

NetEase, Inc.
Form 20-F
April 26, 2012
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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, 2011
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

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Commission file number: 000-30666

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)

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Tsinghua Science Park Building 8

No. 1 Zhongguancun East Road, Haidian District

Beijing 100084, People's Republic of China

(Address of principal executive offices)

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(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 Class)

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

NONE

(Title of Class)

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

NONE
(Title of Class)

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:

3,273,936,881 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

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

U.S. GAAP

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

Other

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

Item 17 Item 18

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

Yes No

(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

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INTRODUCTION

This annual report on Form 20-F includes our audited consolidated financial statements as of December 31, 2010 and 2011 and for the years ended December 31, 2009, 2010 and 2011.

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;

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- 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.

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

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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, 2009, 2010 and 2011 and as of December 31, 2010 and 2011 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 year ended December 31, 2008 and as of December 31, 2009 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 for the years ended December 31, 2007 and as of December 31, 2007 and 2008 were derived from our unaudited consolidated financial statements for those years (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.

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	2007 RMB	2008 RMB	For the year ended December 31, 2009 RMB 2010 RMB		2011 RMB	2011 US\$ (Note 1)
			(in thousands, except per share data)			
Statement of Operations Data:						
Revenues:						
Online game services	1,932,635	2,498,518	3,368,689	4,944,439	6,552,431	1,041,077
Advertising services	305,058	405,887	383,560	633,209	795,422	126,380
Wireless value-added services and others	68,018	71,719	71,202	82,141	124,898	19,844
	2,305,711	2,976,124	3,823,451	5,659,789	7,472,751	1,187,301
Business tax (expense)/benefit	(92,424)	108,460	(66,504)	(152,120)	(182,099)	(28,933)
Net revenues	2,213,287	3,084,584	3,756,947	5,507,669	7,290,652	1,158,368
Cost of revenues	(428,339)	(578,690)	(972,374)	(1,798,841)	(2,372,288)	(376,919)
Gross profit	1,784,948	2,505,894	2,784,573	3,708,828	4,918,364	781,449
Operating expenses:						
Selling and marketing expenses	(243,600)	(232,487)	(351,661)	(656,976)	(849,205)	(134,925)
General and administrative expenses	(140,238)	(137,118)	(165,205)	(189,621)	(280,227)	(44,524)
Research and development expenses	(195,508)	(221,726)	(244,272)	(317,929)	(465,490)	(73,959)
Total operating expenses	(579,346)	(591,331)	(761,138)	(1,164,526)	(1,594,922)	(253,408)
Operating profit	1,205,602	1,914,563	2,023,435	2,544,302	3,323,442	528,041
Other income (expenses):						
Investment income	474	1,518	354	290	14,128	2,245
Interest income	112,600	144,805	128,168	141,001	258,053	41,000
Exchange (losses) gains	(50,891)	(167,102)	9,617	(89,488)	(79,058)	(12,561)
Other, net	(1,084)	3,552	(10,934)	(19,634)	99,164	15,756
Income before tax	1,266,701	1,897,336	2,150,640	2,576,471	3,615,729	574,481
Income tax	(2,689)	(300,673)	(313,861)	(344,446)	(392,756)	(62,402)
Net Income	1,264,012	1,596,663	1,836,779	2,232,025	3,222,973	512,079
Net loss attributable to non-controlling interests	74	25	13,657	3,747	11,291	1,794
Net income attributable to NetEase, Inc.'s shareholders	1,264,086	1,596,688	1,850,436	2,235,772	3,234,264	513,873
Unrealized gains on investments	1,332					
Comprehensive income	1,265,418	1,596,688	1,850,436	2,235,772	3,234,264	513,873
Net income per share, basic	0.41	0.51	0.57	0.69	0.99	0.16
Net income per share, diluted	0.38	0.49	0.57	0.69	0.99	0.16
Net income per ADS, basic	10.24	12.81	14.34	17.22	24.76	3.93
Net income per ADS, diluted	9.55	12.34	14.24	17.14	24.68	3.92
Weighted average number of ordinary shares outstanding, basic	3,086,451	3,117,117	3,225,250	3,246,426	3,265,550	3,265,550
Weighted average number of ADS outstanding, basic	123,458	124,685	129,010	129,857	130,622	130,622
Weighted average number of ordinary shares outstanding, diluted	3,307,538	3,234,214	3,248,983	3,261,886	3,276,704	3,276,704
Weighted average number of ADS outstanding, diluted	132,302	129,369	129,959	130,475	131,068	131,068

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Share-based compensation cost included in:						
Cost of revenues	14,890	13,679	9,021	37,342	57,318	9,107
Selling and marketing expenses	14,357	8,564	2,323	8,123	11,357	1,804
General and administrative expenses	33,887	23,587	9,861	31,580	17,897	2,844
Research and development expenses	32,293	22,119	10,180	25,361	35,460	5,634
	95,427	67,949	31,385	102,406	122,032	19,389
Other Financial Data:						
Capital expenditures	71,516	133,329	407,727	297,980	410,120	65,162
Net cash provided by (used in):						
Operating activities	1,379,902	2,017,799	2,094,495	2,854,954	4,072,948	647,126
Investing activities	952,298	(3,409,258)	(1,907,584)	(2,621,162)	(3,208,233)	(509,737)
Financing activities	(960,410)	(157,293)	40,533	24,139	73,544	11,685

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	2007 RMB	2008 RMB	As of December 31,		2011 RMB	2011 US\$ (Note 1)
			2009 RMB	2010 RMB		
(in thousands, except per share data)						
Balance Sheet Data:						
Cash and cash equivalent	2,482,821	793,408	1,041,290	1,285,137	2,214,618	351,867
Time deposits	1,675,814	4,820,000	5,975,378	8,193,972	9,704,777	1,541,934
Property, equipment and software, net	183,472	258,788	557,756	755,778	848,469	134,808
Total assets	4,685,659	6,345,893	8,803,469	11,586,662	15,444,931	2,453,953
Total current liabilities	1,276,826	829,048	1,377,925	1,828,227	2,282,577	362,665
Total long-term liabilities	10,200	200	200	34,797	63,890	10,151
Working capital (Note 2)	3,159,467	5,144,731	6,594,637	8,798,668	12,191,609	1,937,052
Total shareholders equity	3,398,633	5,516,645	7,425,344	9,723,638	13,098,464	2,081,137

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: RMB6.2939 on the last trading day of 2011 (December 30, 2011) as set forth in the H.10 statistical release of the U.S. Federal Reserve Board. The prevailing rate on April 13, 2012 was US\$1.00: RMB6.3022. 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 30, 2011 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.

The following table sets forth the average buying rate for Renminbi expressed as per one U.S. dollar for the years 2007, 2008, 2009, 2010 and 2011.

Year	Renminbi Average(1)
2007	7.5806
2008	6.9193
2009	6.8295
2010	6.7603
2011	6.4475

(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.

Month Ended	High	Low
October 31, 2011	6.3534	6.3825
November 30, 2011	6.3400	6.3839
December 31, 2011	6.2939	6.3733
January 31, 2012	6.2940	6.3330
February 29, 2012	6.2935	6.3120
March 31, 2012	6.2975	6.3315

B. Capitalization and Indebtedness

Not Applicable.

C. Reasons for the Offer and Use of Proceeds

Not Applicable.

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D. Risk Factors

RISKS RELATED TO OUR COMPANY

Our business depends to a significant extent on certain online games, which accounted for 83.1%, 84.4% and 83.6% of our total net revenues in 2009, 2010 and 2011, 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, Heroes of Tang Dynasty and Ghost, 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 83.1%, 84.4% and 83.6% of our total net revenues in 2009, 2010 and 2011, 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 2011, we released Tianxia III, a comprehensive upgrade that builds on the strong user base of its predecessor, Tianxia II, which further enhanced our leading position in the 3D game market. We also introduced expansion packs for Fantasy Westward Journey, Westward Journey Online II and Heroes of Tang Dynasty. In addition, we engaged celebrity spokespersons to promote certain of our games in 2011.

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

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

New technologies in online game programming or operations could render our current online titles or other online games that we develop in the future obsolete or unattractive to our subscribers, thereby limiting our ability to recover development costs and potentially adversely affecting our future revenues and profitability. In particular, the online game industry in China is transitioning from 2D to 3D games, with numerous new 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. In particular, we have been devoting a significant portion of our research and development efforts to developing new 2.5D and 3D games. For example, we commercially launched Heroes of Tang Dynasty in April 2010, Ghost in July 2010, Legend of Fairy in May 2011, and Tianxia III in October 2011. We are also currently testing several additional new games. Each of these games has required long periods of time

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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. 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.

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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. For further details, see Item 4.B. Business Overview Our Services Game Licensing and Joint Venture with Blizzard. We lack experience in licensing online games from third parties and have limited experience 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. Also, the full benefits of our arrangements with Blizzard may take considerable time to develop, and we cannot be certain that such arrangements will produce their intended benefits. 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.

Shanghai EaseNet, as licensee of the games, has paid to Blizzard initial 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 and April 2009, 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

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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.

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.

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, 2011, we had Euro-denominated cash and cash equivalent and time deposits totaling 74.3 million (approximately US\$96.4 million at an exchange rate of US\$1.00: 0.7708, as reported in the H.10 statistical release of the U.S. Federal Reserve Board on December 30, 2011), representing approximately 5.1% of our total cash and cash equivalents and time deposits. During 2011, the long term structural deficits in numerous European nations coupled with the deterioration of the economic outlook 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.

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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.

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.

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We expect that a portion of our future revenues will continue to come from our advertising services, which represented approximately 9.9% of our total net revenues for 2011, 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.

In addition, the competition in the online advertising industry in China has intensified since Baidu.com, Inc., or Baidu, Sina Corporation, or Sina, Sohu.com Inc., or Sohu, Tencent Inc., or Tencent, Alibaba.com Limited, or Alibaba, Youku Inc., or Youku, and other vertical Internet portals came into the market. 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. We believe that these efforts, together with other factors, contributed to the growth of our net revenues from advertising services in 2010 and 2011. 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.

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.

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.

A renewed outbreak of SARS, the spread of H5N1 or H1N1, 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;

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- closure of Internet cafés and other public areas where people access the Internet; and
- a general slowdown in the Chinese economy.

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

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

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

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

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

- attract and retain users to 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.

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Historically, advertising revenue has followed the same general seasonal trend throughout each year with the first quarter of the year being the weakest quarter due to the Chinese New Year holiday and the traditional close of advertisers' annual budgets and the 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.

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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 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 business operator, and Wangyibao Co., Ltd., or Wangyibao, as the operator of our Wangyibao payment system, 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

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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.

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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, 2011, approximately 44.5% 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 NetEase Information Technology (Beijing) Co., Ltd., or NetEase Beijing, NetEase (Hong Kong) Limited, or NetEase

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Hong Kong, NetEase Interactive Entertainment Limited, or NetEase Interactive, Guangzhou Boguan Telecommunication Technology Co., Ltd., or Boguan, Hong Kong NetEase Interactive Entertainment Limited, or Hong Kong NetEase Interactive, NetEase Youdao Information Technology (Beijing) Co., Ltd. (formerly named NetEase Yodao Information Technology (Beijing) Co., Ltd.), or Youdao Information, Guangzhou NetEase Interactive Entertainment Co., Ltd., or Guangzhou Interactive, NetEase (Hangzhou) Network Co., Ltd., or NetEase Hangzhou, Guangzhou NetEase Information Technology Co., Ltd., or Guangzhou Information, Hangzhou Langhe Technology Co., Ltd., or Hangzhou Langhe, Zhejiang Weiyang Technology Co., Ltd., Ujia.com, Inc., or Ujia Cayman, Ujia (Hong Kong) Limited, or Ujia Hong Kong, and Lede Technology Co., Ltd., or Lede Technology. 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 withholding income tax for any dividends we pay to our non-PRC corporate shareholders on profits earned after January 1, 2008. 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

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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.

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 Beijing, Guangzhou Interactive, Boguan, NetEase Hangzhou and 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.

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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 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 2009 and 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 2009 and 2010. In addition, Boguan was recognized as a Key Software Enterprise in December 2009 and March 2011 and enjoyed a further reduced preferential tax rate of 10% for 2009 and 2010, respectively. We recorded the resulting income tax reduction in our consolidated financial statements in 2009 and 2011, respectively. Boguan renewed its recognition as a HNTE in 2011 and enjoys a preferential tax rate of 15% from 2011 to 2013. 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. See item 5.A. Operating Results Income Taxes.

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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 withholding income tax for any dividends we pay to our non-PRC corporate shareholders on profits earned after January 1, 2008.

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. 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 the value of the investment in our shares or ADSs may be adversely and materially affected.

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

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

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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 data and other 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.

We collect demographic data, such as email addresses, geographic location, income level, online spending patterns and occupation, from our registered users in order to better understand users and their needs. Such information is referred to in our industry as personally identifiable

information, or PII. We also provide PII to online advertisers, on an anonymous aggregate basis, without disclosing personal details such as name and home address, to enable them to target specific demographic groups. 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 PII, software or other computer equipment, we have been subject to denial of service attacks that have caused portions of our network to be inaccessible for limited periods of time. In addition, we have had viruses and worms introduced into our systems. 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 and the increasingly large amount of PII we are collecting.

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 PII, 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.

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We are subject to a variety of laws and other obligations regarding data protection in China. In addition, the data we collect may not be accurate which could adversely affect the development of our services.

We are subject to laws in China relating to the collection, use, retention, security and transfer of PII. 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.

Furthermore, as noted above, we provide PII to online advertisers to enable them to target specific demographic groups. If privacy concerns or regulatory restrictions prevent us from collecting this information or from selling demographically targeted advertising, the NetEase websites may be less attractive to advertisers. If privacy concerns or regulatory restrictions prevent us from collecting or using this data, the analysis of our target market and the developing trend of our services, such as new online games, may not be accurate. Furthermore, we rely solely on the data provided by our users and do not verify the authenticity of such data. If the information that we collect is materially inaccurate or false, this may also adversely affect our understanding of customer needs and our development of attractive new services, including improvements to existing online games and the introduction of new games.

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 (after its merger with China Netcom), 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.

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;

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- illegal or fraudulent use of e-mail; or
- interruptions or delays in e-mail service.

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

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

Violations or perceived violations of Chinese laws arising from information displayed on, retrieved from or linked to the NetEase websites could result in significant penalties, including a temporary or complete cessation of our business. China has enacted regulations governing Internet access and the distribution of news and other information. Furthermore, the Propaganda Department of the Chinese Communist Party has been given the responsibility to censor news published in China to ensure, supervise and control a particular political ideology. In addition, the PRC Ministry of Industries and Information 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.

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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.

Under recently enacted U.S. tax legislation and subject to future guidance, if we are a PFIC, U.S. Holders (as defined below) will be required to file an annual information return with the IRS (on IRS Form 8621) relating to their ownership of our shares or ADSs. Pursuant to Notice 2011-55, the IRS has suspended this new filing requirement for U.S. Holders that are not otherwise required to file the current version of the IRS Form 8621 until the IRS releases a subsequent revision of IRS Form 8621, modified to reflect the recently enacted legislation. Guidance has not yet been issued regarding the information required to be included on such form. Prior to filing their annual income tax returns, U.S. Holders should consult their tax advisers 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.

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

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position or results of operations. In addition, the Chinese economy differs from the economies of most countries belonging to the Organization for Economic Co-operation and Development, or OECD. These differences include:

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

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

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

The value of the Renminbi may fluctuate according to a number of factors. From 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

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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.

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 new 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 the new regulations and any other relevant legislation. However, because it is presently uncertain how the SAFE regulations, and any future legislation concerning offshore or

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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 Securities and Exchange Commission 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

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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.

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.

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 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

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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.

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.

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In addition, we are uncertain as to whether the Chinese government will reclassify our business as a media or retail company, due to our acceptance of fees for Internet advertising, online games and wireless value-added and other services as sources of revenues, or as a result of our current corporate structure. Such reclassification could subject us to penalties or fines or significant restrictions on our business. 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 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.

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

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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.

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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 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.

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

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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 system used by both distributors of our prepaid point cards and end users of our online services. This payment system may require a permit under the PBOC Measures to continue in operation, and we are currently in the process of applying for such permit from the PBOC. As the PBOC Measures are quite new, we cannot be certain how they will be interpreted and enforced by the People's Bank of China and when or if we will be granted such permit. An inability to continue operating our current online payment system would likely materially and adversely affect the operation and profitability of our business.

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 has intensified as new entrants have come into the market, such as Baidu, Sina, Sohu, Tencent, Alibaba, Youku and other vertical Internet portals. Any of our present or future competitors may offer products and

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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.

In connection with the restructuring of our operations which is discussed below in Item 7.B. Major Shareholders and Related Party Transactions Related Party Transactions, NetEase.com, Inc. was incorporated in the Cayman Islands on July 6, 1999, and it operates under the Cayman Islands Companies Law (2011 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 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 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 our mailbox infrastructure, for a total of approximately RMB410.1 million (US\$65.2 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 new research and development complex in Hangzhou in 2010. Our principal capital expenditures for 2009 consisted mainly of the purchase of computer equipment as well as software costs for a total of RMB407.7 million.

In addition, in connection with the licensing of certain online games by Blizzard to Shanghai EaseNet for operation in the PRC, Shanghai EaseNet as licensee of the games has paid to Blizzard an aggregate of RMB271.6 million (US\$40.0 million) as initial license fees as of December 31, 2011. 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. For further details, see Item 4.B. [Business Overview](#) [Our Services](#) [Game Licensing and Joint Venture with Blizzard](#). As of December 31, 2011, we had capital expenditure commitments of RMB77.6 million (US\$12.3 million) for 2012 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 2011 have been, and are expected to continue to be, funded by operating cash flows and our existing capital resources.

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 and wireless value-added services businesses.

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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 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 and April 2009, 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. Most 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, New Fly for Fun, Heroes of Tang Dynasty and Legend of Fairy, as well as Tianxia III, a comprehensive upgrade of Tianxia II. 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 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

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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.

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, news apps, e-reading, matchmaking, clubs and community forums.

Other

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

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Advertising Services

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

Wireless Value-Added Services and Others

We offer a wide range of wireless value-added services, or WVAS, which allow users to receive news and other information, such as stock quotes and e-mails, download ringtones and logos for their mobile phones and participate in matchmaking communities and interactive games. Combining content from our Internet portal with mobile applications we have developed in-house, we can rapidly develop sophisticated WVAS. We also offer free and fee-based premium e-mail services as well as e-commerce related services, such as 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 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 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 business operator) and Wangyibao (the operator of our Wangyibao payment system). 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 individuals. 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, or VIEs, 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.

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 and April 2009, 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.

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Ujia Cayman, Ujia Hong Kong and 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. in March 2010 to operate a swine raising business in Zhejiang Province, China. As of December 31, 2011, this company was still in the process of negotiation with the relevant government authorities over the selection of an appropriate site for this business.

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 (a comprehensive upgrade of Tianxia II), Ghost, Heroes of Tang Dynasty and Westward Journey Online III. These games are MMORPGs set in classical Chinese-themed fantasy worlds, of which Fantasy Westward Journey, Westward Journey Online II and Westward Journey Online III are 2D games, Ghost and Heroes of Tang Dynasty 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.

Game	Genre	Revenue Model	Date of Initial Commercial Launch	Date of Issue of Latest Expansion Pack
Westward Journey Online II	MMORPG, classical Chinese setting	Time-Based	August 2002	May 2011
Fantasy Westward Journey	MMORPG, classical Chinese setting	Time-Based	December 2004	September 2011
Datang	MMORPG, Tang dynasty setting	Time-Based	July 2006	December 2011
Westward Journey Online III	MMORPG, classical Chinese setting	Time-Based	September 2007	August 2011
Warsong of Westward Journey	MMORPG, classical Chinese setting	Item-Based	September 2008	August 2011
New Fly for Fun	MMORPG, cartoon-style flying theme	Item-Based	October 2008	January 2011
Heroes of Tang Dynasty	MMORPG, classical Chinese setting	Item-Based	April 2010	December 2011
Ghost	MMORPG, classical Chinese setting	Item-Based	July 2010	September 2011
Legend of Fairy	MMORPG, European-style fairy setting	Item-Based	May 2011	December 2011
Tianxia III (a comprehensive upgrade of Tianxia II)	MMORPG, classical Chinese setting	Item-Based	October 2011	

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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.

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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 are Storm of Empires, Crazy Man and Fairyland Village, all of which use an item-based revenue model.

Casual Games

In 2005, we launched an online casual game platform which has various multi-player games such as billiards, card games and mahjong. Casual games are easier to play than MMORPGs and can be played to a conclusion within a short period of time. The basic versions of such games are available free-of-charge, and we sell virtual game enhancements, such as options for changing the appearance of the gameplay or advanced tools, which players can use in the game, utilizing our prepaid point card system. As of December 31, 2011, our online casual game platform offered more than 30 casual games to users.

Customer Service

We believe that providing strong, dependable customer support is a key component to success in the online games business. Our customer service center provides 24 hour-a-day, 7 day-a-week customer service and technical support and can be contacted via telephone or e-mail. As of December 31, 2011, our company employed approximately 1,568 personnel in our call center as customer service specialists for our online games as well as for our other services, of which 878 personnel provided customer service support for World of Warcraft.

User Fees

Users of Fantasy Westward Journey, Westward Journey Online II, Datang and Westward Journey Online III pay fees according to the amount of time they play the games, which is currently RMB0.40 (US\$0.06) per hour for each game. For our item-based games, such as Tianxia III, Heroes of Tang Dynasty, Warsong of Westward Journey and Ghost, 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 88.9%, 88.1% and 88.4% of our total net revenues in 2009, 2010 and 2011, respectively.

Game Licensing and Joint Venture with Blizzard

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 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 RMB27.5 million (US\$4.0 million) as an initial license fee as of December 31, 2008 and recorded the payment as prepayment for license rights. In April 2011, Shanghai EaseNet paid the remainder of the license fee of RMB39.3 million (US\$6.0 million) to Blizzard and recognized the total amount of RMB66.8 million (US\$10.0 million) as intangible assets.

In addition, 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, and its third expansion pack, Cataclysm, in September 2009, August 2010 and July 2011, respectively. Shanghai EaseNet's license to operate World of Warcraft in the PRC has a

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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.

With respect to the license agreements with Blizzard, Shanghai EaseNet is required to pay license fees, royalties and consultancy fees to Blizzard for the games. The license agreements also include minimum marketing expenditure commitments. In sum, the total commitments amount to approximately RMB2.2 billion (US\$322 million) over the terms of the agreements. As of December 31, 2011, our outstanding commitments under the two license agreements totaled RMB576.9 million (US\$91.7 million). 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. In addition, in connection with the three-year extension of the World of Warcraft license, we expect to incur an additional commitment totaling approximately RMB1.3 billion (US\$0.2 billion), including royalty, consultancy fees to Blizzard and minimum marketing expenditure.

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

Concurrently with the licensing of the foregoing games, 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 apps, 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, 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.

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The NetEase websites currently include various channels focusing on news, automobile, sports, finance, real estate, entertainment, science and information technology.

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

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with us online to interact with other registered community members. We believe that as users become more involved with our online community, they will return to the NetEase websites frequently.

NetEase users can interact through a variety of community services, 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 micro-blogging service which allows users to exchange small elements of content such as short sentences, image or video links. With this service, registered user 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. As of December 31, 2011, we had approximately 97.6 million registered micro-blogging users. We also offer a traditional blogging service for registered users, which allows the posting of larger messages than micro-blogging.
- *Instant Messaging.* We offer NetEase registered users a communications platform to notify their online friends and other users with similar interests when they are online and to send and receive text messages seen by both parties nearly instantaneously, allowing NetEase registered users to participate in real-time dialogues. Users can access this service by downloading free software from the NetEase websites. During December 2011, we had approximately 206,000 peak concurrent users of our instant messaging service.
- *Matchmaking and Others.* We offer a large number of other community services including online matchmaking services, a dedicated dating center, online greeting cards, photo album sharing and diary. Several of these services have significant subscriber bases. For example, our online matchmaking service had approximately 8.3 million accumulated registered accounts and approximately 24,000 subscribers as of December 31, 2011.

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, online dictionary, desktop dictionary, toolbar and web notes, which automatically retrieves syndicated Web content and customized sets of search results. Those products are powered by our own proprietary Internet search engine,

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Youdao, which was officially launched in December 2007. Among these, Youdao Dictionary has become one of the most popular online translation tools among Chinese Internet users, achieved over 140 million installations as of December 31, 2011.

Mobile Phone Applications

Many of our services, such as news content, micro-blogging, open courses, Web dictionary, Web note and reader 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, 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

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websites, advertising through interactive media-rich sites and sponsored special events that integrate live events with online promotion and other media.

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

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.

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 9.2%, 10.4% and 9.9% of our total net revenues in 2009, 2010 and 2011, respectively.

Wireless Value-added Services and Others

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 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.

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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.

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 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, 2011, we had approximately 450 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, 2011, we had approximately 676,000 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, 2011, we had approximately 40,000 paid corporate e-mail customers.

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During 2011, 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 preinstall our e-mail services on their mobile devices.

Applications

We offer various types of applications (apps), such as news, reader and Youdao Dictionary, that can be accessed or downloaded through our portal and mobile Internet and mobile applications, such as those operating on iPhone, iPad and Android devices. These apps are free of charge.

Others

In addition to the services described above, the NetEase websites provide e-commerce services, such as photo-based products, and other services to our users.

Revenues from wireless value-added services and others accounted for 1.9%, 1.5% and 1.7% of total net revenues in 2009, 2010 and 2011, respectively. Nonetheless, we intend to continue promoting SMS and non-SMS services which have a strong tie-in with the NetEase websites, such as matchmaking community, e-mail and photo album.

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, 2011. 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 11.0%-14.0% discount off of their face value. We reduced the discount to 6.0% - 12.0% in March 2009. For the distributors selling prepaid point cards for use with the games licensed from Blizzard, the discount is 9.0 % -12.0%. The discount for each distributor varies based on that distributor s volume of point cards purchased. There was no change made to our discount rates in 2010 and 2011.

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 268 sales professionals located in Beijing, Shanghai and Guangzhou as of December 31, 2011.

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

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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 2011, 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 and Heroes of Tang Dynasty, 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.

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 and localizing licensed games, and we plan to continue this focus in the future. As of December 31, 2011, we had approximately 1,600 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 closed 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 open 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 open beta testing. However, for games using the item-based revenue model, users in the open beta testing can purchase in-game items, which allow those games to start generating revenue from the open beta testing phase onwards. Accordingly, for item-based games, the beginning of open 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 open beta testing. User statistics gathered from closed beta and open 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 MMORPGs.

INFRASTRUCTURE AND TECHNOLOGY

Our infrastructure and technology have been designed for reliability, scalability and flexibility and are administered by our technical staff. The NetEase websites are made available primarily through network servers co-located in the facilities of China Unicom's Beijing affiliate and China Telecom's Beijing affiliates. As of December 31, 2011, there were approximately 26,800 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.

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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. These include Perfect World Company Limited, or Perfect World, Giant Interactive Group Inc, or Giant, Shanda Games Limited, or Shanda, The9 Limited, or The9, Sina, Sohu, Tom Online Inc., or Tom.com, 263.net, Tencent, Chinadotcom Corporation, or Chinadotcom, Baidu, 21cn.com, Changyou.com Limited, or Changyou, and Youku. Specifically, we are encountering competition from companies offering MMORPGs and casual games that target the China market, such as Perfect World, Giant, Shanda, Softworld, Softstar Entertainment Inc., Actoz Soft Co., Ltd., The9, 9you, Kingsoft Corporation Limited, and Waei International Digital Entertainment Co., Ltd. We face competition from other websites that offer online content and online community services, including Sina, Sohu, Tom.com, Tencent, 263.net, Baidu, 21cn.com, Alibaba and Changyou. 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.

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

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

GOVERNMENT REGULATIONS

Overview

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

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

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.

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

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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,

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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.

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 are currently in the process of applying for 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,

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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

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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.

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.

Information Security and Censorship

Regulations governing information security and censorship include:

- *The Law of the People's Republic of China on the Preservation of State Secrets (1988)* and its Implementation Rules (1990).
- *The Law of the People's Republic of China on the Preservation of State Security (1993)* and its Implementation Rules (1994).
- *The Rules of the People's Republic of China for Protecting the Security of Computer Information Systems (1994)*.
- *The Administrative Regulations for the Protection of Secrecy on Computer Information System Connected to International Networks (1997)*.

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

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

- opposes the fundamental principles set forth in China's Constitution;

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

Failure to comply with these content censorship requirements may result in the revocation of licenses and the closing down of the concerned websites. To ensure compliance with these regulatory requirements, Guangzhou NetEase has taken all reasonable steps to avoid displaying any of the prohibited 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.

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, Datang, Tianxia III, Heroes of Tang Dynasty, Westward Journey Online III, Warsong of Westward Journey, Ghost, Legend of Fairy, New Fly For Fun, Legend of Datang, Storm of Empires 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 and Cataclysm 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.

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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.

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 NCIC, 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 NCIC 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 administrated 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 and Cataclysm, 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

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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

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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.

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, Datang, Westward Journey III, Tianxia III, Heroes of Tang Dynasty, New Fly For Fun, Storm of Empires, Legend of Fairy, Ghost, DREAM and Pop 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.

Wireless Value-Added Services

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

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

Telecommunications Business Operating License from MII, and has completed the requisite registrations with the local offices of MII in 31 provinces.

Online Advertising

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

INTELLECTUAL PROPERTY AND PROPRIETARY RIGHTS

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

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

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- 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, Datang, Heroes of Tang Dynasty, Westward Journey Online III, Warsong of Westward Journey, Tianxia III, Ghost, Legend of Fairy and Legend of Datang and other online products, including Wangyibao, Yinxiangpai 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 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, 2011, we leased office facilities with a total effective annual rent of RMB48.4 million (US\$7.7 million), including management fees, and an aggregate of approximately 29,750 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.

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In 2010, we substantially completed and moved into our newly constructed research and development center in Hangzhou, China on land with an area of approximately 56,160 square meters. As of December 31, 2011, the accumulated capital expenditures in connection with the construction and renovation of our new research and development center were RMB396.7 million (US\$63.0 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, 2011.

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, 2011, we had incurred construction in progress cost of RMB110.9 million (US\$17.6 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, 2011, 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 RMB238.7 million (US\$37.9 million) for the year ended December 31, 2011, of which approximately 48% 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 Securities Exchange Act of 1934, as amended, or the Exchange Act, including, without limitation, statements regarding our expectations, beliefs, intentions or future strategies that are signified by the words expect, anticipate, intend, believe, or similar language. All forward-looking statements included in this annual report are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. In evaluating our business, you should carefully consider the information provided under Item 3.D. Risk Factors. Actual results could differ materially from those projected in the forward-looking statements. We caution you that our businesses and financial performance are subject to substantial risks and uncertainties.

A. OPERATING RESULTS

Overview

NetEase is a leading Internet technology company in China. Our innovative online games, communities and personalized premium services, which allow registered users to interact with other community members, have established a large and stable user base for the NetEase websites which are operated by our affiliate. As of December 31, 2011, we had approximately 545 million accumulated registered accounts for our in-house MMORPGs and a total of approximately 1.5 billion accumulated registered accounts for our other online services.

For the year ended December 31, 2011, we continued to develop our online games and advertising business. We also provide wireless value-added and other fee-based premium services, but we expect that revenue from such services will remain a relatively small part of our total revenue for the foreseeable future. In addition, in August 2008 and April 2009, Blizzard agreed to license certain online games to Shanghai EaseNet for operation in the PRC.

We achieved a net profit of RMB3,234.3 million (US\$513.9 million) for 2011 and generated positive operating cash flows of RMB4,072.9 million (US\$647.1 million) during the year. We recorded retained earnings of RMB6,425.8 million, RMB8,565.4 million and RMB11,649.1 million (US\$1,850.9 million) as of December 31, 2009, 2010 and 2011, 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

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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.

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

NetEase Beijing, Guangzhou Interactive, Boguan, Youdao Information, NetEase Hangzhou, Guangzhou Information, 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 April 2010, respectively. 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, Hangzhou Langhe, Guangzhou Interactive and Boguan provide technical consulting and related services to the VIEs. In addition, Guangzhou NetEase has two majority-owned subsidiaries, Youdao Computer (a search business operator) and Wangyibao (the operator of our Wangyibao payment system).

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 the previously unconsolidated affiliated companies, Guangzhou

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NetEase and Guangyitong Advertising. We have concluded that Guangzhou NetEase and Guangyitong Advertising are VIEs, and NetEase, Inc. is the primary beneficiary of these affiliated companies. Accordingly, we adopted the provisions of FIN 46 and consolidated Guangzhou NetEase (including its subsidiaries) and Guangyitong Advertising on a prospective basis from January 1, 2004. In addition, according to the assessment under FIN 46-R, we have concluded that Shanghai EaseNet was 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.

In June 2009, the FASB also issued an amendment to the accounting and disclosure requirements for the consolidation of variable interest entities. 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

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November 15, 2009. The adoption of this new accounting standard did not result in a material impact on our consolidated financial statements for the years ended December 31, 2010 and 2011.

Revenues

We generate our revenues from the provision of online games services, advertising services and 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, 2009, 2010 and 2011.

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 and April 2009, 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

We derive most of our advertising services revenue from fees we earn from advertisements placed on the NetEase websites. Approximately 97.8%, 94.8% and 92.0% of our total advertising revenue was derived from brand advertising for the years ended December 31, 2009, 2010 and 2011, respectively, with the remainder generated from advertisers in our search engine business.

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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.

Wireless Value-Added Services and Others

We derive a portion of our wireless value-added services and others revenues from providing to our customers value-added services through SMS. Our online fee-based premium services, supplied to registered users of the NetEase websites, include premium e-mail and premium matchmaking and dating services. In addition, wireless value-added services and others revenue includes revenue generated from our Wangyibao payment platform. In February 2009 we launched our Wangyibao 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.

We also generate revenue from personalized photo-based products 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.

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Seasonality of Revenues

Historically, advertising revenues have followed the same general seasonal trend throughout each year, with the first quarter of the year being the weakest quarter, due to the Chinese New Year holiday and the traditional close of advertisers' annual budgets, and the 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 business tax payable 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

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

Wireless Value-Added Services and Others

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

Operating Expenses

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

Selling and Marketing Expenses

Selling and marketing expenses consist primarily of salary and welfare expenses, 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.

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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, 2009, 2010 and 2011, we recorded share-based compensation cost of approximately RMB31.4 million, RMB102.4 million and RMB122.0 million (US\$19.4 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.

As of December 31, 2011, total unrecognized compensation cost related to unvested awards granted under the 2000 Stock Incentive Plan, adjusted for estimated forfeitures, was RMB1.3 million (US\$0.2 million) and is expected to be recognized through the remaining vesting period of each grant. As of December 31, 2011, the weighted average remaining vesting period was 1.88 years. As of December 31, 2011, total unrecognized compensation cost related to unvested awards granted under the RSU Plan, adjusted for estimated forfeitures, was RMB253.0 million (US\$40.2 million) and is expected to be recognized through the remaining vesting period of each grant. As of December 31, 2011, the weighted average remaining vesting period was 3.24 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 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 2009, 2010 and 2011. 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.

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.

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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 2011, NetEase Beijing was also recognized as a Key Software Enterprise and enjoyed a preferential tax rate of 10% for 2010. We recorded the resulting income tax reduction in our consolidated financial statements in 2011.

Guangzhou Interactive 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 2009 to 2013. In 2009, Guangzhou Interactive was also recognized as a Key Software Enterprise and enjoyed a preferential tax rate of 10% for 2009.

For 2009 and 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 2009 and 2010. In addition, Boguan was recognized as a Key Software Enterprise in December 2009 and March 2011 and enjoyed a further reduced preferential tax rate of 10% for 2009 and 2010, respectively. We recorded the resulting income tax reduction in our consolidated financial statements in 2009 and 2011, respectively. Boguan renewed its recognition as a HNTE in 2011 and enjoys a preferential tax rate of 15% from 2011 to 2013.

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.

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 from 2012 to 2014.

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.

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

Business Taxes and Cultural Development Fee

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

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.

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Critical Accounting Policies and Estimates Regarding Revenue Recognition

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.

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

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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

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action such as purchasing a product from or registering with the advertiser. Revenue for CPA contracts is recognized when the specific action is completed.

Wireless Value-Added Services and Others

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

Other Critical Accounting Policies and Estimates

Research and Development Costs

Costs incurred for the development of online game products prior to the establishment of technological feasibility are expensed when incurred. Once an online game has reached technological feasibility with a proven ability to operate in the Chinese market, all subsequent online game development costs are capitalized until that game is marketed. Technical feasibility is evaluated on a product-by-product basis, but typically encompasses both technical design and game design documentation. The costs incurred for development of online game products have not historically been capitalized because the period after the date when technical feasibility is reached and the time when the game is marketed is short historically and the development cost incurred in such period is insignificant. All online game development costs have been expensed when incurred for the years ended December 31, 2009, 2010 and 2011.

We expense all costs that are incurred in connection with the planning and implementation phases of development and costs that are associated with repair or maintenance of the existing websites and software. Direct costs incurred to develop the software during the application development stage that can provide future benefits are capitalized.

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.

Held-to-Maturity Investment

All highly liquid investments with stated maturities of greater than 90 days but less than 365 days are classified as held-to-maturity investment which are stated at their approximate fair value.

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We account for our investments in accordance with ASC subtopic 320-10, or ASC 320-10, Investments – Debt and Equity Securities: Overall. ASC 320-10 classifies the investments in debt securities as held-to-maturity.

The securities that we have positive intent and ability to hold to maturity are classified as held-to-maturity securities and stated at amortized cost. For individual securities classified as held-to-maturity securities, we evaluate whether a decline in fair value below the amortized cost basis is other than temporary in accordance to ASC subtopic 320-10, or ASC 320-10, Investments – Debt and Equity Securities: Overall. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security would be written down to fair value as a new cost basis and the amount of the write-down is included in earnings. Dividend and interest income, including amortization of the premium and discount arising at acquisition, for all categories of investments in securities are included in earnings. Any realized gains or losses on the sale of the investments are determined on a specific identification method, and such gains and losses are reflected as a component of interest income.

Any negative events or deterioration in financial well-being with respect to the counterparties and the underlying collateral could materially impact our financial position and results of operations.

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.

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.

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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 RMB63.7 million (US\$10.1 million) and RMB39.7 million (US\$6.3 million), respectively, as of December 31, 2011).

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.

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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:

	2009		For the Year Ended December 31, 2010		2011	
	RMB 000	%	RMB 000	%	RMB 000	%
Statement of Operations Data:						
Revenues:						
Online game services	3,368,689	88.1	4,944,439	87.4	6,552,431	87.7
Advertising services	383,560	10.0	633,209	11.2	795,422	10.6
Wireless value-added services and others	71,202	1.9	82,141	1.5	124,898	1.7
Total revenues	3,823,451	100.0	5,659,789	100.0	7,472,751	100.0
Business tax expense	(66,504)	(1.7)	(152,120)	(2.7)	(182,099)	(2.4)
Net revenues	3,756,947	98.3	5,507,669	97.3	7,290,652	97.6
Cost of revenues:						
Online game services	(638,473)	(16.7)				