust and one or more U.S. persons (within the meaning of the Code) have the authority to control all substantial decisions of the trust, or if a valid election is in effect to be treated as a U.S. person.

If a partnership or other entity or arrangement classified as a partnership for United States federal income tax purposes holds shares or ADSs, the United States federal income tax treatment of a partner generally will depend on the status of the partner and the activities of the partnership. This summary does not address the tax consequences of any such partner. If you are a partner of a partnership holding shares or ADSs, you should consult your tax advisors.

The discussion below is written on the basis that the representations contained in the deposit agreement are true and that the obligations in the deposit agreement and any related agreement will be performed in accordance with the terms. If you hold ADSs, you generally will be treated as the owner of the underlying shares represented by those ADSs for United States federal income tax purposes. Accordingly, deposits or withdrawal of shares for ADSs will not be subject to United States federal income tax.

**TAXATION OF U.S. HOLDERS**

**Taxation of Dividends and Other Distributions on the Shares or ADSs**

## Edgar Filing: NetEase, Inc. - Form 20-F

Subject to the passive foreign investment company ( PFIC ) rules discussed below, distributions paid by our company out of current or accumulated earnings and profits (as determined for United States federal income tax purposes) generally will be taxable to a U.S. Holder as foreign source dividend income, and will not be eligible for the dividends received deduction generally allowed to corporations. Distributions in excess of current and accumulated earnings and profits will be treated as a non-taxable return of capital to the extent of the U.S. Holder's adjusted tax basis in the shares or ADSs and thereafter as capital gain. However, we do not maintain calculations of our earnings and profits in accordance with United States federal income tax accounting principles. U.S. Holders should therefore assume that any distribution by our company with respect to the shares or ADSs will constitute dividend income. U.S. Holders should consult their own tax advisors with respect to the appropriate United States federal income tax treatment of any distribution received from our company.

Certain dividends received by non-corporate U.S. Holders, including individuals, are generally subject to the special reduced rates normally applicable to long term capital gains, provided that certain conditions are satisfied. A U.S. Holder is not able to claim the reduced rate for any year in which we are treated as a PFIC. See *Passive Foreign Investment Company Considerations*, below. Dividends may be taxed at the lower applicable capital gains rate provided that (1) our shares or ADSs, as applicable, are readily tradable on an established securities market in the United States, (2) our company is not a PFIC (as discussed below) for either our taxable year in which the dividends were paid or the preceding taxable year, and (3) certain holding period and other requirements are met. Since our ADSs are listed on the NASDAQ Global Select Market, they are considered for purposes of clause (1) above to be readily tradable on an established securities market in the United States.

In the event that dividends from our company are subject to withholding by the PRC, a U.S. Holder may be eligible, subject to a number of complex limitations, to claim a foreign tax credit in respect of any foreign withholding taxes imposed on dividends received on the shares or ADSs. A U.S. Holder who does not elect to claim a foreign tax credit for foreign income tax withheld, may instead claim a deduction, for United States federal income tax purposes, in respect of such withholdings, but only for a year in which such holder elects to do so for all creditable foreign income taxes. Dividends will constitute foreign source income for United States foreign tax credit purposes.

Table of Contents

**Taxation of Disposition of Shares or ADSs**

Subject to the PFIC rules discussed below, you will generally recognize taxable gain or loss on any sale or exchange of a share or ADS in an amount equal to the difference between the amount realized (in U.S. dollars) for the share or ADS and your tax basis (in U.S. dollars) in the share or ADS. The gain or loss will generally be capital gain or loss and will be long-term capital gain or loss if you have held the share or ADS for more than one year. Long-term capital gains of non-corporate U.S. Holders are eligible for reduced rates of taxation. The deductibility of a capital loss may be subject to limitations. Any gain or loss that you recognize generally will be treated as United States source gain or loss for United States foreign tax credit purposes. In the event PRC tax were to be imposed on any gain from the disposition of shares or ADSs, such gain may be treated as PRC source gain under the income tax treaty between the United States and the PRC, in which case a U.S. Holder eligible for treaty benefits may be able to claim a foreign tax credit, subject to applicable limitations. U.S. Holders should consult their tax advisors regarding the creditability of any PRC tax.

**Tax on Net Investment Income**

For taxable years beginning after December 31, 2012, a 3.8% tax is imposed on the net investment income (as defined in section 1411 of the Code) of individuals whose income exceeds certain threshold amounts, and of certain trusts and estates under similar rules.

**Passive Foreign Investment Company**

A foreign corporation will be classified as a PFIC for any taxable year in which, after taking into account the income and assets of the corporation and certain subsidiaries pursuant to applicable look-through rules, either (i) at least 75 percent of its gross income is passive income or (ii) at least 50 percent of the average value of its assets is attributable to assets which produce passive income or are held for the production of passive income.

For this purpose, cash and investment securities are categorized as passive assets and our company's unbooked intangibles are taken into account. We will be treated as owning our proportionate share of the assets and earning our proportionate share of the income of any other corporation in which we own, directly or indirectly, more than 25% (by value) of the stock.

We do not believe that we are currently a PFIC for United States federal income tax purposes and do not expect to become a PFIC in the future. However, the determination of whether we will be classified as a PFIC is made annually and may involve facts that are not within our control. In particular, the fair market value of some of our company's assets may be determined in large part by the market price of the shares, which is likely to fluctuate. In addition, the composition of our company's income and assets will be affected by how, and how quickly, our company spends any cash that is raised. Thus, no assurance can be provided that our company would not be classified as a PFIC for the current or any future taxable year. Furthermore, while we believe our valuation approach is reasonable, it is possible that the IRS could challenge our determination concerning our PFIC status.



## Edgar Filing: NetEase, Inc. - Form 20-F

If our company is classified as a PFIC for any taxable year during which a U.S. Holder owns shares or ADSs, the U.S. Holder, absent certain elections (including a mark-to-market election), will generally be subject to adverse rules (regardless of whether our company continues to be classified as a PFIC) with respect to (i) any excess distributions (generally, any distributions received by the U.S. Holder on the shares or ADSs in a taxable year that are greater than 125 percent of the average annual distributions received by the U.S. Holder in the three preceding taxable years or, if shorter, the U.S. Holder's holding period for the shares or ADSs) and (ii) any gain realized on the sale or other disposition of shares or ADSs.

Under these adverse rules (a) the excess distribution or gain will be allocated ratably over the U.S. Holder's holding period, (b) the amount allocated to the current taxable year and any taxable year prior to the first taxable year in which our company is classified as a PFIC will be taxed as ordinary income, and (c) the amount allocated to each of the other taxable years during which our company was classified as a PFIC will be subject to tax at the highest rate of tax in effect for the applicable category of taxpayer for that year and an interest charge will be imposed with respect to the resulting tax attributable to each such other taxable year.

Alternatively, a U.S. Holder may be eligible to make a mark-to-market election. A U.S. Holder that makes a mark-to-market election must include in ordinary income, rather than capital gain, for each year an amount equal to the excess, if any, of the fair market value of the shares or ADSs, as applicable, at the close of the taxable year over the U.S. Holder's adjusted basis in the shares or ADSs. Additional complex rules apply and the election cannot be revoked without the consent of the IRS unless the shares or ADSs cease to be marketable.

Table of Contents

Although the PFIC rules permit a holder of PFIC stock in certain circumstances to avoid some of the disadvantageous tax treatment described above by making a qualified electing fund, or QEF, election, a U.S. Holder will not be able to elect to treat our company as a QEF because our company does not intend to prepare the information that the U.S. Investor would need to make a QEF election.

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

In addition, under recently enacted U.S. tax legislation, if we are a PFIC U.S. Holders will be required to file an annual information return (also on IRS Form 8621) relating to their ownership of our shares or ADSs. Although the IRS has updated Form 8621 to include a new Part I, Summary of Annual Information, to reflect this filing requirement, pursuant to Notice 2011-55 and the instructions to the Revised Form 8621, completion of that part is not required until the underlying Treasury Regulations are published.

Prior to filing their annual income tax returns, U.S. Holders should consult their tax advisors regarding whether additional guidance has been issued with respect to this reporting requirement, and if so, how to comply with such guidance.

U.S. Holders should consult their tax advisors regarding the potential application of the PFIC regime, including eligibility for and the manner and advisability of making a mark-to-market election.

**Information Reporting and Backup Withholding**

The proceeds of a sale or other disposition, as well as dividends paid with respect to shares or ADSs by a United States payor (including any payments received from a U.S. financial intermediary), generally will be reported to the IRS and to the U.S. Holder as required under applicable regulations. Backup withholding tax may apply to these payments if the U.S. Holder fails to timely provide an accurate taxpayer identification number or otherwise fails to comply with, or establish an exemption from, such backup withholding tax requirements. Certain U.S. Holders (including, among others, corporations) are not subject to the information reporting or backup withholding tax requirements described herein. U.S. Holders should consult their tax advisors as to their qualification for exemption from backup withholding tax and the procedure for establishing an exemption.

Subject to specified exceptions and future guidance, recently enacted U.S. tax legislation generally requires certain U.S. Holders (that is, an individual or, to the extent provided in final Treasury Regulations when published, certain domestic entities) to report to the IRS on IRS Form 8938 such U.S. Holder's interests in stock or securities issued by a non-U.S. person (such as our company).

U.S. Holders should consult their tax advisors regarding the information reporting obligations that may arise from their acquisition, ownership or disposition of our shares or ADSs.

**Enforcement of Civil Liabilities**

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

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

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

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

Table of Contents

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

A substantial portion of our current operations is conducted in China through our wholly-owned subsidiaries which are incorporated in China, Hong Kong, the British Virgin Islands or the Cayman Islands. All or most of our assets are located in China. A majority of our directors and officers are nationals or residents of jurisdictions other than the United States and a substantial portion of their assets are located outside the United States. As a result, it may be difficult for a shareholder to effect service of process within the United States upon these persons, or to enforce against us or them judgments obtained in United States courts, including judgments predicated upon the civil liability provisions of the securities laws of the United States or any state in the United States.

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

(1) recognize or enforce judgments of United States courts obtained against us or our directors or officers predicated upon the civil liability provisions of the securities laws of the United States or any state in the United States; or

(2) entertain original actions brought in the Cayman Islands or China against us or our directors or officers predicated upon the securities laws of the United States or any state in the United States.

Maples and Calder has further advised us that a final judgment in the federal or state courts of the United States under which the judgment debtor is imposed a liability to pay a liquidated sum for which the judgment has been given, other than a sum payable in respect of taxes, fines or penalties and which was neither obtained in a manner nor is of a kind the enforcement of which is contrary to natural justice or the public policy of the Cayman Islands, may be recognized and enforced in the courts of the Cayman Islands at common law, without any re-examination of the merits of the underlying dispute, by an action commenced on the foreign judgment debt in the Grand Court of the Cayman Islands. However, the Cayman Islands courts are unlikely to enforce a punitive judgment of a United States court predicated upon the liabilities provisions of the federal securities laws in the United States without retrial on the merits if such judgment gives rise to obligations to make payments that may be regarded as fines, penalties or similar charges.

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

**F. Dividends and Paying Agents**

Not applicable.

**G. Statement by Experts**

Not applicable.

**H. Documents on Display**

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

We are subject to the periodic reporting and other informational requirements of the Exchange Act. Under the Exchange Act, we are required to file reports and other information with the SEC. Specifically, we are required to file annually a Form 20-F: (1) within six months after the end of each fiscal year, which is December 31, for fiscal years ending before December 15, 2011; and (2) within four months after the end of each fiscal year for fiscal years ending on or after December 15, 2011. Copies of reports and other information, when so filed, may be inspected without charge and may be obtained at prescribed rates at the public reference facilities maintained by the SEC at 100 F Street, N.E., Washington, D.C. 20549. You can request copies of these documents upon payment of a duplicating fee, by writing to the SEC. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference rooms. The SEC also maintains a website at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements, and other information regarding registrants that make electronic filings with the SEC using its EDGAR system.

Table of Contents

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

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

In accordance with NASDAQ Marketplace Rule 5250(d)(1), we will post this annual report on Form 20-F on our website at <http://ir.netease.com> under the heading Annual Reports. In addition, we will provide hardcopies of our annual report free of charge to shareholders and ADS holders upon request.

**I. Subsidiary Information**

Not applicable.

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

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

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

**A. Debt Securities**

Not applicable.

**B. Warrants and Rights**

Not applicable.

**C. Other Securities**

Not applicable.

**D. American Depositary Shares**

**Fees and charges our ADS holders may have to pay**

The Bank of New York Mellon, the depository of our ADS program, collects its fees for delivery and surrender of ADSs directly from investors depositing ordinary shares or surrendering ADSs for the purpose of withdrawal or from intermediaries acting for them. The depository collects fees for making distributions to investors by deducting those fees from the amounts distributed or by selling a portion of distributable property to pay the fees. The depository may refuse to provide fee-attracting services until its fees for those services are paid.

**Persons depositing or withdrawing shares must pay:**

**For:**

Up to US\$0.05 per ADS

- Issuance of ADSs, including issuances resulting from a distribution of ordinary shares or rights or other property
- Cancellation or withdrawals of ADSs
- Distribution of ADSs pursuant to stock dividends, free stock distributions or exercise of rights
- Distributions of securities other than ADSs or rights to purchase additional ADSs

Up to US\$0.02 per ADS

- Distributions of cash dividends or other cash distributions

US\$1.5 per certificate presented for transfer

- Transfer of American depositary receipts, or ADRs

Taxes and other governmental charges the depository or the custodian have to pay on any ADS or ordinary shares underlying an ADS, for example, stock transfer taxes, stamp duty or withholding taxes

- As necessary

Table of Contents

**Fees and other payments made by the depositary to us**

We did not receive any direct or indirect payment from the depositary in 2012, except that the depositary has agreed to waive certain fees for standard costs associated with the administration of the ADS program and waived such costs in an aggregate amount of US\$25,313 for the year ended December 31, 2012.



Table of Contents

**PART II**

**Item 13. Defaults, Dividend Arrearages and Delinquencies**

None.

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

Not applicable.

**Item 15. Controls and Procedures**

**Disclosure Controls and Procedures**

Our management, with the participation of William Lei Ding, our Chief Executive Officer, and Onward Choi, our Acting Chief Financial Officer, have conducted an evaluation pursuant to Rule 13a-15 promulgated under the Securities Exchange Act of 1934, as amended, of the effectiveness of our disclosure controls and procedures as of December 31, 2012. Based on this evaluation, our Chief Executive Officer and Acting Chief Financial Officer concluded that such disclosure controls and procedures were effective as of December 31, 2012.

**Management's Annual Report on Internal Control over Financial Reporting and Attestation Report of the Registered Public Accounting Firm**

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

**Changes in Internal Control over Financial Reporting**

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

internal control over financial reporting.

**Item 16A. Audit Committee Financial Expert**

Our board of directors has determined that Mr. Joseph Tong qualifies as an Audit Committee Financial Expert as defined by the applicable rules of the SEC and that Mr. Tong is independent as that term is defined in NASDAQ Marketplace Rule 5605(a)(2).

**Item 16B. Code of Ethics**

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

**Item 16C. Principal Accountant Fees and Services**

**Disclosure of Fees Charged by Independent Accountants**

The following table summarizes the fees charged by PricewaterhouseCoopers Zhong Tian CPAs Limited Company for certain services rendered to our company during 2011 and 2012.

|                    | For the year ended<br>December 31, |         |
|--------------------|------------------------------------|---------|
|                    | 2011(1)                            | 2012(1) |
|                    | RMB (in thousands)                 |         |
| Audit fees(2)      | 9,970                              | 9,970   |
| Tax fees(3)        | 737                                | 284     |
| All other fees (4) | 200                                | 180     |
| Total              | 10,907                             | 10,434  |

Table of Contents

---

- (1) The fees disclosed are exclusive of out-of-pocket expenses and taxes on the amounts paid, which totaled approximately RMB610,000 and RMB603,000 in 2011 and 2012, respectively.
  
- (2) **Audit fees** means the aggregate fees billed in each of the fiscal years for professional services rendered by our principal auditors for the audit of our annual financial statements and our internal controls over financial reporting.
  
- (3) **Tax fees** means the aggregate fees billed in each of the fiscal years for professional services rendered by our principal auditors for tax compliance and tax advice.
  
- (4) **All other fees** includes the aggregate fees billed in each of the fiscal years for non-audit services rendered which were not listed above.

**Audit Committee Pre-approval Policies and Procedures**

Our audit committee has adopted procedures which set forth the manner in which the committee will review and approve all audit and non-audit services to be provided by PricewaterhouseCoopers Zhong Tian CPAs Limited Company before that firm is retained for such services. The pre-approval procedures are as follows:

- Any audit or non-audit service to be provided to us by the independent accountant must be submitted to the audit committee for review and approval, with a description of the services to be performed and the fees to be charged.
  
- The audit committee in its sole discretion then approves or disapproves the proposed services and documents such approval, if given, through written resolutions or in the minutes of meetings, as the case may be.

**Item 16D. Exemptions from the Listing Standards for Audit Committees**

We have not sought an exemption from the applicable listing standards for the audit committee of our board of directors.

**Item 16E. Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

## Edgar Filing: NetEase, Inc. - Form 20-F

On December 1, 2011, we announced a share repurchase program authorized by our board of directors. Under the terms of the approved share repurchase program, we were authorized to purchase up to US\$50.0 million worth of our issued and outstanding ADSs on the NASDAQ Global Select Market. This share repurchase program expired on February 29, 2012 and no ADSs were purchased.

On November 14, 2012, we announced another share repurchase program authorized by our board of directors. Under the terms of the approved share repurchase program, we were authorized to purchase up to US\$100.0 million worth of our issued and outstanding ADSs on the NASDAQ Global Select Market. This share repurchase program will expire on November 20, 2013, unless terminated earlier.

| Period                                | Total<br>Number of<br>ADSs<br>Purchased(1) | Average<br>Price<br>Paid<br>Per ADS<br>US\$ | Total Number of<br>ADSs<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans<br>or<br>Programs | Approximate<br>Maximum<br>Dollar Value<br>of ADSs<br>that May Yet<br>Be<br>Purchased<br>Under<br>the Plans or<br>Programs<br>US\$ |
|---------------------------------------|--|---|--|---|
| November 21 through November 30, 2012 | 174,647                                    | 43.82                                       | 174,647  | 92,342,718  |
| December 1 through December 31, 2012  | 1,485,529                                  | 40.04                                       | 1,485,529  | 32,834,424  |
| <b>Total</b>                          | <b>1,660,176</b>                           |   | <b>1,660,176</b>   |   |

---

(1) Our ADS to ordinary share ratio is one ADS for every 25 ordinary shares.

**Item 16F. Change in Registrant's Certifying Accountants**

Not applicable.

Table of Contents

**Item 16G. Corporate Governance**

As permitted by NASDAQ, in lieu of the NASDAQ corporate governance rules, but subject to certain exceptions, we may follow the practices of our home country which for the purpose of such rules is the Cayman Islands. Specifically, our board of directors adopted our RSU Plan without seeking shareholder approval which is generally required under Rule 5635(c) of the NASDAQ Marketplace Rules. There is no specific requirement under Cayman Islands law for shareholder approval to be obtained with respect to the establishment or amendment of equity compensation arrangements.

**Item 16H. Mine Safety Disclosure**

Not applicable.

Table of Contents

**PART III**

**Item 17. Financial Statements**

The company has elected to provide financial statements pursuant to Item 18.

**Item 18. Financial Statements**

The consolidated financial statements for NetEase, Inc. and its subsidiaries are included at the end of this annual report.

**Item 19. Exhibits**

| <b>Exhibit Number</b> | <b>Document</b>   |
|-----------------------|---|
| 1.1                   | Amended and Restated Memorandum of Association of NetEase.com, Inc. (incorporated by reference to Exhibit 3.1 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)   |
| 1.2                   | Amended and Restated Articles of Association of NetEase.com, Inc. (incorporated by reference to Exhibit 3.2 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)   |
| 1.3                   | Amendment to Amended and Restated Articles of Association of NetEase.com, Inc. dated as of June 6, 2003 (incorporated by reference to Exhibit 1.3 to the company's Annual Report on Form 20-F for the year ended December 31, 2002 filed with the SEC on June 27, 2003)   |
| 2.1                   | Specimen American Depositary Receipt of NetEase.com, Inc. (incorporated by reference to Exhibit 4.1 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)   |
| 2.2                   | Specimen Stock Certificate of NetEase.com, Inc. (incorporated by reference to Exhibit 4.2 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)   |
| 3.1                   | Shareholder Voting Rights Trust Agreement dated May 12, 2000 among William Lei Ding, Bo Ding and NetEase Information Technology (Beijing) Co., Ltd. (incorporated by reference to Exhibit 10.40 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000) |
| 4.1                   | Amended and Restated 2000 Stock Incentive Plan and Form of Stock Option Agreement (including standard and non-standard form) (incorporated by reference to Exhibit 4.2 to the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the SEC on August 31, 2001)                                  |
| 4.2                   |   |

## Edgar Filing: NetEase, Inc. - Form 20-F

2009 Restricted Share Unit Plan (incorporated by reference to Exhibit 10.1 to the company's Registration Statement on Form S-8 (file no. 333-164249) filed with the SEC on January 8, 2010)

- 4.3 Form of Employment Agreement between NetEase.com, Inc. and its executive officers (incorporated by reference to Exhibit 4.3 to the company's Annual Report on Form 20-F for the year ended December 31, 2009 filed with the SEC on June 29, 2010)
- 4.4 Domain Name License Agreement dated February 3, 2000 between NetEase.com, Inc. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.7 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on March 27, 2000)
- 4.5 Copyright License Agreement dated February 3, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.8 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on March 27, 2000)
- 4.6 Trademark License Agreement dated February 3, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.9 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on March 27, 2000)

## Edgar Filing: NetEase, Inc. - Form 20-F

### Table of Contents

| <b>Exhibit Number</b> | <b>Document</b>  |
|-----------------------|--|
| 4.7                   | Supplemental Agreement (to Copyright License Agreement and Domain Name License Agreement) dated April 27, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.10 to Amendment No.1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)                                     |
| 4.8                   | Notice of Renewal dated April 2, 2001 relating to the Copyright License Agreement and the Trademark License Agreement each dated February 3, 2000 and made between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 4.14 to the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the SEC on August 31, 2001) |
| 4.9                   | Exclusive Advertising Agency Agreement dated February 3, 2000 between Guangzhou NetEase Computer System Co., Ltd. and NetEase.com, Inc. (incorporated by reference to Exhibit 10.13 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on March 27, 2000)   |
| 4.10                  | Notice of Renewal dated April 2, 2001 relating to the Exclusive Advertising Agency Agreement dated February 3, 2000 between Guangzhou NetEase Computer System Co., Ltd. and NetEase.com, Inc. (incorporated by reference to Exhibit 4.18 to the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the SEC on August 31, 2001)   |
| 4.11                  | Trademark Transfer Agreement dated March 29, 2000 between Guangzhou NetEase Computer System Co., Ltd. and NetEase Information Technology (Beijing) Co., Ltd. (incorporated by reference to Exhibit 10.14 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)   |
| 4.12                  | Online Advertising Agreement dated February 15, 2000 between Guangzhou NetEase Computer System Co., Ltd. and Beijing Guangyitong Advertising Co., Ltd. (incorporated by reference to Exhibit 10.15 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on March 27, 2000)  |
| 4.13                  | Notice of Renewal dated April 2, 2001 relating to the Online Advertising Agreement dated February 15, 2000 and made between Guangzhou NetEase Computer System Co., Ltd. and Beijing Guangyitong Advertising Co., Ltd. (incorporated by reference to Exhibit 4.21 to the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the SEC on August 31, 2001)   |
| 4.14                  | Supplemental Agreement dated May 15, 2000 (amending the Domain Name License Agreement) between NetEase.com, Inc. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.37 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)   |
| 4.15                  | Agreement dated May 12, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.41 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)  |
| 4.16                  | Operating Agreement dated May 10, 2000 among NetEase Information Technology (Beijing) Co., Ltd., Beijing Guangyitong Advertising Co., Ltd., Bo Ding and William Lei Ding (incorporated by reference to Exhibit 10.42 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)   |
| 4.17                  | Supplemental Agreement dated May 12, 2000 (supplementing the Online Advertising Agreement dated February 15, 2000) between Guangzhou NetEase Computer System Co., Ltd. and Beijing Guangyitong Advertising Co., Ltd. (incorporated by reference to Exhibit 10.47 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on May 15, 2000)   |
| 4.18                  | Supplemental Agreement dated May 15, 2000 (supplementing the Domain Name License Agreement dated February 3, 2000) between NetEase.com, Inc. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.48 to Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the  |



SEC on May 15, 2000)

## Edgar Filing: NetEase, Inc. - Form 20-F

### Table of Contents

| <b>Exhibit Number</b> | <b>Document</b>  |
|-----------------------|--|
| 4.19                  | Letter of Agreement, dated June 6, 2000, among William Lei Ding, Bo Ding and NetEase.com, Inc. (incorporated by reference to Exhibit 10.49 to Amendment No. 2 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on June 15, 2000)  |
| 4.20                  | Supplemental Agreement dated June 15, 2000 (supplementing the Online Advertising Agreement dated February 15, 2000), between Beijing Guangyitong Advertising Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.50 to Amendment No. 2 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the SEC on June 15, 2000)  |
| 4.21                  | Trademark Assignment Agreement dated August 17, 2001 between Guangzhou NetEase Computer System Co., Ltd. and NetEase Information Technology (Beijing) Co., Ltd. and its Supplemental Agreement dated August 27, 2001 (incorporated by reference to Exhibit 4.53 to the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the SEC on August 31, 2001)  |
| 4.22                  | Supplemental Letter of Agreement dated May 17, 2004 (supplementing the Letter Agreement dated June 6, 2000 by and among William Lei Ding, Bo Ding and NetEase.com, Inc.) by and among William Lei Ding, Bo Ding, Jun Liang and NetEase.com, Inc. (incorporated by reference to Exhibit 4.39 to the company's Annual Report on Form 20-F for the year ended December 31, 2004 filed with the SEC on June 27, 2005)  |
| 4.23                  | Second Supplemental Letter of Agreement dated July 15, 2004 (supplementing the Letter Agreement dated June 6, 2000 by and among William Lei Ding, Bo Ding and NetEase.com, Inc., as supplemented by the Supplemental Letter of Agreement dated May 17, 2004 by and among William Lei Ding, Bo Ding, Jun Liang and NetEase.com, Inc.) by and among William Lei Ding, Bo Ding, Jun Liang and NetEase.com, Inc. (incorporated by reference to Exhibit 4.40 to the company's Annual Report on Form 20-F for the year ended December 31, 2004 filed with the SEC on June 27, 2005)  |
| 4.24                  | No. 3 Supplemental Letter of Agreement dated July 20, 2004 (supplementing the Letter Agreement dated June 6, 2000 by and among William Lei Ding, Bo Ding and NetEase.com, Inc., as supplemented by the Supplemental Letter of Agreement dated May 17, 2004 and the Second Supplemental Letter of Agreement dated July 15, 2004, each by and among William Lei Ding, Bo Ding, Jun Liang and NetEase.com, Inc.) by and among William Lei Ding, Bo Ding, Jun Liang and NetEase.com, Inc. (incorporated by reference to Exhibit 4.41 to the company's Annual Report on Form 20-F for the year ended December 31, 2004 filed with the SEC on June 27, 2005) |
| 4.25                  | Form of Cooperative Agreement  |
| 8.1                   | Subsidiaries and Variable Interest Entities of NetEase, Inc.   |
| 11.1                  | Code of Business Conduct (incorporated by reference to Exhibit 11.1 to the company's Annual Report on Form 20-F for the year ended December 31, 2006 filed with the SEC on June 26, 2007)  |
| 12.1                  | Certification of Chief Executive Officer Required by Rule 13a-14(a)  |
| 12.2                  | Certification of Acting Chief Financial Officer Required by Rule 13a-14(a)   |
| 13.1                  | Certification of Chief Executive Officer Required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code   |
| 13.2                  | Certification of Acting Chief Financial Officer Required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code  |
| 15.1                  | Charter of Audit Committee of the Board of Directors of the Registrant (incorporated by reference to Exhibit 15.1 to the company's Annual Report on Form 20-F for the year ended December 31, 2006 filed with the SEC on June 26, 2007)  |
| 15.2                  | Consent of PricewaterhouseCoopers Zhong Tian CPAs Limited Company, Independent Registered Public Accounting Firm   |



Table of Contents

| <b>Exhibit<br/>Number</b> | <b>Document</b>  |
|---------------------------|--|
| 15.3                      | Consent of Maples and Calder                           |
| 15.4                      | Consent of King&Wood Mallesons Lawyers                 |
| 101.INS*                  | XBRL Instance Document                                 |
| 101.SCH*                  | XBRL Taxonomy Extension Schema Document                |
| 101.CAL*                  | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.LAB*                  | XBRL Taxonomy Extension Label Linkbase Document        |
| 101.PRE*                  | XBRL Taxonomy Extension Presentation Linkbase Document |
| 101.DEF*                  | XBRL Taxonomy Extension Definition Linkbase Document   |

---

\* XBRL (eXtensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act, is deemed not filed for purposes of Section 18 of the Exchange Act, and otherwise is not subject to liability under these sections.

Table of Contents

**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

**NETEASE, INC.**

By: /s/ William Lei Ding  
William Lei Ding  
Chief Executive Officer

Date: April 22, 2013

Table of Contents

**NETEASE, INC.**

|  |     |
|--|-----|
| <u>Management's report on internal control over financial reporting</u>  | F-1 |
| <u>Report of independent registered public accounting firm</u>   | F-2 |
| <u>Consolidated balance sheets at December 31, 2011 and 2012</u>   | F-3 |
| <u>Consolidated statements of operations and comprehensive income for the years ended December 31, 2010, 2011 and 2012</u> | F-4 |
| <u>Consolidated statements of shareholders' equity for the years ended December 31, 2010, 2011 and 2012</u>                | F-5 |
| <u>Consolidated statements of cash flows for the years ended December 31, 2010, 2011 and 2012</u>                          | F-6 |
| <u>Notes to the consolidated financial statements</u>  | F-7 |

---

Table of Contents

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

The management of NetEase, Inc., or the Company, is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) and 15d-15(f) promulgated under the Securities Exchange Act of 1934, as amended.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company's management, with the participation of the Company's principal executive and principal financial officer, assessed the effectiveness of the Company's internal control over financial reporting as of the end of the most recent fiscal year, December 31, 2012. In making this assessment, the Company's management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework*. Based on its assessment, management concluded that, as of the end of the Company's most recent fiscal year, December 31, 2012, the Company's internal control over financial reporting is effective based on those criteria.

PricewaterhouseCoopers Zhong Tian CPAs Limited Company, our independent registered public accounting firm, has audited the effectiveness of the Company's internal control over financial reporting as of December 31, 2012, as stated in their report, which is included herein.

Table of Contents

**Report of Independent Registered Public Accounting Firm**

**To the Board of Directors and Shareholders of NetEase, 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 present fairly, in all material respects, the financial position of NetEase, Inc. and its subsidiaries (the Company) at December 31, 2012 and December 31, 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012 based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control over Financial Reporting appearing on Page F-1 of this Annual Report on Form 20-F. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers Zhong Tian CPAs Limited Company

PricewaterhouseCoopers Zhong Tian CPAs Limited Company  
Beijing, the People's Republic of China  
April 22, 2013





Table of Contents**NetEase, Inc.****Consolidated Balance Sheets**

(in thousands except per share data)

|  | December 31,<br>2011<br>RMB | December 31,<br>2012<br>RMB | December 31,<br>2012<br>US\$ |
|--|-----------------------------|-----------------------------|------------------------------|
| <b>Assets</b>  |                             |                             |                              |
| Current assets:  |                             |                             |                              |
| Cash and cash equivalents  | 2,214,618                   | 1,590,769                   | 255,336                      |
| Time deposits  | 9,704,777                   | 13,098,661                  | 2,102,480                    |
| Restricted cash  | 318,684                     | 570,506                     | 91,573                       |
| Accounts receivable, net   | 230,047                     | 269,485                     | 43,255                       |
| Prepayments and other current assets   | 900,464                     | 1,121,784                   | 180,059                      |
| Short-term investments   | 993,606                     | 1,073,539                   | 172,315                      |
| Deferred tax assets  | 111,990                     | 143,929                     | 23,102                       |
| Total current assets   | 14,474,186                  | 17,868,673                  | 2,868,120                    |
| Non-current assets:  |                             |                             |                              |
| Property, equipment and software, net  | 848,469                     | 815,026                     | 130,821                      |
| Land use right, net  | 11,788                      | 11,529                      | 1,851                        |
| License rights   | 48,962                      |                             |                              |
| Deferred tax assets  | 2,586                       | 2,215                       | 356                          |
| Time deposits  |                             | 490,000                     | 78,650                       |
| Other long-term assets   | 58,940                      | 90,513                      | 14,528                       |
| Total non-current assets   | 970,745                     | 1,409,283                   | 226,206                      |
| Total assets   | 15,444,931                  | 19,277,956                  | 3,094,326                    |
| <b>Liabilities and Shareholders Equity</b>                                     |                             |                             |                              |
| Current liabilities:   |                             |                             |                              |
| Accounts payable   | 134,217                     | 157,764                     | 25,323                       |
| Salary and welfare payables  | 244,398                     | 289,848                     | 46,524                       |
| Dividend payable   |                             | 814,934                     | 130,806                      |
| Taxes payable  | 391,769                     | 389,465                     | 62,513                       |
| Deferred revenue   | 1,014,073                   | 1,160,018                   | 186,196                      |
| Accrued liabilities and other payables   | 498,120                     | 764,473                     | 122,706                      |
| Total current liabilities  | 2,282,577                   | 3,576,502                   | 574,068                      |
| Long-term payable:   |                             |                             |                              |
| Other long-term payable  | 63,890                      | 99,968                      | 16,046                       |
| Total liabilities  | 2,346,467                   | 3,676,470                   | 590,114                      |
| Commitments and contingencies (See Note 20)                                    |                             |                             |                              |
| Shareholders equity:   |                             |                             |                              |
| Ordinary shares, US\$0.0001 par value:   |                             |                             |                              |
| 1,000,300,000 shares authorized, 3,273,937 shares issued and outstanding as of |                             |                             |                              |
| December 31, 2011 and 3,287,546 shares issued and 3,246,042 shares             |                             |                             |                              |
| outstanding as of December 31, 2012  |                             |                             |                              |
|  | 2,687                       | 2,696                       | 433                          |

Edgar Filing: NetEase, Inc. - Form 20-F

|   |            |            |           |
|---|------------|------------|-----------|
| Additional paid-in capital                | 1,002,336  | 1,156,681  | 185,660   |
| Treasury stock                            |            | (422,489)  | (67,814)  |
| Statutory reserves                        | 472,586    | 634,108    | 101,781   |
| Retained earnings                         | 11,649,092 | 14,309,609 | 2,296,851 |
| NetEase, Inc s shareholders equity        | 13,126,701 | 15,680,605 | 2,516,911 |
| Noncontrolling interests                  | (28,237)   | (79,119)   | (12,699)  |
| Total shareholders equity                 | 13,098,464 | 15,601,486 | 2,504,212 |
| <br>                                      |            |            |           |
| Total liabilities and shareholders equity | 15,444,931 | 19,277,956 | 3,094,326 |

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

Table of Contents

## NetEase, Inc.

## Consolidated Statements of Operations and Comprehensive Income

(in thousands except per share data or per ADS data)

|  | For the year ended December 31, |                  |                  |                |
|--|---------------------------------|------------------|------------------|----------------|
|  | 2010                            | 2011             | 2012             | 2012           |
|  | RMB                             | RMB              | RMB              | US\$           |
| <b>Revenues:</b>   |                                 |                  |                  |                |
| Online game services   | 4,944,439                       | 6,552,431        | 7,287,063        | 1,169,654      |
| Advertising services   | 633,209                         | 795,422          | 850,157          | 136,460        |
| E-mail, WVAS and others  | 82,141                          | 124,898          | 242,741          | 38,963         |
|  | 5,659,789                       | 7,472,751        | 8,379,961        | 1,345,077      |
| Sales tax expense  | (152,120)                       | (182,099)        | (179,005)        | (28,732)       |
| Net revenues   | 5,507,669                       | 7,290,652        | 8,200,956        | 1,316,345      |
| Cost of revenues   | (1,798,841)                     | (2,372,288)      | (2,578,067)      | (413,808)      |
| <b>Gross profit</b>  | <b>3,708,828</b>                | <b>4,918,364</b> | <b>5,622,889</b> | <b>902,537</b> |
| <b>Operating expenses:</b>   |                                 |                  |                  |                |
| Selling and marketing expenses   | (656,976)                       | (849,205)        | (906,707)        | (145,537)      |
| General and administrative expenses  | (189,621)                       | (280,227)        | (286,223)        | (45,942)       |
| Research and development expenses  | (317,929)                       | (465,490)        | (718,315)        | (115,298)      |
| Total operating expenses   | (1,164,526)                     | (1,594,922)      | (1,911,245)      | (306,777)      |
| <b>Operating profit</b>  | <b>2,544,302</b>                | <b>3,323,442</b> | <b>3,711,644</b> | <b>595,760</b> |
| Other income (expenses):   |                                 |                  |                  |                |
| Investment income  | 290                             | 14,128           | 43,770           | 7,026          |
| Interest income  | 141,001                         | 258,053          | 423,634          | 67,998         |
| Exchange losses  | (89,488)                        | (79,058)         | (554)            | (89)           |
| Other, net   | (19,634)                        | 99,164           | 99,718           | 16,006         |
| <b>Income before tax</b>   | <b>2,576,471</b>                | <b>3,615,729</b> | <b>4,278,212</b> | <b>686,701</b> |
| Income tax   | (344,446)                       | (392,756)        | (691,642)        | (111,016)      |
| <b>Net income</b>  | <b>2,232,025</b>                | <b>3,222,973</b> | <b>3,586,570</b> | <b>575,685</b> |
| Add: Net loss attributable to noncontrolling interests                       | 3,747                           | 11,291           | 50,882           | 8,167          |
| <b>Net income attributable to the NetEase, Inc. s shareholders</b>           | <b>2,235,772</b>                | <b>3,234,264</b> | <b>3,637,452</b> | <b>583,852</b> |
| <b>Comprehensive income</b>  | <b>2,232,025</b>                | <b>3,222,973</b> | <b>3,586,570</b> | <b>575,685</b> |
| Add: Comprehensive loss attributable to noncontrolling interests             | 3,747                           | 11,291           | 50,882           | 8,167          |
| <b>Comprehensive income attributable to the NetEase, Inc. s shareholders</b> | <b>2,235,772</b>                | <b>3,234,264</b> | <b>3,637,452</b> | <b>583,852</b> |
| Net income per share, basic  | 0.69                            | 0.99             | 1.11             | 0.18           |
| Net income per ADS, basic  | 17.22                           | 24.76            | 27.70            | 4.45           |
| Net income per share, diluted  | 0.69                            | 0.99             | 1.11             | 0.18           |
| Net income per ADS, diluted  | 17.14                           | 24.68            | 27.65            | 4.44           |
| Weighted average number of ordinary shares outstanding, basic                | 3,246,426                       | 3,265,550        | 3,282,663        | 3,282,663      |
| Weighted average number of ADS outstanding, basic                            | 129,857                         | 130,622          | 131,307          | 131,307        |

Edgar Filing: NetEase, Inc. - Form 20-F

|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Weighted average number of ordinary shares outstanding, diluted | 3,261,886 | 3,276,704 | 3,288,330 | 3,288,330 |
| Weighted average number of ADS outstanding, diluted             | 130,475   | 131,068   | 131,533   | 131,533   |

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

Table of Contents

## NetEase, Inc.

## Consolidated Statements of Shareholders' Equity

(Amounts and share numbers, in thousands)

|   | Ordinary shares<br>Share | Amount<br>RMB | Additional<br>paid-in capital<br>RMB | Treasury stock<br>Share | Amount<br>RMB | Statutory<br>reserves<br>RMB | Retained<br>earnings<br>RMB | Noncontrolling<br>interests<br>RMB | Total<br>shareholders<br>equity<br>RMB |
|---|--------------------------|---------------|--------------------------------------|-------------------------|---------------|------------------------------|-----------------------------|------------------------------------|--|
| Balance as of<br>December 31, 2009  | 3,238,025                | 2,664         | 784,489                              |                         |               | 225,784                      | 6,425,841                   | (13,434)                           | 7,425,344                              |
| Ordinary shares issued<br>upon exercise of<br>employee stock options      | 14,339                   | 9             | 24,114                               |                         |               |                              |                             |                                    | 24,123                                 |
| Share-based<br>compensation   |                          |               | 42,130                               |                         |               |                              |                             |                                    | 42,130                                 |
| Appropriation to<br>statutory reserves                                    |                          |               |                                      |                         |               | 96,184                       | (96,184)                    |                                    |  |
| Net income  |                          |               |                                      |                         |               |                              | 2,235,772                   | (3,747)                            | 2,232,025                              |
| Others  |                          |               | (9)                                  |                         |               |                              | 17                          | 8                                  | 16                                     |
| Balance as of<br>December 31, 2010  | 3,252,364                | 2,673         | 850,724                              |                         |               | 321,968                      | 8,565,446                   | (17,173)                           | 9,723,638                              |
| Ordinary shares issued<br>upon exercise of<br>employee stock options      | 15,539                   | 10            | 73,327                               |                         |               |                              |                             |                                    | 73,337                                 |
| Ordinary shares issued<br>upon settlement of<br>restricted share units    | 6,034                    | 4             | (4)                                  |                         |               |                              |                             |                                    |  |
| Share-based<br>compensation   |                          |               | 78,289                               |                         |               |                              |                             |                                    | 78,289                                 |
| Appropriation to<br>statutory reserves                                    |                          |               |                                      |                         |               | 150,618                      | (150,618)                   |                                    |  |
| Net income  |                          |               |                                      |                         |               |                              | 3,234,264                   | (11,291)                           | 3,222,973                              |
| Capital injection in a<br>subsidiary by<br>noncontrolling<br>shareholders |                          |               |                                      |                         |               |                              |                             | 227                                | 227                                    |
| Balance as of<br>December 31, 2011  | 3,273,937                | 2,687         | 1,002,336                            |                         |               | 472,586                      | 11,649,092                  | (28,237)                           | 13,098,464                             |
| Ordinary shares issued<br>upon exercise of<br>employee stock options      | 4,929                    | 3             | 24,709                               |                         |               |                              |                             |                                    | 24,712                                 |
| Ordinary shares issued<br>upon settlement of<br>restricted share units    | 8,680                    | 6             | (6)                                  |                         |               |                              |                             |                                    |  |
| Share-based<br>compensation   |                          |               | 129,642                              |                         |               |                              |                             |                                    | 129,642                                |
| Appropriation to<br>statutory reserves                                    |                          |               |                                      |                         |               | 161,522                      | (161,522)                   |                                    |  |
| Net income  |                          |               |                                      |                         |               |                              | 3,637,452                   | (50,882)                           | 3,586,570                              |
| Repurchase of shares  |                          |               |                                      | (41,504)                | (422,489)     |                              |                             |                                    | (422,489)                              |
|   |                          |               |                                      |                         |               |                              | (815,413)                   |                                    | (815,413)                              |

Edgar Filing: NetEase, Inc. - Form 20-F

Dividend to  
shareholders

Balance as of

|                   |           |       |           |          |           |         |            |          |            |
|-------------------|-----------|-------|-----------|----------|-----------|---------|------------|----------|------------|
| December 31, 2012 | 3,287,546 | 2,696 | 1,156,681 | (41,504) | (422,489) | 634,108 | 14,309,609 | (79,119) | 15,601,486 |
|-------------------|-----------|-------|-----------|----------|-----------|---------|------------|----------|------------|

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

F-5

---

Table of Contents

## NetEase, Inc.

## Consolidated Statements of Cash Flows (in thousands)

|   | 2010<br>RMB  | For the year ended December 31, |              | 2012<br>US\$ |
|---|--------------|---------------------------------|--------------|--------------|
|   |              | 2011<br>RMB                     | 2012<br>RMB  |              |
| <b>Cash flows from operating activities:</b>                                      |              |                                 |              |              |
| Net income  | 2,232,025    | 3,222,973                       | 3,586,570    | 575,685      |
| Adjustments to reconcile net income to net cash provided by operating activities: |              |                                 |              |              |
| Depreciation and amortization   | 232,171      | 293,239                         | 233,509      | 37,481       |
| Impairment loss for license right   |              | 50,316                          |              |              |
| Share-based compensation cost   | 102,406      | 122,032                         | 203,018      | 32,587       |
| (Reversal of) allowance for provision for doubtful debts                          | (20,029)     | 416                             | 3,088        | 495          |
| Losses (gains) on disposal of property, equipment and software                    | 13,985       | (74)                            | (42)         | (7)          |
| Unrealized exchange losses (gains)  | 100,219      | 76,262                          | (5,665)      | (909)        |
| Deferred income taxes   | 8,619        | (42,442)                        | (31,568)     | (5,067)      |
| Net equity share of (gains) losses from associated companies                      | (1,093)      | 1,195                           | (842)        | (135)        |
| Others  |              | (12,580)                        | 21,758       | 3,492        |
| Changes in operating assets and liabilities:                                      |              |                                 |              |              |
| Accounts receivable   | (89,997)     | 10,800                          | (70,318)     | (11,288)     |
| Prepayments and other current assets  | 3,047        | (83,490)                        | (68,833)     | (11,049)     |
| Accounts payable  | (37,557)     | 22,710                          | 43,168       | 6,929        |
| Salary and welfare payables   | 52,480       | 62,425                          | 45,434       | 7,293        |
| Taxes payable   | 12,592       | 33,329                          | (34,449)     | (5,530)      |
| Deferred revenue  | 190,482      | 240,121                         | 145,946      | 23,426       |
| Accrued liabilities and other payables  | 55,604       | 75,716                          | 153,516      | 24,641       |
| Net cash provided by operating activities   | 2,854,954    | 4,072,948                       | 4,224,290    | 678,044      |
| <b>Cash flows from investing activities</b>                                       |              |                                 |              |              |
| Purchase of property, equipment and software                                      | (297,980)    | (410,120)                       | (178,654)    | (28,676)     |
| Proceeds from sale of property, equipment and software                            | 359          | 263                             | 777          | 125          |
| Purchase of other intangible assets   |              | (1,042)                         | (32)         | (5)          |
| Net change of short-term investments with terms of three months or less           |              |                                 | (120,000)    | (19,261)     |
| Purchase of short-term investments  |              | (1,001,026)                     | (1,101,691)  | (176,834)    |
| Proceeds from maturities of short-term investments                                |              | 20,000                          | 1,120,000    | 179,772      |
| Purchase of license right   |              | (39,300)                        |              |              |
| Long-term investments   |              |                                 | (7,915)      | (1,270)      |
| Transfer to restricted cash   | (16,736)     | (178,085)                       | (251,822)    | (40,420)     |
| Net change in time deposits with terms of three months                            | (338,570)    | (318,937)                       | 889,350      | 142,751      |
| Placement/rollover of matured time deposits                                       | (10,402,822) | (10,861,505)                    | (16,393,642) | (2,631,361)  |
| Proceeds from maturity of time deposits   | 8,443,805    | 9,598,470                       | 11,626,594   | 1,866,197    |
| Net increase in other assets  | (9,218)      | (16,951)                        | (37,003)     | (5,940)      |
| Net cash used in investing activities   | (2,621,162)  | (3,208,233)                     | (4,454,038)  | (714,922)    |
| <b>Cash flows from financing activities:</b>                                      |              |                                 |              |              |



Edgar Filing: NetEase, Inc. - Form 20-F

|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Proceeds from employees exercising stock options  | 24,123    | 73,337    | 24,712    | 3,967     |
| Payments of other long-term payable   |           | (20)      |           |           |
| Repurchase of shares  |           |           | (414,942) | (66,603)  |
| Capital contribution from noncontrolling interests  | 16        | 227       |           |           |
| Net cash provided by (used in) financing activities   | 24,139    | 73,544    | (390,230) | (62,636)  |
| <b>Effect of exchange rate changes on cash held in foreign currencies</b>                   | (14,084)  | (8,778)   | (3,871)   | (621)     |
| <b>Net increase (decrease) in cash and cash equivalents</b>                                 | 243,847   | 929,481   | (623,849) | (100,135) |
| <b>Cash and cash equivalents beginning of the year</b>                                      | 1,041,290 | 1,285,137 | 2,214,618 | 355,471   |
| <b>Cash and cash equivalents end of the year</b>  | 1,285,137 | 2,214,618 | 1,590,769 | 255,336   |
| <b>Supplemental disclosures of cash flow information:</b>                                   |           |           |           |           |
| Cash paid for income taxes, net of tax refund   | 252,040   | 371,238   | 648,609   | 104,109   |
| Withholding income tax paid associated with the repatriation of cash for a special dividend |           |           | 35,000    | 5,618     |
| <b>Supplemental schedule of non-cash investing and financing activities:</b>                |           |           |           |           |
| Share repurchase financed by accounts payable   |           |           | 7,547     | 1,211     |
| Dividend payable  |           |           | 814,934   | 130,806   |
| Fixed asset purchases financed by accounts payable  | 146,523   | 37,614    | 7,228     | 1,160     |

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

Table of Contents**Notes to the Consolidated Financial Statements**

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

**1. Organization and Nature of Operations****(a) The Group**

NetEase.com, Inc. was incorporated in the Cayman Islands on July 6, 1999 and changed its name to NetEase, Inc. (the Company) with effect from March 29, 2012 after its approval at the Company's extraordinary general meeting of shareholders held on the same day. The Company has been listed on the Nasdaq National Market (now the Nasdaq Global Select Market) in the United States of America since July 2000. As of December 31, 2012, the Company had the following principal subsidiaries and variable interest entities ( VIEs ) for which the Company is the primary beneficiary:

| Name  | Place and date of incorporation          |
|---|--|
| NetEase Information Technology (Beijing) Co., Ltd. ( NetEase Beijing )                | Beijing, China<br>August 30, 1999        |
| NetEase Interactive Entertainment Limited ( NetEase Interactive )                     | British Virgin Islands<br>April 12, 2002 |
| Guangzhou NetEase Interactive Entertainment Co., Ltd. ( Guangzhou Interactive )       | Guangzhou, China<br>October 15, 2002     |
| Guangzhou Boguan Telecommunication Technology Co., Ltd. ( Boguan )                    | Guangzhou, China<br>December 8, 2003     |
| NetEase Youdao Information Technology (Beijing) Co., Ltd. ( Youdao Information )      | Beijing, China<br>March 21, 2006         |
| NetEase (Hangzhou) Network Co., Ltd. ( NetEase Hangzhou )                             | Hangzhou, China<br>June 2, 2006          |
| Hong Kong NetEase Interactive Entertainment Limited ( Hong Kong NetEase Interactive ) | Hong Kong, China<br>November 26, 2007    |
| NetEase (Hong Kong) Limited ( NetEase Hong Kong )                                     | Hong Kong, China<br>November 26, 2007    |
| Guangzhou NetEase Information Technology Co., Ltd. ( Guangzhou Information )          | Guangzhou, China<br>June 24, 2008        |
| Hangzhou Langhe Technology Co., Ltd. ( Hangzhou Langhe )                              | Hangzhou, China<br>July 14, 2009         |

Edgar Filing: NetEase, Inc. - Form 20-F

|   |                                     |
|---|-------------------------------------|
| Zhejiang Weiyang Technology Co., Ltd. ( Weiyang )   | Hangzhou, China<br>March 15, 2010   |
| Ujia (Hong Kong) Limited ( Ujia Hong Kong )   | Hong Kong, China<br>May 30, 2011    |
| Ujia.com, Inc. ( Ujia Cayman )  | Cayman Islands<br>June 14, 2011     |
| Lede Technology Co., Ltd. ( Lede Technology )   | Hangzhou, China<br>October 25, 2011 |
| Guangzhou NetEase Computer System Co., Ltd. ( Guangzhou NetEase )   | Guangzhou, China<br>June 24, 1997   |
| Beijing Guangyitong Advertising Co., Ltd. ( Guangyitong Advertising )   | Beijing, China<br>November 8, 1999  |
| Shanghai EaseNet Network Technology Co., Ltd. ( Shanghai EaseNet )  | Shanghai, China<br>January 3, 2008  |
| StormNet Information Technology (Hong Kong) Limited (Formerly known as Hong Kong NetEase Computer Technology Limited ) ( StormNet IT HK ) | Hong Kong, China<br>April 18, 2008  |
| StormNet Information Technology (Shanghai) Co., Ltd. ( StormNet IT SH )   | Shanghai, China<br>December 9, 2008 |

Table of Contents

| Name   | Place and date of incorporation   |
|--|-----------------------------------|
| Hangzhou Leihuo Network Co., Ltd. ( HZ Leihuo )                  | Hangzhou, China<br>April 15, 2009 |
| Ujia E-commerce Co., Ltd. ( Ujia E-commerce )                    | Hangzhou, China<br>August 8, 2011 |
| NetEase Media, Inc. ( NetEase Media Cayman )                     | Cayman Islands<br>April 13, 2012  |
| NetEase Media (Hong Kong) Limited ( NetEase Media Hong Kong )    | Hong Kong, China<br>June 7, 2012  |
| Anji Weiyang Agricultural Development Co., Ltd. ( Anji Weiyang ) | Anji, China<br>September 18, 2012 |

In addition, Guangzhou NetEase has two majority-owned subsidiaries, Wangyibao Co., Ltd. ( Wangyibao Company ) and Beijing NetEase Youdao Computer System Co., Ltd. ( Youdao Computer ). The Company, its subsidiaries and VIEs are hereinafter collectively referred to as the Group or the Company .

As of December 31, 2012, the total assets of all the consolidated VIEs of the Company were RMB1.7 billion, mainly comprising cash and cash equivalents, time deposit, accounts receivable, prepayments and other current assets and fixed assets. As of December 31, 2012, the total liabilities of the consolidated VIEs were RMB1.6 billion, mainly comprising accounts payable, deferred revenue, accrued liabilities and other payables.

In accordance with various contractual agreements, the Company has power to direct the activities of the VIEs and can have assets transferred out of the VIEs. Therefore, the Company considers that there are no assets in the consolidated VIEs that can be used only to settle obligations of the consolidated VIEs, except for the registered capital of the VIEs and certain non-distributable statutory reserves amounting to approximately RMB183.0 million and RMB10.3 million, respectively as of December 31, 2012. As the consolidated VIEs are incorporated as limited liability companies under the PRC Company Law, creditors do not have recourse to the general credit of the Company for the liabilities of the consolidated VIEs.

Currently, there are certain contractual arrangements between the Company and several of its VIEs which require the Company to provide additional financial support or guarantees to its VIEs, where necessary.

There is no entity in the Company's group for which the Company has a variable interest but is not the primary beneficiary as of December 31, 2012.

In August 2008, April 2009 and November 2012, Blizzard Entertainment, Inc. ( Blizzard ) agreed to license certain online games to Shanghai EaseNet for operation in China. Shanghai EaseNet is a PRC company owned by William Lei Ding, the Company's Chief Executive Officer, director and major shareholder, and has contractual arrangements with the joint venture established between, and owned equally by, Blizzard

## Edgar Filing: NetEase, Inc. - Form 20-F

and the Company, and with the Company. The joint venture was established concurrently with the licensing of the games in August 2008 and will provide technical services to Shanghai EaseNet. The joint venture currently consists of two companies, StormNet IT HK and StormNet IT SH. Shanghai EaseNet, StormNet IT HK and StormNet IT SH became fully operational starting in 2009.

As of December 31, 2012, HZ Leihuo, NetEase Media Cayman and NetEase Media Hong Kong were not fully operational.

Weiyang was incorporated in China in March 2010 to operate a swine raising business together with its wholly owned subsidiary, Anji Weiyang, which was established in September 2012. As of December 31, 2012, Weiyang and Anji Weiyang were still in the process of operation preparation on this new business venture.

Wangyibao Company was incorporated in China in July 2010, as a subsidiary of Guangzhou NetEase, for the purpose of operating the Wangyibao online payment platform of the Company which was initially launched in February 2009 to facilitate e-payment by online game customers to the Company.

Table of Contents

Ujia Cayman, Ujia Hong Kong and Lede Technology were incorporated in the Cayman Islands, Hong Kong and China in June, May and October 2011, respectively, for the purpose of operating the Company's e-commerce business together with Ujia E-commerce, a VIE incorporated in China in August 2011 by two Chinese employees of the Company.

In February 2013, we completed the merger of Guangzhou Interactive and Guangzhou Information into Boguan, with Boguan as the surviving entity.

The Group is principally engaged in developing and providing a range of Internet-related services including online games, advertising, e-mail, wireless value-added services and other e-commerce related services in China. Details of the Group's business are described in Note 1(b).

**(b) Nature of operations**

The Group generates revenues from providing online game services and advertising services on the NetEase websites, and to a much lesser extent, from e-mail, wireless value-added and other e-commerce related services. Substantially all of the Company's revenues are directly or indirectly generated through its VIEs.

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; government regulations of the Internet and online game industry in China; significant numbers of new entrants; dependence on key individuals; competition of similar services from larger companies; customer preferences; and the need for the continued successful development, marketing and selling of its services.

*VIE Arrangements with Guangzhou NetEase, Guangyitong Advertising and Shanghai EaseNet*

The Group conducts its business mainly in China. The Chinese government regulates Internet access, telecommunications services, the distribution of news and other information and the provision of commerce through strict business licensing requirements and other governmental regulations, which include, among others, those restricting foreign ownership in Chinese companies providing Internet advertising and other Internet or telecommunications value-added services. To comply with the existing Chinese laws and regulations, the Company and certain of its subsidiaries have entered into a series of contractual arrangements with its principal VIEs with respect to the operation of the NetEase websites, operation of self-developed and licensed online games, Internet content and wireless value-added services, as well as the provision of advertising services. Such VIEs are:

- (1) Guangzhou NetEase (owned by William Lei Ding, our principal shareholder, and his brother, Bo Ding),
- (2) Guangyitong Advertising (owned by Mr. Ding and Guangzhou NetEase), and

(3) Shanghai EaseNet (owned by Mr. Ding).

Based on the agreements with the VIEs, the Company's subsidiaries NetEase BeijingGuangzhou Interactive, Boguan, Guangzhou Information and NetEase Hangzhou provided technical consulting and related services to these VIEs. In 2012, these agreements were replaced with the following new cooperative agreements to reflect a change in the tax rules in China which resulted in our business in China becoming subject to a value-added tax instead of a business tax. The principal agreements that transfer economic benefits to the Company and its subsidiaries are:

- *Cooperative agreements with Guangzhou NetEase* under these agreements, the Company's subsidiaries NetEase Beijing, Boguan and NetEase Hangzhou provide various technical consulting and related services to Guangzhou NetEase in exchange for substantially all of Guangzhou NetEase's net profits.
- *Cooperative agreement with Guangyitong Advertising* under this agreement, NetEase Beijing provides various technical consulting and related services in exchange for substantially all of Guangyitong Advertising's profits.

Each cooperative agreement will remain in effect indefinitely unless any one of the contract parties objects or otherwise required by law.

Table of Contents

The principal agreements that provide the Company and its subsidiaries effective control over these VIEs are:

- Operating Agreement among NetEase Beijing, Guangyitong Advertising and the ultimate shareholders of Guangyitong Advertising. To ensure the successful performance of the various agreements between the parties, Guangyitong Advertising and its ultimate shareholders have agreed that they will not enter into any transaction, or fail to take any action, that would substantially affect the assets, liabilities, equity or operations of Guangyitong Advertising without the prior written consent of NetEase Beijing. The term of this agreement is 20 years from February 3, 2000.
- Shareholder Voting Rights Trust Agreement among William Lei Ding, Bo Ding and NetEase Beijing. Bo Ding irrevocably appoints NetEase Beijing to represent him to exercise all the voting rights to which he is entitled as a shareholder of Guangyitong Advertising and William Lei Ding and Bo Ding agree to cause Guangzhou NetEase to irrevocably appoint NetEase Beijing to represent Guangzhou NetEase to exercise all voting rights. The term of this agreement was 10 years from May 12, 2000, which was extended on June 10, 2011 with a term of 20 years from May 12, 2000.
- Letter of Agreement. Each of William Lei Ding and Bo Ding have agreed that any amendments to be made to the agreements to which Guangzhou NetEase, Guangyitong Advertising and/or William Lei Ding and Bo Ding are parties, shall be subject to the approval by the vote of a majority of the Board of the Company, excluding the vote of William Lei Ding. Messrs. Ding have also agreed that, if any amendments to the above mentioned agreements require a vote of the shareholders of NetEase, Guangzhou NetEase or Guangyitong Advertising, as applicable, both of them will vote in their capacity as direct or indirect shareholders of these companies to act based upon the instructions of our Board. The term of this agreement is 20 years from June 6, 2000.
- Other Governance Arrangements. The parties have agreed that upon NetEase Beijing's determination and at any time when NetEase Beijing is able to obtain approval to invest in and operate all or any part of Guangyitong Advertising or Guangzhou NetEase, NetEase Beijing may acquire all or any part of the assets or equity interests of Guangyitong Advertising or Guangzhou NetEase, to the extent permitted by Chinese law. In addition, the ultimate shareholders of Guangyitong Advertising have agreed that upon instruction from NetEase Beijing, they will appoint or terminate Guangyitong Advertising's board members, General Manager, Chief Financial Officer and other senior officers.

The above-mentioned contractual arrangements enable the Company to:

- have the power to direct activities of these companies that most significantly impact the entities' economic performance;
- receive substantially all of the economic benefits and residual returns, and absorb substantially all the risk of expected losses from these companies as if it were their sole shareholder; and
- have an option to purchase all of the equity interests in these companies at a nominal price.



Management evaluated the relationships among the Company, its subsidiaries and these companies and concluded that the Company is the primary beneficiary of each of them. As a result, these companies' results of operations, assets and liabilities have been included in the Company's consolidated financial statements.

*The Joint Venture*

In addition to the foregoing, in connection with the licensing of certain online games by Blizzard to Shanghai EaseNet for operation in the PRC in August 2008, April 2009 and November 2012, there are certain contractual arrangements among Shanghai EaseNet, the joint venture established between Blizzard and the Company, and the Company.

StormNet IT HK, StormNet IT SH and Shanghai EaseNet (collectively referred to as the JV Group) are variable interest entities as equity investment at risk is not sufficient to permit the JV Group to finance its activities without additional subordinated financial support provided by any parties. Due to the restriction on the disposition of their respective shares in the joint venture, Blizzard and NetEase are considered related parties for purposes of identifying which party is the primary beneficiary under ASC 810. Since the aggregate variable interests held by Blizzard and NetEase would, if held by a single party, identify that party as the primary beneficiary, either Blizzard or NetEase will be the primary beneficiary. Based on the assessment of all relevant facts and circumstances, the Company determined that NetEase is most closely associated with the JV Group and therefore is the primary beneficiary. As a result, the JV Group's results of operations, assets and liabilities have been included in the Company's consolidated financial statements.

Table of Contents

The Company conducts substantially all of its business through the various VIEs discussed above and their subsidiaries, and therefore these companies directly affect the Company's financial performance and cash flows. As discussed below, if the Chinese government determines the VIE agreements do not comply with applicable laws and regulations and requires the Company to restructure its operations entirely or discontinue all or any portion of its business, or if the uncertainties in the PRC legal system limit the Group's ability to enforce these contractual agreements, the Group's business operations will be significantly disrupted and the Group might be unable to consolidate these companies in the future. In the opinion of management, the likelihood of loss in respect of the Group's current ownership structure or the contractual arrangements with its VIEs is remote.

*Risks related to the VIE arrangements*

The Company believes that its contractual arrangements with the VIEs are in compliance with PRC law and are legally enforceable. The major shareholder of Guangzhou NetEase, which is in turn the major shareholder of Guanyitong Advertising, Wangyibao Company and Youdao Computer, and Shanghai EaseNet is the largest shareholder of the Company. He therefore has no current interest in seeking to act contrary to the contractual arrangements. However, uncertainties in the PRC legal system could limit the Company's ability to enforce these contractual arrangements and if Mr. Ding were to reduce his interest in the Company, his interests may diverge from that of the Company and that may potentially increase the risk that he would seek to act contrary to the contractual terms, for example by influencing the VIEs not to pay the service fees when required to do so. If the VIEs fail to perform their respective obligations under the current contractual arrangements, the Company may have to incur substantial costs and expend significant resources to enforce those arrangements and rely on legal remedies under Chinese laws. The Chinese laws, rules and regulations are relatively new, and because of the limited volume of published decisions and their non-binding nature, the interpretation and enforcement of these laws, rules and regulations involve substantial uncertainties. These uncertainties may impede the ability of the Company to enforce these contractual arrangements, or suffer significant delay or other obstacles in the process of enforcing these contractual arrangements and materially and adversely affect the results of operations and the financial position of the Company.

In addition, many Chinese regulations are subject to extensive interpretive powers of governmental agencies and commissions, and there are substantial uncertainties regarding the interpretation and application of current and future Chinese laws and regulations. Accordingly, the Company cannot be assured that Chinese regulatory authorities will not ultimately take a contrary view to its belief and will not take action to prohibit or restrict its business activities. The relevant regulatory authorities would have broad discretion in dealing with any deemed violations which may adversely impact the financial statements, operations and cash flows of the Company (including the restriction on the Company to carry out the business). It is unclear, however, how such restructuring could impact the Company's business and operating results, as the Chinese government has not yet found any such contractual arrangements non-compliant. If the legal structure and contractual arrangements were found to be in violation of any existing PRC laws and regulations, the PRC government could potentially:

- revoke the Group's business and operating licenses;
  
- require the Group to discontinue or restrict operations;
  
- restrict the Group's right to collect revenues;

- block the Group's websites;
- require the Group to restructure the operations in such a way as to compel the Group to establish a new enterprise, re-apply for the necessary licenses or relocate our businesses, staff and assets;
- impose additional conditions or requirements with which the Group may not be able to comply; or
- take other regulatory or enforcement actions against the Group that could be harmful to the Group's business.

The imposition of any of these penalties may result in a material and adverse effect on the Group's ability to conduct the Group's business. In addition, if the imposition of any of these penalties causes the Group to lose the rights to direct the activities of the VIEs or the right to receive their economic benefits, the Group would no longer be able to consolidate the VIEs. The Group does not believe that any penalties imposed or actions taken by the PRC government would result in the liquidation of the Company, its subsidiaries or the VIEs.

## **2. Principal Accounting Policies**

### **(a) Basis of consolidation**

The consolidated financial statements include the financial statements of the Company, its subsidiaries and VIEs for which the Company is the primary beneficiary with the ownership interests of minority shareholders reported as noncontrolling interests. All significant transactions and balances among the Company, its subsidiaries and VIEs have been eliminated upon consolidation. The Company consolidates a VIE if the Company has the power to direct matters that most significantly impact the activities of the VIE, and has the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE.

Table of Contents

**(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.

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. These estimates and assumptions include, but are not limited to, assessing the following: lives of the permanent in-game items, the determination of whether sales prices are fixed or determinable and collection is probable or reasonably assured and the recoverability of accounts receivable, realization of deferred tax assets and the determination of uncertain tax positions, useful lives and impairment provision of property, equipment and software and intangibles, and fair value of the Company's stock options and restricted share units.

**(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 collectability is reasonably assured.

Net revenues presented in the consolidated statements of operations and comprehensive income represent revenues from online game services, advertising services, e-mail, wireless value-added services and others recognized net of sales discount, sales tax and related surcharges

**(i) Online game services**

The Group sells prepaid point cards through Guangzhou NetEase and Shanghai EaseNet to the end user. Customers can purchase physical prepaid point cards in different locations in China, including Internet cafés, software stores, convenience stores and bookstores. Customers can also purchase virtual prepaid points from vendors who register the points in the Group's system and virtual prepaid cards online via debit and credit cards or bank transfers via the Company's Wangyibao online payment services platform, and receive the prepaid point information over the Internet. Customers can use the points to play the Group's online games, pay for in-game items and use other fee-based services. Proceeds received from the sales of prepaid point cards and online points to players are recorded as deferred revenues. The Group earns revenue through providing online game services to players under two types of revenue models: time-based revenue model and item-based revenue model. For online games using the time-based model, players are charged based on the time they spend playing games.

Under the item-based model, the basic game play functions are free of charge, and players are charged for purchases of in-game items. Revenues from the sales of in-game items are recognized when the items are consumed by the customers or over the estimated lives of the in-game items. The Company considers the average period that players typically play the games and other game player behavior patterns, as well as various other factors, including the acceptance and popularity of expansion packs, promotional events launched and market conditions to arrive at the

## Edgar Filing: NetEase, Inc. - Form 20-F

best estimates for the estimated lives of the permanent in-game items. The Group assesses the estimated lives of the permanent in-game items for the item-based games on a quarterly basis. Adjustments arising from the changes of estimated lives of permanent in-game items are applied prospectively as such changes are resulted from new information indicating a change in the game player behavior patterns.

Unused online points in a personal game account are recognized as revenues when the likelihood that the Group would provide further online games services with respect to such online points is remote. The Group has determined that such likelihood is remote when the personal game account has been inactive for 540 days or more. The revenue recognized from the inactive accounts was insignificant in 2011 and 2012.

Table of Contents

(ii) Advertising services

The Group derives its advertising revenues principally from short-term online advertising contracts engaged by Guangyitong Advertising. Advertising service contracts may consist of multiple elements that typically spans over a quarter to a year. Before 2011, the Company has not established vendor specific objective evidence of fair value for the multiple components and, as a result, with respect to the advertising contract that do not include a fixed delivery pattern for various types of advertising services, recognition of revenues is deferred until completion of the contract. For the advertising contracts with a fixed delivery pattern, revenues are recognized ratably over the period in which the advertisement is displayed and only if collection of the resulting receivables is probable. In accordance with ASU No.2009-13 Revenue Recognition - Multiple-Deliverable Revenue Arrangements ( ASU No.2009-13 ), on January 1, 2011, the Company began to treat advertising contracts with multiple deliverable elements as separate units of accounting for revenue recognition purposes and to recognize revenue on a periodic basis during the contract when each deliverable service is provided. Since the contract price is for all deliverables, the Company allocates the arrangement consideration to all deliverables at the inception of the arrangement on the basis of their relative selling price according to the selling price hierarchy established by ASU No.2009-13. The Company use (a) vendor-specific objective evidence of selling price, if it exists, otherwise, (b) third-party evidence of selling price. If neither (a) nor (b) exists, the Company will use (c) the management's best estimate of the selling price for that deliverable. The adoption did not have a material impact on the Company's consolidated financial statements.

In the search engine business, Youdao Information enters into cost per action ( CPA ) advertising contracts and receives fees when an online user performs a specific action such as purchasing a product from or registering with the advertiser. Revenue for CPA contracts is recognized when the specific action is completed. Youdao Information may also enter into advertising business contracts with advertisers that 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 related revenues are deferred until the remaining guaranteed impression levels are achieved.

The Company recognizes revenue and expense 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 and cash equivalents, marketable securities, or other consideration that is readily convertible to a known amount of cash for similar advertising from buyers unrelated to the counterparty in the barter transaction.

For the years ended December 31, 2010, 2011 and 2012, the Group engaged in certain advertising barter transactions for which the fair value was not determinable 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, content, consulting services and software provided by the counterparties.

(iii) E-mail, wireless value-added services and others

Revenue from e-mail, wireless value-added services and others ( e-mailWVAS and others ) is predominantly derived from activities related to fee-based premium services, e-commerce and online payment platform services.

## Edgar Filing: NetEase, Inc. - Form 20-F

Fee-based premium services revenues, operated on a monthly subscription basis, are derived principally from providing premium e-mail and WVAS services. Prepaid subscription revenues are deferred and are recognized by the Group over the period in which the services are provided.

In February 2009, the Company launched its Wangyibao payment platform, through which game players registered for Wangyibao operations can deposit money in their accounts and use the accounts to pay for game point cards and other fee-based services and products rendered by the Company. The Company recognizes revenue when services are rendered to account holders in accordance with service agreement.

Revenues from e-commerce services mainly include personalized photo-based products, game accessories and other e-commerce related services. Revenues are recognized when such products are transferred to the customers or the services are rendered and collections are reasonably assured.

### **(d) Cost of revenues**

Costs of online game services, advertising services and e-mail, WVAS and others consist primarily of staff costs, royalties and consultancy fees related to licensed games, depreciation and amortization of computers and software, server custody fees, bandwidth, sales tax paid by the Company and its subsidiaries on intra-group revenues from the VIEs and other direct costs of providing these services. These costs are charged to the consolidated statements of operations and comprehensive income as incurred.

Table of Contents**(e) Research and development costs**

Research and development costs mainly consist of personnel-related expenses and technology service costs incurred for the development of online games prior to the establishment of technological feasibility and costs associated with new product development. For the years ended December 31, 2010, 2011 and 2012, the costs incurred for development of online game products have not been capitalized because the period after the date technical feasibility is reached and the time when the game is marketed is short historically and the development cost incurred in the period are insignificant.

**(f) Cash, cash equivalents and time deposits**

Cash and cash equivalents represent cash on hand, demand deposits placed with large reputable banks in Hong Kong or China, and highly liquid investments that are readily convertible to known amounts of cash and with original maturities from the date of purchase with terms of less than three months. As of December 31, 2011, there were cash at bank and demand deposits with terms of less than three months denominated in US dollars and Euro amounting to approximately US\$32.1 million and Euro18.6 million, respectively. As of December 31, 2012, there were cash at bank and demand deposits with terms of less than three months denominated in US dollars and Euro amounting to approximately US\$30.1 million and Euro23.6 million, respectively (equivalent to approximately RMB189.5 million and RMB196.3 million, respectively).

Time deposits represent time deposits placed with banks with original maturities of three months or more. As of December 31, 2011, there were time deposits denominated in US dollars and Euro amounting to approximately US\$34.5 million and Euro55.8 million, respectively. As of December 31, 2012, there were time deposits denominated in US dollars and Euro amounting to approximately US\$29.9 million and Euro18.4 million (equivalent to approximately RMB188.2 million and RMB152.8 million, respectively).

As of December 31, 2011 and 2012, the Company had approximately RMB11.6 billion and RMB13.4 billion cash and cash equivalents and time deposits held by its PRC subsidiaries and VIEs, representing 97.4% and 88.1% of total cash and cash equivalents and time deposits of the Company, respectively.

As of December 31, 2011 and 2012, the Company had a restricted cash balance which is set aside for a period of 12 months or less of approximately RMB318.7 million and RMB570.5 million, respectively, comprising as follows (in millions):

|  | <b>December 31,<br/>2011<br/>RMB</b> | <b>December 31,<br/>2012<br/>RMB</b> |
|--|--------------------------------------|--------------------------------------|
| Guarantee deposit for consulting fee payments due to Blizzard                                  | 85.0                                 | 85.0                                 |
| Escrow account deposit for funding sales and marketing activities of Blizzard's licensed games | 233.7                                | 209.2                                |
| Customer deposit of Wangyibao accounts   | 276.3                                | 276.3                                |
|  | 318.7                                | 570.5                                |

The Company had no other lien arrangements during 2011 and 2012.



**(g) Fair value of financial instruments**

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

Accounting guidance establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. Accounting guidance establishes three levels of inputs that may be used to measure fair value:

Level 1 Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets

Level 2 Include other inputs that are directly or indirectly observable in the marketplace

Level 3 Unobservable inputs which are supported by little or no market activity

The Group's financial instruments include cash and cash equivalents and time deposits, accounts receivable prepayments and other current assets, short-term investments, accounts payable, deferred revenue and accrued liabilities and other payables, which the carrying values approximate their fair value. Please see Note 25 for additional information.

Table of Contents**(h) Short-term investment**

Short-term investments include investments in financial instruments with a variable interest rate indexed to performance of underlying assets and investments that the Company has positive intent and ability to hold to maturity.

In accordance with ASC 825, for investments in financial instruments with a variable interest rate indexed to performance of underlying assets, the Company elected the fair value method at the date of initial recognition and carried these investments at fair value. Changes in the fair value are reflected in the consolidated statements of operations and comprehensive income as other income/(expense). Fair value is estimated based on quoted prices of similar products provided by banks at the end of each period. The Company classifies the valuation techniques that use these inputs as Level 2 of fair value measurements. Please see Note 25 for additional information.

The investments that the Company has positive intent and ability to hold to maturity are classified as held-to-maturity investments and stated at amortized cost. For individual investment classified as held-to-maturity investments, the Company evaluates whether a decline in fair value below the amortized cost basis is other than temporary in accordance with the Company's policy and ASC 320-10. If the Company concludes that, it does not intend or is not required to sell an impaired debt investment before the recovery of its amortized cost basis, the impairment is considered temporary and the held-to-maturity investments continue to be recognized at the amortized cost.

**(i) Investment in associated companies**

Investments in associated companies in which the Company is in a position to exercise significant influence by participating in, but not controlling or jointly controlling, the financial and operating policies are accounted for using the equity method and are reported under other long-term assets in the consolidated balance sheets.

**(j) Property, equipment and software**

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

|  |  |
|--|--|
| Building                                 | 20 years   |
| Decoration                               | 5 years  |
| Leasehold improvements                   | lesser of the term of the lease and the estimated useful lives of the assets |
| Furniture, fixtures and office equipment | 5-10 years   |
| Vehicles                                 | 5 years  |
| Servers and computers                    | 3 years  |
| Software                                 | 3 years  |

## Edgar Filing: NetEase, Inc. - Form 20-F

Repairs and maintenance expenditures, which are not considered improvement and do not extend the useful life of the property and equipment, are expensed as incurred. When the Company retires or disposes its property, equipment and software, it records any gain or loss arising from the retirement or disposal under Other, net in its consolidated statements of operations and comprehensive income.

### (k) Intangible assets

Finite-lived intangible assets are tested for impairment if impairment indicators arise. The Company amortizes its finite-lived intangible assets from business acquisition using the straight-line method:

|                                      |  |
|--------------------------------------|--|
| Land use right                       | over the remaining term of the land use right period |
| License right                        | over the license period                              |
| Customer contracts and relationships | 8-10 years   |
| Technology                           | 3 years  |

### (l) Advertising expenses

The Company expenses advertising costs as incurred and reports these costs under selling and marketing expense. Advertising expenses totaled approximately RMB203.7 million, RMB247.0 million and RMB242.8 million for the years ended December 31, 2010, 2011 and 2012, respectively.

Table of Contents

**(m) Foreign currency translation**

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

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 = RMB6.2301 on the last trading day of 2012 (December 31, 2012) as set forth in the H.10 statistical release of the U.S. Federal Reserve Board. No representation is made that the RMB amounts could have been, or could be, converted into United States dollars at such rate.

**(n) Share-based compensation**

The Company measures the cost of employee services received in exchange for stock options at the grant date fair value of the award under its 2000 Stock Incentive Plan (see Note 18(a)). The Company recognizes the share-based compensation costs, net of a forfeiture rate, on a straight-line basis of 25% a year over a vesting term of four years. The Company adopts the Black-Scholes option pricing model to determine the fair value of stock options and account for share-based compensation cost using an estimated forfeiture rate at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Under its 2009 Restricted Share Unit Plan (see Note 18(b)), the Company issues restricted share units (RSUs) to its employees, directors and consultants with performance conditions and service vesting periods ranging from one year to five years. Some of the RSUs issued are to be settled, at the Company's discretion, in stock or cash upon vesting based on the stock price at grant date. At each reporting period, the Company evaluates the likelihood of performance conditions being met. Share-based compensation costs are then recorded for the number of RSUs expected to vest on a graded-vesting basis, net of estimated forfeitures, over the requisite service period. The compensation cost of the RSUs to be settled in stock only is measured based on the fair value of stock when all conditions to establish the grant date have been met. The compensation cost of RSUs to be settled either in stock or cash at the Company's discretion is remeasured until the date when settlement in stock or cash is determined by the Company.

The Company records share-based compensation to the consolidated statements of operations and comprehensive income with the corresponding credit to the additional paid-in-capital for share options and RSUs to the extent that such awards are to be settled only in stock. On the other hand, for RSUs which will either be settled in stock or cash as discussed above, the Company continues to mark to market such awards and, in accordance with the vesting schedules of such awards, record the resulting potential liabilities under other long-term payables and accrued liabilities which totaled RMB99.8 million and RMB75.6 million, respectively as of December 31, 2012. There were no significant cash payments for share-based liabilities for the year ended 2010, 2011 and 2012.

Forfeitures were estimated based on the Company's weighted average historical forfeiture rate of the past five years. Differences between actual and estimated forfeitures are expensed in the period that the differences occur. See Note 18 for further information regarding share-based compensation assumptions and expense.

**(o) Taxation**

Income tax expense is recognized in accordance with the laws of the relevant taxing authorities, with deferred taxes being provided for temporary differences between amounts of assets and liabilities for financial reporting purposes and such amounts as measured by tax laws. Tax rate changes are reflected in income during the period the changes are enacted.

A deferred income tax asset or liability is computed for the expected future impact of differences between the financial reporting and tax bases of assets and liabilities as well as the expected future tax benefit to be derived from tax loss and tax credit carry forwards. The Company classifies deferred tax assets and liabilities into current and non-current based on the classification of the related asset or liability for financial reporting. A deferred tax liability or asset that is not related to an asset or liability for financial reporting, including deferred tax assets related to tax loss carry forwards, is classified according to the expected reversal date of the temporary difference.

Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount more likely than not to be realized in future tax returns. The valuation allowance for a particular tax jurisdiction is allocated between current and non-current deferred tax assets for that tax jurisdiction on a pro rata basis.

Table of Contents

For a particular tax-paying component of an enterprise and within a particular tax jurisdiction, (a) all current deferred tax assets and liabilities are offset and presented as a single amount and (b) all non-current deferred tax assets and liabilities are offset and presented as a single amount. The Company does not offset deferred tax assets and liabilities attributable to different tax-paying components of the enterprise or to different tax jurisdictions.

The Company reports tax-related interest expense and penalty in Other, net in the consolidated statements of operations and comprehensive income, if there is any. The Company did not incur any material penalty or interest payments in connection with tax positions during the years ended December 31, 2010, 2011 and 2012.

The Company did not have any significant unrecognized uncertain tax positions as of December 31, 2011 and 2012.

In order to assess uncertain tax positions, the Company applies a more likely than not threshold and a two-step approach for the tax position measurement and financial statement recognition. Under the two-step approach, the first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon settlement.

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

Basic earnings per share are computed on the basis of the weighted-average number of ordinary shares outstanding during the period under measurement. Diluted earnings per share are based on the weighted-average number of ordinary shares outstanding and potential ordinary shares. Potential ordinary shares result from the assumed exercise of outstanding stock options, RSUs or other potentially dilutive equity instruments, when they are dilutive under the treasury stock method or the if-converted method.

**(q) Statutory reserves**

The Company's subsidiaries and VIEs incorporated in China are required to make appropriations to certain non-distributable statutory reserves. In accordance with the laws applicable to China's Foreign Investment Enterprises, its subsidiaries have to make appropriations from its after-tax profit as reported in their PRC Statutory Accounts to non-distributable statutory reserves including (i) general reserve fund and (ii) staff bonus and welfare fund. The appropriation to the general reserve fund is at least 10% of the after-tax profits as reported in the PRC Statutory Accounts. Appropriation is not required if the reserve fund has reached 50% of the registered capital of the respective company. The appropriation to the other reserve funds is at the discretion of the Board of Directors of the respective company. At the same time, the Company's VIEs, in accordance with the China Company Laws, must make appropriations from their after-tax profit as reported in their PRC Statutory Accounts to non-distributable statutory reserves including (i) statutory surplus fund and (ii) discretionary surplus fund. The appropriation to the statutory surplus fund is at least 10% of the after-tax profits as reported in their PRC Statutory Accounts. Appropriation is not required if the statutory surplus fund has reached 50% of the registered capital of the respective company. Appropriation to the discretionary surplus fund is made at the discretion of the Board of Directors of the respective companies.

## Edgar Filing: NetEase, Inc. - Form 20-F

The general reserve fund and statutory surplus fund are restricted to set off against losses, expansion of production and operation or increase in the registered capital of the respective companies. The staff bonus and welfare fund is available to fund payments of special bonuses to staff and for collective welfare benefits. Upon approval by the Board of Directors, the discretionary surplus can be used to offset accumulated losses or to increase capital.

The staff bonus and welfare fund is a liability in nature. The other statutory reserves are not transferable to the Company in the form of cash dividends, loans or advances, and therefore, are not available for distribution except in liquidation.

The following table presents the Group's appropriations to general reserve fund and statutory surplus fund for the years ended December 31, 2010, 2011 and 2012 (in thousands):

|   | For the year ended December 31, |             |             |
|---|---------------------------------|-------------|-------------|
|   | 2010<br>RMB                     | 2011<br>RMB | 2012<br>RMB |
| Appropriations to general reserve fund and statutory surplus fund | 96,184                          | 150,618     | 161,522     |

For the years ended December 31, 2010, 2011 and 2012, NetEase Beijing did not make appropriations to statutory reserves as their cumulative appropriations in the past have already reached the statutory limit, namely 50% of the registered capital of the respective companies.

Table of Contents

**(r) Noncontrolling interests**

In 2009, the Company adopted the retrospective presentation and disclosure requirements on the noncontrolling interest which became effective for fiscal years beginning on or after December 31, 2008. The noncontrolling interest will continue to be attributed its share of losses even if that attribution results in a deficit noncontrolling interest balance.

**(s) Related parties**

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

**(t) Comprehensive income**

Comprehensive income is defined as the change in equity of the Company during a period arising from transactions and other events and circumstances excluding transactions resulting from investments by shareholders and distributions to shareholders. The comprehensive income and the net income are the same during the years ended December 31, 2010, 2011 and 2012.

**(u) Segment reporting**

The Group's internal organizational structure as well as information about geographical areas, business segments and major customers in financial statements is set out in details under Note 24.

**(v) Dividends**

Dividends of the Company are recognized when declared.

**(w) Recently issued accounting pronouncements**



## Edgar Filing: NetEase, Inc. - Form 20-F

In July 2012, the FASB issued ASU 2012-02, *Intangibles – Goodwill and Other: Testing Indefinite Lived Intangible Assets for Impairment*. The Update applies to all entities, both public and nonpublic, that have indefinite-lived intangible assets, other than goodwill, reported in their financial statements. Per the Update, an entity has the option first to assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the indefinite-lived intangible asset is impaired. If, after assessing the totality of events and circumstances, an entity concludes that it is not more likely than not that the indefinite-lived intangible asset is impaired, then the entity is not required to take further action. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted, including for annual and interim impairment tests performed as of a date before July 27, 2012, if financial statements for the most recent annual or interim period have not yet been issued. This Update will not have a material impact on the Company's consolidated financial statements.

In February 2013, the FASB issued revised guidance on *Comprehensive Income: Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. This revised guidance does not change the current requirements for reporting net income or other comprehensive income in financial statements. However, this revised guidance requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. This revised guidance is effective prospectively for reporting periods beginning after December 15, 2012 for public entities. This revised guidance will not have a material impact on the Company's consolidated financial statements.

Table of Contents**3. Concentrations and Risks****(a) Bandwidth and server custody service provider**

The Group relied on telecommunications service providers and their affiliates for bandwidth and server custody service to support its operations during fiscal years 2010, 2011 and 2012 as follows:

|  | For the year ended December 31, |       |       |
|--|---------------------------------|-------|-------|
|  | 2010                            | 2011  | 2012  |
| Total number of telecommunications service providers                               | 12                              | 12    | 11    |
| Service providers providing 10% or more of the Company's requirements              | 3                               | 3     | 2     |
| Total % of the Company's requirements provided by 10% or greater service providers | 87.9%                           | 86.6% | 82.1% |

**(b) Credit risk**

Financial instruments that potentially subject the Group to significant concentrations of credit risk consist primarily of cash and cash equivalents, time deposits, restricted cash, accounts receivable and short-term investments. As of December 31, 2011 and 2012, substantially all of the Company's cash equivalents, time deposits and restricted cash were held in major financial institutions located in the PRC or Hong Kong, which management consider being of high credit quality. Accounts receivable are typically unsecured and are generally derived from revenue earned from advertising services. No single customer has a receivable balance exceeding 10% of the total accounts receivable balance for the years ended 31 December, 2011 and 2012.

The short-term investments consist of the held-to-maturity investment of fixed-rate corporate bonds of well-known Chinese companies and other short-term investments of financial products issued by commercial banks in China with a variable interest rate indexed to performance of underlying assets, both have a maturity date within one year as of the purchase date. The held-to-maturity investments have a credit rating of Aa or Aaa by Moody's Investors Service, or AA or AAA by Standard & Poor's Corp., or an equivalent rating by another reputable PRC licensed rating service agency. The effective yields of the held-to-maturity investments and other short-term investments range from 4.00% to 4.75% per annum. Any negative events or deterioration in financial well-being with respect to the counterparties of the above investments and the underlying collateral may cause a material loss to the Company and have a material effect on the Company's financial condition and results of operations.

**(c) Major Customers**

No single customer represented 10% or more of the Company's total revenues for the years ended December 31, 2010, 2011 and 2012.

**(d) Online Games**

The Company derived a combined total of 95.8%, 94.5% and 93.7% of its total net game revenues for the years ended December 31, 2010, 2011 and 2012, respectively from several of the Company's self-developed massively multi-player online role-playing games, including Fantasy Westward Journey, Westward Journey Online II, Tianxia III, Ghost and Heroes of Tang Dynasty II (a comprehensive upgrade from Heroes of Tang Dynasty) as well as World of Warcraft®, a game developed by and licensed from Blizzard.

**(e) Chinese Regulations**

The Chinese market in which the Group operates exposes the Company to certain macro-economic and regulatory risks and uncertainties. These uncertainties extend to the ability of the Group to provide Internet services through contractual arrangements in China as this industry remains highly regulated. The Chinese government may issue from time to time new laws or new interpretations on existing laws to regulate this industry. Regulatory risk also encompasses the interpretation by the tax authorities of current tax laws, the status of properties leased for the Group's operations, its legal structure and scope of operations in China, which could be subject to further restrictions resulting in limitations on the Company's ability to conduct business in China. The Chinese government may also require the Company to restructure its operations entirely if it finds that its contractual arrangements do not comply with the applicable laws and regulations. It is unclear how such a restructuring could impact the Company's business and operating results, as the Chinese government has not yet found any such contractual arrangements non-compliant. However, any such restructuring may cause significant disruption to the Company's business operations.

**4. Allowance for Doubtful Accounts**

The Company closely monitors the collection of its accounts receivables and records a reserve for doubtful accounts against aged accounts and for specifically identified non-recoverable amounts. If the economic situation and the financial condition of the customer deteriorate resulting in an impairment of the customer's ability to make payments, additional allowances might be required. Receivable balances are written off when they are determined to be uncollectible. The following table sets out the movements of the allowance for doubtful accounts for the years ended December 31, 2010, 2011 and 2012 (in thousands):

Table of Contents

|      | Balance at<br>January 1,<br>RMB | Charged to (write-<br>back against) cost<br>and expenses<br>RMB | Write-off of<br>receivable balances<br>and corresponding<br>provisions<br>RMB | Balance at<br>December 31,<br>RMB |
|------|---------------------------------|---|---|-----------------------------------|
| 2010 | 30,015                          | (20,029)  | (2,164)   | 7,822                             |
| 2011 | 7,822                           | 416   | (266)   | 7,972                             |
| 2012 | 7,972                           | 3,088   | (668)   | 10,392                            |

## 5. Prepayments and Other Current Assets

The following is a summary of prepayments and other current assets (in thousands):

|   | December 31,<br>2011<br>RMB | December 31,<br>2012<br>RMB |
|---|-----------------------------|-----------------------------|
| Guarantee payment made to Blizzard - royalty fees   | 363,508                     | 424,757                     |
| Prepayment for royalties - current portion  | 225,307                     | 257,037                     |
| Interest receivable   | 105,798                     | 182,681                     |
| Prepayments   | 65,659                      | 43,686                      |
| Wangyibao operating funds held by third party online payment settlement service providers | 63,745                      | 105,735                     |
| Prepayment for sales tax  | 46,623                      | 63,303                      |
| Employee advances   | 6,288                       | 9,892                       |
| Security and rental deposits  | 5,679                       | 8,505                       |
| Other   | 17,857                      | 26,188                      |
|   | 900,464                     | 1,121,784                   |

In accordance with the license agreements of World of Warcraft and StarCraft® II: Wings of Liberty®, the Company made the guarantee payments to Blizzard on behalf of Shanghai EaseNet for the minimum guaranteed royalties as of December 31, 2011 and 2012. The guarantee amounts will be released to the Company when actual royalties are paid by Shanghai EaseNet to Blizzard.

As of December 31, 2011 and 2012, prepayments for royalties representing prepaid royalties based on game cards activated but remaining unconsumed related to operations of games licensed from Blizzard.

In February 2009, the Company launched its Wangyibao online payment platform, through which game players registered for Wangyibao online payment services can deposit money in their accounts and use the accounts to pay for game point cards and other fee-based services and products rendered by the Company. Account holders may also withdraw money from their accounts at any time, such as to pay for items purchased from other players or when they want the return of their money. The Company engages certain third party online payment settlement service providers to collect payments from and process withdrawals by customers. As of December 31, 2011 and 2012, the Company had operating funds held by its third party online payment settlement service providers as shown above.

## Edgar Filing: NetEase, Inc. - Form 20-F

The amount of employee advances listed above included staff housing loan balances of RMB5.4 million and RMB9.1 million repayable within 12 months from December 31, 2011 and 2012, respectively (see Note 10 (b)). No advances were made directly or indirectly to the Company's executive officers for their personal benefit for the years ended December 31, 2011 and 2012.

### 6. Short-term Investments

As of December 31, 2011 and 2012, the Group's short-term investments consisted of held-to-maturity investments including fixed-rate corporate bonds and other short-term investments of financial products issued by commercial banks in China with a variable interest rate indexed to performance of underlying assets and a maturity date within one year when purchased. As of December 31, 2012, the effective yields of short-term investments ranged from 4.00% to 4.75% per annum (2011: 4.27% to 5.65% per annum).

The following is a summary of short-term investments (in thousands):

|  | Carrying Value<br>RMB | December 31, 2012<br>Unrecognized<br>Gains/(Loss)<br>RMB | Estimated<br>Fair Value<br>RMB |
|--|-----------------------|--|--------------------------------|
| Held-to-maturity securities-fixed rate investments | 953,035               |  | 953,035                        |
| Other short-term investments                       | 120,504               |  | 120,504                        |

F-20

---

Table of Contents

|  | December 31, 2011 | Estimated    |
|--|-------------------|--------------|
|  | Carrying Value    | Fair Value   |
|  | RMB               | RMB          |
|  | Unrecognized      | Gains/(Loss) |
|  | RMB               | RMB          |
| Held-to-maturity securities-fixed rate investments | 993,606           | 993,606      |

During the years ended December 31, 2010, 2011 and 2012, the Company recorded investment income related to short-term investments of nil, RMB13.1million and RMB42.9 million in the consolidated statements of operations and comprehensive income, respectively.

## 7. Property, Equipment and Software

The following is a summary of property, equipment and software (in thousands):

|  | December 31,<br>2011<br>RMB | December 31,<br>2012<br>RMB |
|--|-----------------------------|-----------------------------|
| Building and decoration                  | 534,375                     | 564,001                     |
| Leasehold improvements                   | 35,181                      | 39,062                      |
| Furniture, fixtures and office equipment | 42,432                      | 47,628                      |
| Vehicles                                 | 7,167                       | 10,095                      |
| Servers and computers                    | 643,033                     | 729,724                     |
| Software                                 | 37,853                      | 38,182                      |
| Construction in progress                 | 118,581                     | 135,041                     |
|  | 1,418,622                   | 1,563,733                   |
| Less: accumulated depreciation           | (570,153)                   | (748,707)                   |
| Net book value                           | 848,469                     | 815,026                     |

Depreciation expense was RMB153.3 million, RMB208.3 million and RMB184.2 million for the years ended 2010, 2011 and 2012, respectively.

The Company occupies a building in Guangzhou with floor space of approximately 20,000 square meters which was previously owned by a third party property developer. William Lei Ding, the Company's Chief Executive Officer, Director and major shareholder, had previously paid a deposit of RMB62.4 million to the property developer and agreed to purchase the property from the land developer once the title is issued. The Company and Mr. Ding had negotiated with the property developer to return Mr. Ding's deposit and grant the Company the right to purchase the property upon the title being issued. However, these negotiations were unsuccessful and the property developer was found to have mortgaged such property to the bank. In February 2009, the Company and Mr. Ding agreed that Mr. Ding would initiate certain arbitration proceedings against the property developer to demand that the developer discharge the mortgage and complete registration for the transfer of title to Mr. Ding. Following negotiations during the arbitration process, both parties entered into a settlement agreement on December 24, 2009. Under the settlement agreement, the Company made a payment of approximately RMB13.7 million to the land developer on behalf of Mr. Ding and the land developer completed the transfer of the entire property to Mr. Ding in January 2010. By July 2010, Mr. Ding completed the transfer of his interest in the property to the Company at cost of RMB72.2 million. (see Notes 23). In addition, the Company incurred miscellaneous property-related transfer costs at a total of RMB8.4 million upon this property transfer which was capitalized as part of the property additions in 2010. As a result of the foregoing property transfer, the Company records its property interest in the Guangzhou office building at a total cost of RMB80.6 million during 2010.

From the date the Company commenced occupying this property in July 2006 to its acquisition of the title to the property in June 2010, the Company did not paid any rent for its occupation of this property. The Company has incurred payments for various improvements to the property and installation of equipment in the aggregate amount of approximately RMB75.3 million as of December 31, 2009. Although the Company did not paid any rent for this property, it accrued an imputed rent payable (based on the prevailing market rental) of approximately RMB33.9 million for the period from July 2006 to June 2010. The provision of the imputed rent was previously reported under accounts payable in the Company's consolidated balance sheets. Following the successful transfer of the building to the Company by Mr. Ding in June 2010, the Company credited the total amount of imputed rental accrued to date of approximately RMB33.9 million to the accumulated depreciation account and will amortize the remaining cost of the building over the estimated useful life of the building.

Table of Contents

During 2007, the Company started to construct a new research and development center in Hangzhou, China. Construction of the main building was completed in December 2010 and relevant depreciation began in January 2011. As of December 31, 2012, the accumulated capital expenditures in connection with the construction and renovation of this center were RMB431.9 million, excluding payment for the land use right, which was recorded separately (see Note 8). The Company does not expect to incur material costs for the completion of certain parts of the building which remained unfurnished and unused as of December 31, 2012.

As of December 31, 2011 and 2012, Construction in progress balance mainly represented a prepayment of RMB110.9 million and RMB112.0 million, respectively for the construction of an office building in Beijing. All the related cost is capitalized in construction in progress to the extent they are incurred for the purposes of bringing the construction development to a usable state.

**8. Land Use Right**

The Company acquired the land use right in 2007 for the purpose of constructing a new research and development center in Hangzhou, China. Amortization of the land use right is made over the remaining term of the land use right period of 50 years from the date when the Company first obtained the land use right certificate from the local authorities. The land use right will be fully amortized by August 31, 2057. The land use right is summarized as follows (in thousands):

|  | <b>December 31,<br/>2011<br/>RMB</b> | <b>December 31,<br/>2012<br/>RMB</b> |
|--|--------------------------------------|--------------------------------------|
| Cost   | 27,779                               | 27,779                               |
| Incentive payment from Hangzhou local government | (15,000)                             | (15,000)                             |
| Accumulated amortization                         | (991)                                | (1,250)                              |
| Land use right, net                              | 11,788                               | 11,529                               |

The total amortization expense for each of the years ended December 31, 2010, 2011 and 2012 amounted to approximately RMB258,000. The estimated amortization expense for each of the five succeeding fiscal years is expected to be approximately RMB258,000 each year.

**9. License Rights**

In August 2008, Blizzard agreed to license to Shanghai EaseNet on an exclusive basis in China three personal computer strategy games: StarCraft II: Wings of Liberty, a sequel to Blizzard's space-themed game, which was commercially launched in China on April 6, 2011; Warcraft® III: Reign of Chaos, a fantasy-themed strategy game; and Warcraft III: The Frozen Throne, an expansion pack to Warcraft III: Reign of Chaos. Blizzard also licenses on an exclusive basis in China its Battle.net® platform which enables multiplayer interaction within these games and other online services. The term of these licenses will be three years, with an additional one year extension upon agreement of the parties, commencing from the commercial launch of StarCraft II: Wings of Liberty in China. On behalf of Shanghai EaseNet as licensee of the games, the Company has paid to Blizzard US\$4.0 million (RMB27.5 million) and US\$6.0 million (RMB39.3 million) as initial license fee in 2008 and 2011, respectively, and started amortizing those prepaid license fees since April 2011.



## Edgar Filing: NetEase, Inc. - Form 20-F

As of December 31, 2011, the Company made an assessment of the above license rights for impairment using an income approach, which involved applying an appropriate discount rate to estimate the cash flows forecasts. Based on the assessment result, the Company recorded an impairment charge of approximately RMB50.3 million in general and administrative expenses of the consolidated statements of operations and comprehensive income, which representing 100% provision on the unamortized portion of those license rights as of December 31, 2011.

Additionally, in April 2009, the Company paid Blizzard a 3-year license fee of US\$30 million (RMB204.8 million) for the right to operate World of Warcraft. As World of Warcraft was commercially re-launched in September 2009, the Company started amortizing the prepayment for the license right over the license term which was fully amortized as of December 31, 2012. In March 2012, the Company and Blizzard agreed to extend the license of World of Warcraft for an additional 3 years from September 2012 with no additional initial license fees.

The foregoing license rights are summarized as follows (in thousands):

|  | <b>December 31,<br/>2011<br/>RMB</b> | <b>December 31,<br/>2012<br/>RMB</b> |
|--|--------------------------------------|--------------------------------------|
| Payment for license rights   | 271,582                              | 271,582                              |
| Accumulated amortization   | (172,304)                            | (221,266)                            |
| Impairment provision for license rights other than World of Warcraft | (50,316)                             | (50,316)                             |
|  | 48,962                               |                                      |

Table of Contents

The total amortization expense for the years ended December 31, 2010, 2011 and 2012 amounted to approximately RMB68.2 million, RMB84.7 million and RMB49.0 million, respectively.

**10. Other Long-term Assets**

The following is a summary of other long-term assets (in thousands):

|                                    | December 31,<br>2011<br>RMB | December 31,<br>2012<br>RMB |
|------------------------------------|-----------------------------|-----------------------------|
| Investment in associated companies | 33,482                      | 34,323                      |
| Staff housing loans                | 14,004                      | 26,529                      |
| Non-current deposits               | 9,747                       | 17,704                      |
| Others                             | 1,707                       | 11,957                      |
|                                    | 58,940                      | 90,513                      |

(a) In August 2008, the Company acquired a 38.5% equity interest in SunEase, Inc., a provider of e-mail integration solution and corporate email post office operation services, sales of domain names and search engine marketing, for a consideration of approximately RMB31.0 million in cash. The investment was accounted for under the equity method of accounting with allocation of the purchase price set out as follows (in thousands):

|                   | RMB     |
|-------------------|---------|
| Tangible assets   | 12,050  |
| Intangible assets | 6,722   |
| Goodwill          | 14,046  |
| Liabilities       | (1,818) |
|                   | 31,000  |

The above intangible assets consisted of trade name, customer contracts and relationships and technology valued at RMB2.3 million, RMB2.8 million and RMB1.6 million, respectively, which were fully amortized as of December 31, 2012. Amortization expense of the above-mentioned intangible assets was approximately RMB1.0 million, RMB0.8 million and RMB3.4 million for the years ended December 31, 2010, 2011 and 2012, respectively.

The Company recorded equity share of profits from associated companies totaling RMB1.1 million for the year ended December 31, 2010, equity share of losses of RMB1.2 million for the year ended December 31, 2011 and equity share of profits of RMB0.8 million for the year ended December 31, 2012, respectively.

(b) The Company made housing loans to its employees (excluding executive officers) for house purchases via a third-party commercial bank in China. Each individual staff housing loan is secured either by the property for which the loan is extended or by approved personal

## Edgar Filing: NetEase, Inc. - Form 20-F

guarantees for the loan amount granted. The repayment term is five years from the date of drawdown. The interest rate is fixed between 2.25% to 3.50% per annum for the years ended December 31, 2011 and 2012, respectively. The outstanding portion of the staff housing loans repayable within 12 months as of December 31, 2011 and 2012 amounted to approximately RMB5.4 million and RMB9.1 million, respectively, and are reported under prepayments and other current assets in the consolidated balance sheets (see Note 5).

### **11. Taxation**

#### **(a) Income taxes**

##### *Cayman Islands*

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

Table of Contents

*British Virgin Islands ( BVI )*

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

*Hong Kong*

Hong Kong NetEase Interactive, NetEase Hong Kong, Ujia Hong Kong and StormNet IT HK are subject to 16.5% income tax for 2011 and 2012 on their taxable income generated from operation in Hong Kong. The payments of dividends by these companies to their shareholders are not subject to any Hong Kong withholding tax.

*China*

In accordance with the Income Tax Law of the People's Republic of China concerning Foreign Investment Enterprises and Foreign Enterprises ( the previous income tax laws ) prevailing prior to January 1, 2008, foreign invested enterprises were generally subject to a national and local enterprise income tax ( EIT ) at the statutory rates of 30% and 3%, respectively.

On March 16, 2007, the National People's Congress of PRC enacted the Enterprise Income Tax Law, under which Foreign Invested Enterprises ( FIEs ) and domestic companies would be subject to EIT at a uniform rate of 25%. Preferential tax treatments will continue to be granted to FIEs or domestic companies which conduct businesses in certain encouraged sectors and to entities otherwise classified as Software Enterprises and/or High and New Technology Enterprises ( HNTEs ). The Enterprise Income Tax Law became effective on January 1, 2008.

The Enterprise Income Tax Law provides a five-year transition period for FIEs to gradually increase their tax rates to the uniform tax rate of 25% for those entities established before March 16, 2007, which enjoyed a favorable income tax rate of less than 25% under the previous income tax laws. In addition, the Enterprise Income Tax Law provides grandfather treatment for enterprises which were qualified as HNTEs under the previous income tax laws and were established before March 16, 2007, if they continue to be recognized as HNTEs under the Enterprise Income Tax Law. The grandfather provision allows these enterprises to continue to enjoy their unexpired tax holiday provided by the previous income tax laws.

In March 2011, NetEase Beijing was also approved as a Key Software Enterprise and enjoyed a preferential tax rate of 10% for fiscal year 2010; the Company recorded the resulting income tax reduction in its consolidated financials in 2011. NetEase Beijing renewed the qualifications as HNTe in 2011 and enjoys the preferential enterprise income tax rate of 15% from 2011 to 2013.

Boguan renewed its HNTe qualification and enjoys a preferential tax rate of 15% from 2011 to 2013. Guangzhou Interactive renewed its HNTe qualification and enjoyed a preferential tax rate of 15% from 2010 to 2012. Guangzhou Information was recognized as Software Enterprise in

## Edgar Filing: NetEase, Inc. - Form 20-F

2009 and exempt from EIT for 2010 and 2011 and enjoyed a preferential tax rate of 12.5% in 2012.

NetEase Hangzhou was recognized as a Software Enterprise and HNTE in 2007. Accordingly, NetEase Hangzhou enjoyed a preferential tax rate of 12.5% from 2009 to 2011. NetEase Hangzhou renewed its qualification as HNTE in 2011 and enjoys the preferential enterprise income tax rate of 15% from 2012 to 2013.

Hangzhou Langhe was recognized as a Software Enterprise in 2010. As 2010 was its first tax profit year, Hangzhou Langhe was exempt from EIT for 2010 and 2011 and subject to a 50% reduction in its EIT rate from 2012 to 2014.

Wangyibao was recognized as a Software Enterprise in 2011. It is exempt from EIT for 2011 and 2012 and subject to a 50% reduction in its EIT rate from 2013 to 2015.

In March 2013, certain of our subsidiaries, including Boguan, were approved as Key Software Enterprises and enjoyed a preferential tax rate of 10% for fiscal years 2011 and 2012; the Company will record the resulting income tax reduction in its 2013 consolidated financials.

The aforementioned preferential tax rates are subject to annual review by the relevant tax authorities in China.

Edgar Filing: NetEase, Inc. - Form 20-F

Table of Contents

The following table presents the increase to net income resulting from the combined effects of EIT exemptions and tax rate reductions enjoyed by the Group for the years ended December 31, 2010, 2011 and 2012 (in thousands except per share data):

|  | For the year ended December 31, |             |             |
|--|---------------------------------|-------------|-------------|
|  | 2010<br>RMB                     | 2011<br>RMB | 2012<br>RMB |
| Aggregate amount of EIT exemptions and tax rate reductions | 376,720                         | 559,032     | 503,045     |
| Earnings per share effect, basic                           | 0.12                            | 0.17        | 0.15        |
| Earnings per share effect, diluted                         | 0.12                            | 0.17        | 0.15        |

The following table sets forth the component of income tax expenses of the Company for the years ended December 31, 2010, 2011 and 2012 (in thousands):

|                                | For the year ended December 31, |             |             |
|--------------------------------|---------------------------------|-------------|-------------|
|                                | 2010<br>RMB                     | 2011<br>RMB | 2012<br>RMB |
| Current tax expense            | 335,827                         | 435,198     | 723,210     |
| Deferred tax expense (benefit) | 8,619                           | (42,442)    | (31,568)    |
| Income tax expenses            | 344,446                         | 392,756     | 691,642     |

The following table presents a reconciliation of the differences between the statutory income tax rate and the Company's effective income tax rate for the years ended December 31, 2010, 2011 and 2012:

|  | For the year ended December 31, |           |           |
|--|---------------------------------|-----------|-----------|
|  | 2010<br>%                       | 2011<br>% | 2012<br>% |
| Statutory income tax rate  | 25.0                            | 25.0      | 25.0      |
| Permanent differences  | 0.1                             | (0.1)     | (1.0)     |
| Effect due to overseas tax-exempt entities   | 2.1                             | 1.4       | 1.2       |
| Effect of lower tax rate applicable to Software Enterprises, Key Software Enterprise and HNTES | (12.9)                          | (15.5)    | (11.8)    |
| Change in valuation allowance  | (0.9)                           | 1.8       | 1.9       |
| Income tax refund  |                                 | (1.0)     |           |
| Withholding income tax accrued for dividend (Note 11(d))                                       |                                 |           | 0.9       |
| Effect of changes in the tax status  |                                 | (0.7)     |           |
| Effective income tax rate  | 13.4                            | 10.9      | 16.2      |

As of December 31, 2012, certain entities of the Group had net operating tax loss carry forwards as follows (in thousands):

|                       |            |
|-----------------------|------------|
|                       | <b>RMB</b> |
| Loss expiring in 2013 | 33,733     |

Edgar Filing: NetEase, Inc. - Form 20-F

|                       |         |
|-----------------------|---------|
| Loss expiring in 2014 | 46,233  |
| Loss expiring in 2015 | 57,569  |
| Loss expiring in 2016 | 178,583 |
| Loss expiring in 2017 | 252,783 |
|                       | 568,901 |

Full valuation allowance was provided on the related deferred tax assets as the Company management does not believe that sufficient positive evidence exists to conclude that recoverability of such deferred tax assets is more likely than not to be realized.

Table of Contents

**(b) Sales tax and cultural development fee**

Sales tax includes business tax and value added tax.

In China, business taxes are imposed by the government on the revenues reported by the selling entities for the provision of taxable services in China, transfer of intangible assets and the sale of immovable properties in China. The business tax rate varies depending on the nature of the revenues. The applicable business tax rate for the Company's revenues generally ranges from 3% to 5%. The Company is also subject to cultural development fee on the provision of advertising services in China. The applicable tax rate is 3% of the advertising services revenue.

Pursuant to the Provision Regulation of the PRC on value added tax and its implementation rules, all entities engaged in the sale of goods in china are generally required to pay value added tax at a rate of 17.0% or other applicable value added tax rate implemented by the Provision Regulation of the gross sales proceeds received, less any creditable value added tax already paid or borne by the taxpayer.

During 2012, a pilot program of transition specified industries from being subject to Business Tax ( BT ) to Value Added Tax ( VAT ) formally commenced in certain provinces ( Pilot Program ). This round of Pilot Program starts with the Transportation industry and certain Modern Service Industries , which may possibly be extended to countrywide. According to the implementation circulars released by the Ministry of Finance and the State Administration of Taxation on the Pilot Program, the Modern Service Industries includes research, development and technological services, information technology services, cultural innovation services, logistics support, lease of corporeal properties, attestation and consulting services. Accordingly, most of our subsidiaries and VIEs were in the Pilot Program and subject to VAT with tax rate of 6% from the original BT rate of 5%.

According to the prevailing tax regulation, urban maintenance and construction tax and education surcharges shall be collected based on VAT, consumption tax and BT of foreign-invested enterprises effective from December 1, 2010. The urban maintenance and construction tax rates shall be: 7% for a taxpayer in a city, 5% for a taxpayer in a county town or town, and 1% for a taxpayer living in a place other than a city, county town or town. And the education surcharge rate and the local education surcharge is 3% and 2% respectively. As a result, the rate for urban maintenance and construction tax, education surcharge and local education surcharge applicable to the Company's foreign-invested enterprises is 12%.

**(c) Deferred tax assets and liabilities**

The following table presents the tax impact of significant temporary differences that give rise to the deferred tax assets and liabilities as of December 31, 2011 and 2012 (in thousands):

| December 31,<br>2011<br>RMB | December 31,<br>2012<br>RMB |
|-----------------------------|-----------------------------|
|-----------------------------|-----------------------------|



Edgar Filing: NetEase, Inc. - Form 20-F

|   |          |           |
|---|----------|-----------|
| Deferred tax assets - Current:  |          |           |
| Deferred revenue, primarily for advanced payments from online games customers | 66,108   | 90,555    |
| Accruals  | 56,364   | 83,864    |
|   | 122,472  | 174,419   |
| Less: valuation allowance   | (10,482) | (30,490)  |
| Total   | 111,990  | 143,929   |
| Deferred tax assets - Non-current:  |          |           |
| Depreciation of fixed assets  | 2,586    | 2,215     |
| Impairment of license rights  | 12,579   | 7,021     |
| Net operating tax loss carry forward  | 62,265   | 119,795   |
|   | 77,430   | 129,031   |
| Less: valuation allowance   | (74,844) | (126,816) |
| Total   | 2,586    | 2,215     |

The Company does not believe that sufficient positive evidence exists to conclude that the recoverability of deferred tax assets of certain entities of the group is more likely than not to be realized. Consequently, the Company has provided full valuation allowances on the related deferred tax assets. The following table sets forth the movement of the aggregate valuation allowances for deferred tax assets for the periods presented (in thousands):

Table of Contents

|      | Balance at<br>January 1<br>RMB | Provision<br>(write-back)<br>for the year<br>RMB | Balance at<br>December 31<br>RMB |
|------|--------------------------------|--|----------------------------------|
| 2010 | 42,330                         | (23,705)   | 18,625                           |
| 2011 | 18,625                         | 66,701   | 85,326                           |
| 2012 | 85,326                         | 71,980   | 157,306                          |

**(d) Withholding income tax**

The new Enterprise Income Tax Law also imposes a withholding income tax of 10% on dividends distributed by a FIE to its immediate holding company outside of China. A lower withholding income tax rate of 5% is applied if the FIE's immediate holding company is registered in Hong Kong or other jurisdictions that have a tax treaty arrangement with China. Such withholding income tax was exempted under the previous income tax law. On February 22, 2008, the Ministry of Finance and State Administration of Taxation jointly issued a circular which stated that for FIEs, all profits accumulated up to December 31, 2007 are exempted from withholding tax when they are distributed to foreign investors. Based on the interpretation of the current tax laws, management believes that the Company and all its non-PRC subsidiaries are not considered as a resident enterprise in China for corporate income tax purposes, but it cannot be certain that the relevant PRC tax authorities will agree with this determination. Except for the foregoing withholding taxes, the Company's non-PRC subsidiaries, which are currently all incorporated in Hong Kong, the British Virgin Islands or Cayman Islands are not subject to taxation on dividends they receive from the Company's PRC subsidiaries.

In November 2012, the Company's Board of Directors determined to cause two PRC subsidiaries to distribute RMB800.0 million to its overseas parent company. Accordingly, the Company accrued income tax liabilities in the amount of RMB40.0 million for withholding taxes associated with this distribution plan.

After the above distribution plan, in the foreseeable future, the Company intends to reinvest all remaining undistributed earnings in PRC subsidiaries, except for StormNet IT SH in China. Hence, no other withholding tax is expected to be incurred. Accordingly, the unrecognized deferred tax liabilities as of December 31, 2011 and 2012 were approximately RMB493.0 million and RMB655.9 million, respectively.

**12. Taxes Payable**

The following is a summary of taxes payable as of December 31, 2011 and 2012 (in thousands):

|   | December 31,<br>2011<br>RMB | December 31,<br>2012<br>RMB |
|---|-----------------------------|-----------------------------|
| Sales tax   | 71,371                      | 41,028                      |
| Withholding individual income taxes for employees | 27,445                      | 31,335                      |
| Enterprise income taxes                           | 269,198                     | 297,457                     |
| Others  | 23,755                      | 19,645                      |
|   | 391,769                     | 389,465                     |

**13. Accrued Liabilities and Other Payables**

The following is a summary of accrued liabilities and other payables as of December 31, 2011 and 2012 (in thousands):

|   | December 31,<br>2011<br>RMB | December 31,<br>2012<br>RMB |
|---|-----------------------------|-----------------------------|
| Customer deposits on Wangyibao accounts             | 267,372                     | 382,029                     |
| Accrued fixed assets related payables               | 35,663                      | 5,410                       |
| Marketing expenses                                  | 57,937                      | 94,609                      |
| Royalty and consulting fee payments due to Blizzard |                             | 84,982                      |
| Server custody fees and telecommunication charges   | 27,136                      | 31,694                      |
| RSU payables (see Note 2(n))                        | 39,733                      | 75,639                      |
| Option proceeds payable to employees                | 12,058                      | 481                         |
| Professional fees                                   | 9,108                       | 8,109                       |
| Accrued revenue sharing                             | 10,014                      | 11,463                      |
| Content cost  | 5,609                       | 22,342                      |
| Others  | 33,490                      | 47,715                      |
|   | 498,120                     | 764,473                     |

Table of Contents**14. Deferred Revenue**

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

**15. Other Long-term Payable**

The following is a summary of other long-term payables as of December 31, 2011 and 2012 (in thousands):

|                                       | December 31,<br>2011<br>RMB | December 31,<br>2012<br>RMB |
|---------------------------------------|-----------------------------|-----------------------------|
| RSU long-term payable (see Note 2(n)) | 63,690                      | 99,768                      |
| Other                                 | 200                         | 200                         |
|                                       | 63,890                      | 99,968                      |

**16. Capital Structure**

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

**17. Employee Benefits**

The Company's subsidiaries and VIEs incorporated in China participate in a government-mandated multi-employer defined contribution plan under which certain retirement, medical, housing and other welfare benefits are provided to employees. Chinese labor regulations require the Company's Chinese subsidiaries and VIEs to pay to the local labor bureau a monthly contribution at a stated contribution rate based on the monthly basic compensation of qualified employees. The relevant local labor bureau is responsible for meeting all retirement benefit obligations; hence, the Company has no further commitments beyond its monthly contribution. The following table presents the Group's employee welfare benefits for the years ended December 31, 2010, 2011 and 2012 (in millions):

|  | For the year ended December 31 |             |             |
|--|--------------------------------|-------------|-------------|
|  | 2010<br>RMB                    | 2011<br>RMB | 2012<br>RMB |
| Contributions to medical and pension schemes | 109.8                          | 137.2       | 160.9       |

|                         |       |       |       |
|-------------------------|-------|-------|-------|
| Other employee benefits | 44.6  | 68.9  | 95.6  |
|                         | 154.4 | 206.1 | 256.5 |

**18. Share-based Compensation****(a) Description of stock option plan**

According to a resolution of the Board of Directors of the Company in 2000, the Company adopted its 2000 Stock Incentive Plan which was amended and restated in 2001 (the 2000 Stock Incentive Plan).

According to resolutions of the Board of Directors and the shareholders of the Company in 2001, the 2000 Stock Incentive Plan was amended and restated. Under the amended plan, the number of ordinary shares available for issuance was increased 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" was suspended following a resolution of the Board of Directors dated March 25, 2002. The 2000 Stock Incentive Plan expired in February 2010.

Table of Contents**(b) Restricted share units plan**

In November 2009, the Company adopted a restricted share units plan for the Company's employees, directors and consultants (the 2009 RSU Plan). The Company had reserved 323,694,050 ordinary shares for issuance under the plan. The 2009 RSU Plan was adopted by a resolution of the Board of Directors on November 17, 2009 and became effective for a term of ten years unless sooner terminated.

**(c) Share-based compensation expense**

The Company recognizes share-based compensation cost in the consolidated statements of operations and comprehensive income based on awards ultimately expected to vest, after considering estimated forfeitures. Forfeitures are estimated based on the Company's historical experience over the last five years and revised in subsequent periods if actual forfeitures differ from those estimates.

The table below presents a summary of the Company's share-based compensation cost for the years ended December 31, 2010, 2011 and 2012 (in thousands):

|                                     | <b>2010</b> | <b>For the year ended December 31,</b> |             |
|-------------------------------------|-------------|--|-------------|
|                                     | <b>RMB</b>  | <b>2011</b>                            | <b>2012</b> |
|                                     |             | <b>RMB</b>                             | <b>RMB</b>  |
| Cost of revenues                    | 37,342      | 57,318                                 | 100,540     |
| Selling and marketing expenses      | 8,123       | 11,357                                 | 13,368      |
| General and administrative expenses | 31,580      | 17,897                                 | 33,374      |
| Research and development expenses   | 25,361      | 35,460                                 | 55,736      |
|                                     | 102,406     | 122,032                                | 203,018     |

As of December 31, 2012, total unrecognized compensation cost related to the unvested awards under the 2000 Stock Incentive Plan, adjusted for estimated forfeitures, was US\$0.1 million (RMB0.6 million) and is expected to be recognized through the remaining vesting period of each grant. As of December 31, 2012, the weighted average remaining vesting period was 0.88 year.

As of December 31, 2012, total unrecognized compensation related to unvested awards under the 2009 RSU Plan, adjusted for estimated forfeitures, was US\$57.1 million (RMB355.9 million) and is expected to be recognized through the remaining vesting period of each grant. As of December 31, 2012, the weighted average remaining vesting period was 2.90 years.

**(d) Valuation assumptions**

## Edgar Filing: NetEase, Inc. - Form 20-F

The Company uses the Black-Scholes option pricing model to determine the fair value of stock options. The Company did not grant any stock options in 2010, 2011 and 2012. Refer to Note 2 (n) for the description of the bases the Company follows in the valuation of RSUs.

(e) **Stock options and restricted share units award activities**

The following table presents a summary of the Company's stock options and RSUs award activities for the years ended December 31, 2010, 2011 and 2012:

|   | Employees<br>(in thousands) | Senior<br>Management<br>(in thousands) | Director and<br>Consultants<br>(in thousands) | Total<br>(in thousands) | Weighted Average<br>Exercise Price<br>US\$ |
|---|-----------------------------|--|---|-------------------------|--|
| <b>Number of ordinary shares issuable upon exercise of stock options:</b> |                             |  |   |                         |  |
| Outstanding at January 1, 2010  | 38,609                      | 4,395                                  | 1,812   | 44,816                  | 0.706                                      |
| Exercised   | (17,946)                    | (2,520)                                |   | (20,466)                | 0.641                                      |
| Expired/forfeited   | (3,294)                     |  |   | (3,294)                 | 0.728                                      |
| Outstanding at December 31, 2010  | 17,369                      | 1,875                                  | 1,812   | 21,056                  | 0.767                                      |
| Outstanding at January 1, 2011  | 17,369                      | 1,875                                  | 1,812   | 21,056                  | 0.767                                      |
| Exercised   | (13,664)                    | (1,875)                                |   | (15,539)                | 0.728                                      |
| Expired/forfeited   | (63)                        |  |   | (63)                    | 0.728                                      |
| Reclassification due to position change                                   | 875                         |  | (875)   |                         |  |
| Outstanding at December 31, 2011  | 4,517                       |  | 937   | 5,454                   | 0.877                                      |
| Outstanding at January 1, 2012  | 4,517                       |  | 937   | 5,454                   | 0.877                                      |
| Exercised during the year   | (3,992)                     |  | (937)   | (4,929)                 | 0.794                                      |
| Outstanding at December 31, 2012  | 525                         |  |   | 525                     | 1.659                                      |

Table of Contents

For the year ended December 31, 2012, no stock options expired and forfeited.

|   | Employees<br>(in thousands) | Senior<br>Management<br>(in thousands) | Director and<br>Consultants<br>(in thousands) | Total<br>(in thousands) |
|---|-----------------------------|--|---|-------------------------|
| <b>Number of ordinary shares issuable upon vesting of restricted share units:</b> |                             |  |   |                         |
| Granted during 2010   | 9,138                       |  | 720   | 9,858                   |
| Forfeited during 2010   | (758)                       |  |   | (758)                   |
| Outstanding at December 31, 2010  | 8,380                       |  | 720   | 9,100                   |
| Outstanding at January 1, 2011  | 8,380                       |  | 720   | 9,100                   |
| Granted   | 12,854                      | 4,368                                  | 580   | 17,802                  |
| Vested  | (5,024)                     | (290)                                  | (720)   | (6,034)                 |
| Forfeited   | (3,838)                     | (2,378)                                |   | (6,216)                 |
| Outstanding at December 31, 2011  | 12,372                      | 1,700                                  | 580   | 14,652                  |
| Outstanding at January 1, 2012  | 12,372                      | 1,700                                  | 580   | 14,652                  |
| Granted   | 18,451                      |  | 265   | 18,716                  |
| Vested  | (8,390)                     |  | (290)   | (8,680)                 |
| Forfeited   | (1,973)                     | (1,700)                                | (290)   | (3,963)                 |
| Outstanding at December 31, 2012  | 20,460                      |  | 265   | 20,725                  |

The following table presents the total intrinsic value of options exercised and the total fair value of RSUs on vesting dates for the years ended 2010, 2011 and 2012, respectively:

|   | Stock Options |                       |                      |
|---|---------------|-----------------------|----------------------|
|   |               | US\$<br>(in millions) | RMB<br>(in millions) |
| <b>Total intrinsic value exercised:</b> |               |                       |                      |
|   | 2010          | 18.2                  | 120.2                |
|   | 2011          | 17.2                  | 111.2                |
|   | 2012          | 6.3                   | 39.1                 |
|   | RSU           |                       |                      |
|   |               | US\$<br>(in millions) | RMB<br>(in millions) |
| <b>Total fair value vested:</b>         |               |                       |                      |
|   | 2010          | Note (a) below        | Note (a) below       |
|   | 2011          | 11.0                  | 71.2                 |
|   | 2012          | 18.6                  | 115.8                |

Note (a): The Company made its first award of RSUs in 2010, and none of such awards vested in 2010.





Table of Contents

The following table presents the weighted average remaining contractual life for the options and RSUs outstanding as of December 31, 2012:

| Exercise Price                     | Number Outstanding (in thousands) | Weighted Average Remaining Contractual Life Years | Weighted Average Exercise Price US\$ | Number Exercisable (in thousands) | Weighted Average Remaining Contractual Life Years | Weighted Average Exercise Price US\$ |
|------------------------------------|-----------------------------------|---|--------------------------------------|-----------------------------------|---|--------------------------------------|
| <b>Stock Options</b>               |                                   |   |                                      |                                   |   |                                      |
| US\$1.659                          | 525                               | 1.88  | 1.659                                | 306                               | 1.88  | 1.659                                |
|                                    | 525                               | 1.88  | 1.659                                | 306                               | 1.88  | 1.659                                |
| <b>Restricted Share Units</b>      |                                   |   |                                      |                                   |   |                                      |
| Performance-based settled in stock | 531                               | 2.17  | n/a                                  | n/a                               | n/a   | n/a                                  |
| Time-based-settled in stock/cash   | 28,934                            | 3.45  | n/a                                  | n/a                               | n/a   | n/a                                  |
| Time-based-settled in stock        | 20,725                            | 3.18  | n/a                                  | n/a                               | n/a   | n/a                                  |
|                                    | 50,190                            | 3.32  | n/a                                  | n/a                               | n/a   | n/a                                  |

The aggregate intrinsic value of options outstanding and exercisable as of December 31, 2012 was US\$0.02 million and US\$0.01 million, respectively. The intrinsic value was calculated as the difference between the Company's closing stock price of US\$42.53 per ADS, or US\$1.7012 per ordinary share as of December 31, 2012, and the exercise price of the underlying options as of that date.

The aggregate intrinsic value of RSUs outstanding as of December 31, 2012 was US\$82.9 million. The intrinsic value was calculated based on the Company's closing stock price of US\$42.53 per ADS, or US\$1.7012 per ordinary share as of December 31, 2012.

It is the Company's policy to issue new shares upon share option exercise and vesting of RSUs. The number of shares available for future grant under the Company's 2009 RSU plan was 258,789,450 as of December 31, 2012.

**19. Net Income Per Share**

The following table sets forth the computation of basic and diluted net income per share for the years ended December 31, 2010, 2011 and 2012:

|   | 2010      | For the year ended December 31, 2011 | 2012      |
|---|-----------|--------------------------------------|-----------|
| <b>Numerator (RMB in thousands):</b>  |           |                                      |           |
| Net income attributable to NetEase, Inc.'s shareholders for basic/dilutive net income per share calculation | 2,235,772 | 3,234,264                            | 3,637,452 |
| <b>Denominator (No. of shares in thousands):</b>  |           |                                      |           |
| Weighted average number of ordinary shares outstanding, basic   | 3,246,426 | 3,265,550                            | 3,282,663 |
| Dilutive effect of employee stock options and restricted share units  | 15,460    | 11,154                               | 5,667     |

## Edgar Filing: NetEase, Inc. - Form 20-F

|   |           |           |           |
|---|-----------|-----------|-----------|
| Weighted average number of ordinary shares outstanding, diluted | 3,261,886 | 3,276,704 | 3,288,330 |
| Net income per share, basic (RMB)                               | 0.69      | 0.99      | 1.11      |
| Net income per share, diluted (RMB)                             | 0.69      | 0.99      | 1.11      |

Basic net income per share is computed using the weighted average number of the ordinary shares outstanding during the year. Diluted net income per share is computed using the weighted average number of ordinary shares and potential ordinary shares outstanding during the year. For the years ended December 31, 2010, 2011 and 2012, options to purchase ordinary shares and RSUs that were anti-dilutive and excluded from the calculation of diluted net income per share was approximately 5.0 million shares, 9.6 million shares and 4.2 million shares, respectively.

Table of Contents**20. Commitments and Contingencies****(a) Commitments**

The Company leases office space, staff quarters and certain equipment under non-cancelable operating lease agreements, which expire at various dates through December 2022. As of December 31, 2012, future minimum lease under non-cancelable operating lease agreements, capital commitments and other commitment related to content and services purchases were as follows (in thousands):

|             | Rental<br>Commitments<br>RMB | Server Custody<br>Fee<br>Commitments<br>RMB | Capital<br>Commitments<br>RMB | Office<br>Machines and<br>Other<br>Commitments<br>RMB | Total<br>RMB |
|-------------|------------------------------|---|-------------------------------|---|--------------|
| 2013        | 47,193                       | 24,003                                      | 87,197                        | 51,524  | 209,917      |
| 2014        | 16,188                       | 1,544                                       |                               | 5,015   | 22,747       |
| 2015        | 4,134                        | 289   |                               | 1,078   | 5,501        |
| 2016        | 2,162                        | 289   |                               | 997   | 3,448        |
| Beyond 2016 | 14,295                       | 96  |                               | 837   | 15,228       |
|             | 83,972                       | 26,221                                      | 87,197                        | 59,451  | 256,841      |

For the years ended December 31, 2010, 2011 and 2012, the Company incurred rental expenses in the amounts of approximately RMB42.2 million, RMB50.5 million and RMB59.8 million, respectively.

Additionally, in August 2008, Blizzard agreed to license to Shanghai EaseNet on an exclusive basis in China three personal computer strategy games and its Battle.net platform, as described in Note 9 above. The term of the license will be three years, with an additional one year extension upon agreement of the parties, commencing from the commercial release of StarCraft II: Wings of Liberty in China in April 2011. In April 2009, Blizzard and the Company announced that Blizzard's World of Warcraft would also be licensed to Shanghai EaseNet in mainland China for a term of three years following the expiration of its previous license agreement on June 5, 2009 with another game operator. In March 2012, Blizzard and Shanghai EaseNet renewed the license agreement of World of Warcraft, and extended the license period to another three-year period commencing from September 2012. Under these license agreements, Shanghai EaseNet is required to pay license fees, royalties and consultancy fees to Blizzard for the games, and it also has a minimum marketing expenditure commitment. In accordance with the above-mentioned two license contracts, the Company has incurred an overall commitment totaling approximately RMB3.5 billion. As of December 31, 2012, the Company's outstanding commitments under the two license contracts totaled RMB1,123.9 million which can be summarized as follows (in millions):

|       | RMB     |
|-------|---------|
| 2013  | 636.7   |
| 2014  | 401.9   |
| 2015  | 85.3    |
| Total | 1,123.9 |

## Edgar Filing: NetEase, Inc. - Form 20-F

Furthermore, under a license agreement entered into in November 2012, Blizzard agreed to license to Shanghai EaseNet the exclusive right to operate Blizzard All-Stars in the PRC for a period of three years from the game's commercial release. The Company expects to incur a commitment totaling approximately RMB375.9 million (US\$60.3 million), including royalty, consultancy fees to Blizzard and minimum marketing expenditure.

In addition, Shanghai EaseNet is also obligated to purchase or lease certain prescribed hardware and then make such prescribed hardware available to fulfill its obligations under the three license agreements with Blizzard in the aggregate amount of up to approximately RMB218.0 million over the remaining term of licenses as of December 31, 2012. This amount represents the maximum expenditure Shanghai EaseNet would have to make for the prescribed hardware, but it may not be required to spend this amount in order to satisfy its obligations with respect to such hardware.

With respect to the above commitment table related to Blizzard licensed games, the Company has guaranteed the foregoing amounts if and to the extent Shanghai EaseNet has insufficient funds to make such payments. The Company will be entitled to reimbursement of any amounts paid for the marketing of the games and for hardware support to operate the games under the guarantee from any net profits subsequently generated by Shanghai EaseNet, after the deduction of, among other things, various fees and expenses payable to Blizzard, the Company and the joint venture with Blizzard which provides technical services to Shanghai EaseNet.

### **(b) Litigation**

From time to time, the Company is involved in claims and legal proceedings that arise in the ordinary course of business. Based on currently available information, management does not believe that the ultimate outcome of these unresolved matters, individually and in the aggregate, is likely to have a material adverse effect on the Company's financial position, results of operations or cash flows. However, litigation is subject to inherent uncertainties and the Company's view of these matters may change in the future. Were an unfavorable outcome to occur, there exists the possibility of a material adverse impact on the Company's financial position, results of operations or cash flows for the period in which the unfavorable outcome occurs, and potentially in future periods.

Table of Contents

**21. Dividends**

On November 13, 2012, the Company's Board approved a special cash dividend of US\$1.00 per ADS in order to give value back to shareholders. The special cash dividend amounting to RMB815.4 million (US\$130.8 million) was payable to shareholders of record as of January 15, 2013 and was paid on January 18, 2013.

**22. Share Repurchase Programs**

The Company's Board has approved five share repurchase programs prior to 2012 which authorized management to repurchase the Company's ordinary shares to enhance shareholder value. On November 13, 2012, the Company's Board approved a new share repurchase program authorizing management to repurchase up to US\$100 million of the Company's ordinary shares to enhance shareholder value for a period not to exceed twelve months. The timing and actual number of shares subject to repurchase were at the discretion of the Company's management and contingent on a number of factors and limitations, including the price of the Company's stock, corporate and regulatory requirements, alternative investment opportunities and other market conditions. The share repurchase program specified a maximum dollar value of shares subject to repurchase and had an expiration date and could have been limited or terminated at any time without prior notice.

The Company accounts for repurchased ordinary shares under the cost method and include such treasury stock as a component of the common shareholders' equity. Cancellation of treasury stock is recorded as a reduction of ordinary shares, additional paid-in-capital and retained earnings, as applicable. An excess of purchase price over par value is allocated to additional paid-in-capital first with any remaining excess charged entirely to retained earnings.

As of December 31, 2012, the Company had repurchased 1.66 million ADSs (equivalent to 41.50 million ordinary shares) for consideration amounting to approximately US\$67.2 million pursuant to the above referenced new share repurchase program, which were recorded as treasury stock pending cancellation.

**23. Related Party Transactions**

As explained in Note 7, by July 2010, Mr. Ding completed the transfer of his interest in the Guangzhou property to the Company at cost of RMB72.2 million.

**24. Segment Information**

**(a) Description of segments**

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker ( CODM ), or decision making group, in deciding how to allocate resources and in assessing performance. The Company s CODM is the Chief Executive Officer.

The Company s organizational structure is based on a number of factors that the CODM uses to evaluate, view and run its business operations which include, but are not limited to, customer base, homogeneity of products and technology. The Company s operating segments are based on this organizational structure and information reviewed by the Company s CODM to evaluate the operating segment results. The Company has determined that its operations are organized into three reportable segments: 1) Online Game Services; 2) Advertising Services; and 3) E-mail, Wireless Value-added Services and Others.

**(b) Segment data**

The table below provides a summary of the Group s operating segment results for the years ended December 31, 2010, 2011 and 2012. The Group does not allocate any operating costs or assets to its business segments as the Company s CODM does not use this information to measure the performance of the operating segments. There was no significant transaction between reportable segments for the years ended December 31, 2010, 2011 and 2012 (in thousands).

Table of Contents

|  | For the year ended December 31, |                    |                    |
|--|---------------------------------|--------------------|--------------------|
|  | 2010<br>RMB                     | 2011<br>RMB        | 2012<br>RMB        |
| <b>Total revenues:</b>                           |                                 |                    |                    |
| Online game services                             | 4,944,439                       | 6,552,431          | 7,287,063          |
| Advertising services                             | 633,209                         | 795,422            | 850,157            |
| E-mail, wireless value-added services and others | 82,141                          | 124,898            | 242,741            |
| <b>Total revenues</b>                            | <b>5,659,789</b>                | <b>7,472,751</b>   | <b>8,379,961</b>   |
| <b>Sales tax expense (Note 11(b)):</b>           |                                 |                    |                    |
| Online game services                             | (89,937)                        | (103,824)          | (86,478)           |
| Advertising services                             | (60,551)                        | (75,349)           | (82,680)           |
| E-mail, wireless value-added services and others | (1,632)                         | (2,926)            | (9,847)            |
| <b>Total Sales taxes</b>                         | <b>(152,120)</b>                | <b>(182,099)</b>   | <b>(179,005)</b>   |
| <b>Net revenues:</b>                             |                                 |                    |                    |
| Online game services                             | 4,854,502                       | 6,448,607          | 7,200,585          |
| Advertising services                             | 572,658                         | 720,073            | 767,477            |
| E-mail, wireless value-added services and others | 80,509                          | 121,972            | 232,894            |
| <b>Total net revenues</b>                        | <b>5,507,669</b>                | <b>7,290,652</b>   | <b>8,200,956</b>   |
| <b>Cost of revenues:</b>                         |                                 |                    |                    |
| Online game services                             | (1,378,018)                     | (1,859,176)        | (1,872,734)        |
| Advertising services                             | (312,921)                       | (380,201)          | (474,165)          |
| E-mail, wireless value-added services and others | (107,902)                       | (132,911)          | (231,168)          |
| <b>Total cost of revenues</b>                    | <b>(1,798,841)</b>              | <b>(2,372,288)</b> | <b>(2,578,067)</b> |
| <b>Gross profit (loss):</b>                      |                                 |                    |                    |
| Online game services                             | 3,476,484                       | 4,589,431          | 5,327,851          |
| Advertising services                             | 259,737                         | 339,872            | 293,312            |
| E-mail, wireless value-added services and others | (27,393)                        | (10,939)           | 1,726              |
| <b>Total gross profit</b>                        | <b>3,708,828</b>                | <b>4,918,364</b>   | <b>5,622,889</b>   |

All revenues of the Company's reportable segments are derived from China based on the geographical locations where services are provided to customers.

## 25. Financial Instruments

The following table sets forth the financial instruments, measured at fair value, by level within the fair value hierarchy as of December 31, 2012 (in thousands):

|              | Fair Value Measurements<br>(RMB)                                       |   |
|--------------|--|---|
|              | Quoted Prices in<br>Active Market<br>for Identical Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) |
| <b>Total</b> |  |   |



Edgar Filing: NetEase, Inc. - Form 20-F

|  |            |            |           |
|--|------------|------------|-----------|
| Time deposits-short term                           | 13,098,661 | 13,098,661 |           |
| Time deposits-long term                            | 490,000    | 490,000    |           |
| Held-to-maturity securities-fixed rate investments | 953,035    |            | 953,035   |
| Other short-term investments                       | 120,504    |            | 120,504   |
| Total  | 14,662,200 | 13,588,661 | 1,073,539 |

F-34

---

Table of Contents

The following table sets forth the financial instruments, measured at fair value, by level within the fair value hierarchy as of December 31, 2011 (in thousands):

|  | <b>Total</b> | <b>Fair Value Measurements<br/>(RMB)<br/>Quoted Prices in<br/>Active Market<br/>for Identical Assets<br/>(Level 1)</b> | <b>Significant Other<br/>Observable Inputs<br/>(Level 2)</b> |
|--|--------------|--|--|
| Liquid investments within 3 months (1)             | 153,853      | 153,853  |  |
| Time deposits-short term                           | 9,704,777    | 9,704,777  |  |
| Held-to-maturity securities-fixed rate investments | 993,606      |  | 993,606  |
| Total  | 10,852,236   | 9,858,630  | 993,606  |

For other financial assets and liabilities with carrying values that approximate fair value. If measured at fair value in the financial statements, these financial instruments would be classified as Level 3 in the fair value hierarchy.

---

(1) Included in cash and cash equivalents on the Company's consolidated balance sheets.

## 26. Restricted Net Assets

Relevant PRC laws and regulations permit PRC companies to pay dividends only out of their retained earnings, if any, as determined in accordance with PRC accounting standards and regulations. Additionally, the Company's PRC subsidiaries and VIEs can only distribute dividends upon approval of the shareholders after they have met the PRC requirements for appropriation to the general reserve fund and the statutory surplus fund respectively. The general reserve fund and the statutory surplus fund require that annual appropriations of 10% of net after-tax income should be set aside prior to payment of any dividends. As a result of these and other restrictions under PRC laws and regulations, the PRC subsidiaries and VIEs are restricted in their ability to transfer a portion of their net assets to the Company either in the form of dividends, loans or advances, which restricted portion amounted to approximately RMB2.6 billion or 17% of the Company's total consolidated net assets as of December 31, 2012. Even though the Company currently does not require any such dividends, loans or advances from the PRC subsidiaries and VIEs for working capital and other funding purposes, the Company may in the future require additional cash resources from its PRC subsidiaries and VIEs due to changes in business conditions, to fund future acquisitions and developments, or merely declare and pay dividends to or distributions to the Company's shareholders. There were no undistributed retained earnings in associated companies in the consolidated retained earnings due to losses incurred by them.