

NETEASE COM INC  
Form 20-F/A  
July 07, 2004  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**Amendment No. 2**

**to**

**FORM 20-F/A**

(Mark One)

**REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (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, 2002

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number: 333-11724

# **NETEASE.COM, 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)

**Suite 1901, Tower E3**

**The Towers, Oriental Plaza, Dong Cheng District**

**Beijing 100738, People's Republic of China**

(Address of principal executive offices)

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

**NONE**

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

**Name of each exchange and Title of each class on which registered :**

**American Depositary Shares, each representing 100 ordinary shares, par value US\$0.0001 per share,**

**Nasdaq National Market**

(Title of Class)

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

**NONE**

(Title of Class)

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Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report: 3,100,162,536 ordinary shares, par value US\$0.0001 per share.

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 which financial statement item the registrant has elected to follow:

Item 17  Item 18

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**EXPLANATORY NOTE**

This amendment no. 2 on Form 20-F/A hereby amends Items 4, 5, 18 and 19 of NetEase.com, Inc.'s annual report on Form 20-F for the fiscal year ended December 31, 2002, which was filed on June 27, 2003, as amended by amendment no. 1 on Form 20-F/A filed on December 29, 2003. This amendment no. 2 is being filed for the purpose of providing additional details to our disclosures in the original report as well as providing additional clarifying information in the notes to our financial statements pursuant to comments we received from the Staff of the U.S. Securities and Exchange Commission in connection with its review of our periodic filings. This amendment no. 2 is not intended to revise other information presented in our annual report on Form 20-F (as amended by amendment no. 1) for the fiscal year ended December 31, 2002 as originally filed and all such other information in the original filing and amendment no. 1, which remains unchanged.

This amendment no. 2 on Form 20-F/A does not reflect events occurring after the filing of the original Form 20-F and does not modify or update the disclosure therein in any way other than as required to reflect the amendments discussed above. As a result, this amendment no. 2 to the annual report on Form 20-F continues to speak as of June 27, 2003.

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**FORWARD-LOOKING INFORMATION**

This amendment no. 2 on Form 20-F/A 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 affected 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 we will not be able to continue to successfully monetize the user base of the NetEase Web sites and that our e-commerce and other fee-based services revenues will not continue to grow;

the risk that the current popularity of short messaging services (SMS) in China will not continue for whatever reason, including SMS being superseded by other technologies for which we are unable to offer attractive products and services;

the risk that we may not be able to continuously develop new and creative online services;

the risk that the online game market will not continue to grow or that we will not be able to maintain our position in that market;

the risk that the online advertising market in China will not continue to grow and will remain subject to intense competition;

the impact of the outbreak in China of severe acute respiratory syndrome, or SARS, on our business and results of operations;

the risk that we will not be able to control our expenses in future periods;

the possibility that our company and our board of directors have not implemented effective or complete steps to ensure that the circumstances which led to the restatement of our financial statements for the year ended December 31, 2000 will not recur;

our ability to develop and implement additional operational and financial systems to manage our operations;

governmental uncertainties, general competition and price pressures in the marketplace;

uncertainty as to future profitability and the risk that security, reliability and confidentiality concerns may impede broad use of the Internet and e-commerce and other services; and

other risks outlined in our filings with the Securities and Exchange Commission, including our registration statement on Form F-1, as amended.

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All forward-looking statements in this amendment no. 2 on Form 20-F/A are made as of the date of the filing of the original Form 20-F, based on information available to us as of that date, and we assume no obligation to update or revise any of these forward-looking statements even if experience or future changes show that the indicated results or events will not be realized.

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**PART I**

**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 Web sites. In July 1999, we began to offer e-commerce platforms and to provide online shopping mall and other e-commerce services in China through Guangzhou NetEase Computer System Co., Ltd. ( Guangzhou NetEase ), a related party. In 2001, we also began focusing on fee-based premium services and online entertainment services, including wireless value-added services, online games, premium e-mail services and other subscription-type products. Our focus on these services continued throughout 2002.

In connection with the restructuring of our operations which is discussed in Item 7.B. Major Shareholders and Related Party Transactions Related Party Transactions of our annual report on Form 20-F, NetEase.com, Inc. was incorporated in the Cayman Islands on July 6, 1999 and operates under the Cayman Islands Companies Law (2003 Revision). Our principal place of business was 15th Floor, North Tower, Beijing Kerry Centre, No. 1 Guang Hua Road, Chao Yang District, Beijing, People s Republic of China until January 13, 2003 when we moved to Suite 1901, Tower E3, The Towers, Oriental Plaza, Dong Cheng District, Beijing, People s Republic of China. Our telephone number is (86-10) 8518-0163. Our agent for service of process in the United States is CT Corporation System, 111 Eighth Avenue, New York, New York 10011.

In July 2000, we completed the initial public offering of our American Depositary Shares, representing our ordinary shares, and listed those securities on the Nasdaq National Market.

Our principal capital expenditures for 2002 consisted of computer equipment as well as software for a total of approximately RMB12.6 million (US\$1.5 million). Our principal capital expenditures for 2000 and 2001 also consisted of computer equipment as well as software for a total of RMB34.0 million (US\$4.1 million) and RMB21.1 million (US\$2.5 million), respectively.

We have spent approximately RMB4.3 million (US\$0.5 million) from January 1, 2003 until March 31, 2003, principally for purchases of additional computer equipment in order to accommodate the expected increase in traffic on the NetEase Web sites and our online game servers. Our capital expenditure plans for the remainder of 2003 have not yet been fixed, but we expect to spend an additional approximately RMB16.4 million (US\$2.0 million), primarily for further purchases of additional computer equipment in order to accommodate the expected increase in traffic on the NetEase Web sites and our online game servers. Capital expenditures in 2003 have been, and are expected to continue to be, funded through operating cash flows and through our existing capital resources.

**B. Business Overview**

Through our subsidiaries and contracts with our affiliates Guangzhou NetEase and Beijing Guangyitong Advertising Co., Ltd. ( Guangyitong Advertising ), we operate a leading interactive online and wireless community in China and are a major provider of Chinese language content and services through our Internet Portal, Wireless Business and Online Games offerings.





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Our business was founded by William Lei Ding, our Chief Architect and one of our directors, in June 1997. Mr. Ding owns 100% of our largest shareholder, Shining Globe International Limited, and 80% of Guangzhou NetEase. The other 20% of Guangzhou NetEase is owned by Bo Ding, the brother of William Lei Ding and a former non-executive employee of NetEase. Guangzhou NetEase has obtained approval from the Guangzhou telecommunications administrative authorities to provide Internet content services, and its 80% owned subsidiary, Guangyitong Advertising, holds a license to operate an advertising business. The other 20% of Guangyitong Advertising is owned by Bo Ding.

We conduct our business in China solely through our wholly owned subsidiaries, NetEase Information Technology (Beijing) Co., Ltd. ( NetEase Beijing ), NetEase Information Technology (Shanghai) Co., Ltd. ( NetEase Shanghai ), NetEase Interactive Entertainment Ltd. and Guangzhou NetEase Interactive Entertainment Limited.

Under current Chinese regulations, there are limitations on the percentage interest foreign companies may have in value-added telecommunications businesses in China, which include the operation of Internet content provision businesses 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. Because of these restrictions, NetEase.com is not permitted directly to wholly own an Internet content provider, wireless value-added services provider or advertising business. NetEase.com has therefore entered into a series of agreements with Guangzhou NetEase and Guangyitong Advertising. Under these 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 Web sites and the online advertising business. For more information on these agreements, see the section entitled Related Party Transactions of our annual report on Form 20-F. We do not have any direct ownership interest in Guangzhou NetEase or Guangyitong Advertising.

Under our agreements with Guangzhou NetEase, we have agreed to pay the operating costs of Guangzhou NetEase. 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. Our obligations to Guangzhou NetEase are contained in the Agreement dated May 12, 2000, identified as exhibit 4.30 to this amendment no. 2 on Form 20-F/A. Our obligations to Guangyitong Advertising are contained in the Operating Agreement dated May 10, 2000, identified as exhibit 4.31 to this amendment no. 2 on Form 20-F/A. Both Guangzhou NetEase and Guangyitong Advertising are prohibited from incurring any debt without our prior approval. For more information about our relationship with Guangzhou NetEase and Guangyitong Advertising, see the section entitled Related Party Transactions of our annual report on Form 20-F.

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The following diagram shows the current group structure of our subsidiaries and affiliated companies:

NetEase.com and its subsidiaries have no equity interest in either Guangzhou NetEase or Guangyitong Advertising.

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Our innovative communities and personalized premium services, which allow users to interact with other community members, have established a large and stable user base for our Internet portal business, and more recently, for our wireless value-added services and online games businesses.

The Internet portal business, which is conducted through the NetEase Web sites, provides Internet users with Chinese language online services centered around content, community and e-commerce. In particular, the NetEase content channels offer users an extensive range of local, regional and international Chinese language content, Web-based communication services and sophisticated search capabilities and provide a destination for Chinese Internet users to identify and access resources, services, content and information on the Internet. Registered community members can personalize their online experience by publishing their own content and interacting with other users that have similar interests. Under the NetEase and 163.com brands, we provide various free services, including Chinese language-based e-mail, online chat rooms and discussion forums.

In addition, the NetEase wireless value-added services offer users timely information (such as news and stock quotes), community interaction and games via SMS. Our online games provide community and entertainment via multi-player online role-playing games, in which users can simultaneously connect and interact on a massive scale.

We believe that demand for our services is growing as the number of users of Internet portals, wireless value-added services and online games in China increases. Furthermore, the NetEase Web sites' market position as one of the leading destinations for such users offers our online advertisers, e-commerce vendors and other partners such as mobile phone operators, value-added service providers and online game operators a strong marketing platform and access to this large and growing market of Chinese online consumers. The monthly average daily page views of the NetEase Web sites for the month ended May 31, 2003 exceeded 280 million, and as of May 31, 2003, those sites had registered approximately 120 million registered accounts.

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Generally, we price our services as follows:

<u>Service</u>	<u>Pricing</u>
Basic Services, including:	Free of charge
<p>content services (such as news, local information, finance and weather);</p> <p>chat rooms;</p> <p>basic e-mail services;</p> <p>instant messaging;</p> <p>classified ads;</p> <p>Web directories;</p> <p>Web searching; and</p> <p>online shopping services.</p>	
Wireless Value-Added Services, including:	Per use basis (ranges from RMB0.10 to RMB2.00 per use)
	Or
<p>news and information;</p> <p>community;</p>	Monthly subscription basis (ranges from RMB5.00 to RMB30.00 per month)

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multi-media downloads; and

Internet related services.

Other Fee-Based Premium Services, including:

Monthly subscription basis (ranges from RMB6.00 to RMB45.00 per month)

premium e-mail services;

premium personals;

premium matchmaking;

premium clubs;

personal homepages; and

electronic greeting cards.

Online Games, including:

Per hour basis (ranges from RMB0.40 to RMB0.50)

Westward Journey Online 2.0; and

PristonTale 2.0.

Advertising Services, including:

Varies depending on service. Basis includes time the advertisement appears on the Web page; number of times it appears in Web pages viewed by users; and number of users that perform a specific action through the advertisement.

banner advertising;

direct e-mail; and

special events.

**Our Business Strategy**

With our strong focus on the Chinese domestic market, we aim to have the NetEase Web sites become the leading online network in China. Key strategies for achieving our goal are to:

Expand Our Fee-Based Value-Added Services. We believe that Chinese Internet users have started to understand the benefits of fee-based value-added services. Accordingly, we have introduced a wide variety of such services, including wireless value-added services, online games and premium e-mail,

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many of which are targeted at the large portion of our registered user base which is under the age of 25. We believe that our concerted effort to capture a portion of this market as it first emerges, combined with our strong background in developing Internet technologies, will enable us to offer services which are valued by our users and establish our company as a reliable, secure and innovative online value-added service provider in the minds of China's Internet users. Moreover, we intend to continuously refine and improve these services, while at the same time looking for additional market opportunities and developing new services to address them. We will also strive to quickly familiarize the large user base of the NetEase Web sites with each of these services as they are introduced through outdoor advertising, notices on the NetEase Web sites and other promotional activities and thereby attempt to achieve a critical mass of users which we hope will create significant economies of scale.

**Continue to Develop User-Friendly Internet Applications, Services and Technologies for the Chinese Market.** We intend to continue our focus on developing user-friendly technologies for the Internet industry in China. We will adapt and modify existing technologies for Chinese language-based Internet applications as well as develop our own proprietary Chinese language Internet applications, such as our online games. We plan to continue to enhance our platforms with user-friendly interfaces and with easy to understand user instructions. While the market in China is not yet mature enough to allow the widespread adoption of broadband Internet services and next generation wireless technologies, we continue to explore ways in which we can utilize these technologies to increase the number of our users. We employed approximately 220 technology and product development professionals as of May 31, 2003.

**Enrich, Expand and Personalize NetEase Content.** The NetEase Web sites contain content from approximately 100 local and international content providers, including Xinhua News Agency, Chinanews.com, Beijing Daily, Nanfang Weekend, Yangcheng Night Newspaper, Guangzhou Daily, China Daily, People's Daily, China Youth Daily, and Reuters. To expand our channel offerings, we are working with vertical portal developers and purchasing or licensing existing content from traditional media providers. We intend to continue to offer content that will be more tailored for and relevant to our users' daily lives. We believe this will:

further differentiate the NetEase Web sites from competing Web sites and enhance our competitive position;

provide users with a more customized, comprehensive and satisfying Internet experience; and

increase the number of visits to the NetEase Web sites and the length of time each user stays on those sites.

**Expand the Number of Our Registered Users and Registered Community Members.** We believe that a Web site must maintain a critical mass of users in order to generate online advertising, e-commerce and fee-based services revenues. Therefore, we strive to keep the NetEase Web sites in their position as one of the top three Web sites in China in order to achieve our goal of converting our registered users into paying customers. To expand the number of registered community members, we plan to enhance the quality of our community services and introduce new applications, services and technology for our online community that will make the Internet in China an increasingly important medium for exchanging ideas. We plan to leverage our technology and Web-based products to increase the NetEase community.

**Expand Our E-commerce Services.** We believe that a growing number of consumers in China will look to the Internet as an alternative source of commerce in the future. We have established an online shopping mall with 13 merchants as of May 31, 2003. We will build upon this experience and our registered users and registered community members to actively develop and pursue e-commerce opportunities. We intend to continue partnering with e-commerce merchants by leveraging our user



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profile information, which allows them to market products to specific demographic groups, and using our registered user database to develop direct marketing opportunities.

Expand the Base of Online Advertisers on Our Network. Online advertisers on the NetEase Web sites have traditionally consisted primarily of merchants from the information technology and telecommunications industries as well as an increasing number of advertisers from traditional industries such as consumer products and media. However, in recent quarters, advertisers in a broader range of industries have begun to advertise online, and we intend to encourage this trend by attracting premier online advertisers through promoting our brand name and providing attractive solutions to online advertisers. We will continue to promote the Internet as an alternative method for advertisers to reach end users through integrated marketing campaigns using banner advertising, direct e-mail, interactive media-rich Web sites, special events, games and contests and other formats and techniques. In addition, we intend to continue to use third party advertising networks to increase the NetEase online advertiser base and improve our ability to collect and correlate information regarding our users and their habits, interests and related items to the extent permitted by law.

## **Our Products and Services**

As discussed above, our basic service offerings on the NetEase Web sites include:

content services (such as news, local information, online entertainment, finance and weather);

chat rooms;

basic e-mail services;

instant messaging;

community forums;

basic matchmaking;

basic personals;

basic alumni directory;

basic clubs;

classified ads;

Web directories;

Web searching; and

online shopping services.

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These basic services are available without charge to our users. We generate revenue from our:

wireless value-added services and other premium value-added services, such as Web page hosting, premium email services, premium personals, premium matchmaking, premium alumni directories, premium clubs, personal homepages, and electronic greeting cards;

online games; and

advertising services.

## **The NetEase Web Sites**

The Internet portal business, which is conducted through the NetEase Web sites, offers Chinese Internet users a network of Chinese language-based online content channels, community products, e-commerce services and other Web-based applications and services to enhance their Internet experience. The NetEase Web sites offer content channels, a full text Chinese language search engine, a Web directory, e-mail, Web hosting, electronic greeting cards, dating services and community tools. We also provide e-commerce services that allow vendors to sell their products online through our online shopping mall. Our content, community and e-commerce services are all designed with user friendly interfaces and easy to understand instructions.

## ***Our Members***

The NetEase Web sites have registered and unregistered users. Any user may visit the NetEase Web sites without registering. Only registered users can use our personalized services such as our free e-mail system and instant messaging, our fee-based premium services such as our premium e-mail and dating services. The NetEase users provide us with valuable demographic and preference information that will allow us to target audiences with relevant online advertising.

## ***Our Content***

The NetEase Web sites homepage provides a destination for Chinese Internet users to identify and access resources, services, content and information on the Internet. The NetEase Web sites 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. Our content distribution platform enables the NetEase Web sites 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 Web sites, but rather obtain content from our content partners. See page 17 of this amendment no. 2 to our annual report on Form 20-F for a discussion of the terms of the agreement with our content providers.

We believe that our broad and relevant content offering increases the number of visits and the amount of time our users spend on the NetEase Web sites. We adopt a significant amount of user-generated content from the community forums on the NetEase Web sites. We believe that this user-generated content is highly effective in maintaining user interest and ensuring repeat visits to the NetEase Web sites.



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The NetEase Web sites currently include 18 media channels in the following categories:

News	Jobs and careers	Information technology
Sports	Culture	Education
Games	Female	Travel
Finance	Entertainment	Mobile phone
Real estate	Automobiles	Guangdong Local
Health	Lifestyle	Shanghai Local

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The NetEase Web sites also include several specialty content channels such as Astrology, Jokes, Flash Cartoons and mini-sites for Movies and Concerts which provide even more variety of content to our users.

### ***Our Community***

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

NetEase users can interact through a variety of community products and services. We offer many products and services free of charge. They include:

*E-mail.* Our technology and services provide registered users with a free Web-based e-mail service which supports both the Chinese and English languages. Registered users can access and send e-mail through their Web browsers or through the POP3 and SMTP standards, which allow users to handle e-mails on their own e-mail applications without opening their browsers. The free Web-based e-mail service also includes the convenience of an address book to maintain user contact lists online, and by paying a fee, users can upgrade this service and receive anti-virus and anti-spam protections and extra memory storage. We also offer a separate fee-based premium e-mail service which is described below.

*Online Community.* We offer NetEase registered community members over 2,000 community forums where they can post messages and articles for viewing by other registered community members and other users. Due to regulatory issues, we no longer allow users to create their own forums in addition to the ones we offer. 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, they monitor the personal homepages hosted by the NetEase Web sites.

*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.

*Chat.* Our chat services allow NetEase registered users to interact in real-time groups or one-on-one discussions. Unlike hyper text markup language, or HTML, our Java-based chat technology allows users to participate in chats without downloading chat software. The NetEase chat rooms are arranged around topics of interest including, among others, relationships and dating, campus life and technology. Registered users can also create their own personal chat rooms.

*Voting System.* We conduct numerous polls on various social, cultural and other topics to provide our registered users with the opportunity to express their views and also to learn about the opinions of other Internet users.

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We also offer these additional fee-based services:

*Premium E-mail Service.* In November 2001, we began offering value-added e-mail services for both individuals, known as VIP, and corporations which provide 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 May 31, 2003, we had more than 190,000 VIP e-mail subscribers. In response to limited market interest, we discontinued our premium corporate e-mail activities in October 2002.

*Web Page Hosting.* In March 2001, we introduced a fee-based premium Web page hosting service which allows subscribers to create and maintain personal homepages. This service was re-launched in March 2002 with enhanced features and, thereafter, renamed Personal Space. The NetEase personal homepages create a Web-based community for Internet users to express themselves, to share ideas, interests and expertise, and to publish personal content accessible by other users with common interests. While we believe most of the NetEase personal homepages are of interest to a small circle of friends and families, there is a core group of users who create homepages with content having broader appeal. Traffic comes from both inside our network of Web sites and from non-registered users visiting from outside. Non-registered users typically find registered users' personal homepages through search engines. With this fee-based premium service, individual users are able to choose from service packages available at different rates to improve the overall quality of their personal homepages.

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Until December 2001, we also offered free computer storage space for personal homepages. We have allowed free personal homepages which were established before that date to remain in existence, though we actively encourage those users to transition their homepages to our premium service. Our premium Web page hosting service provides a more reliable platform as well as improved customer service in comparison to our prior free service. Users of our premium Web page hosting service also benefit from greater storage space, a more secure and faster server, and 24-hour customer support. As of May 31, 2003, we had approximately 27,000 personal homepages which were established under our non-fee based service and more than 74,000 personal homepages which were established under our premium service.

*Love.* Love is an online friend-finder, and we believe it is one of the largest in China with more than 7 million registered members and more than 200,000 paid subscribers. With this service, registered users post their own profiles for periods of two years or more, including photos, background, interests and contact details, and interested parties contact them directly. Our V member service provides enhanced features such as complete member profile access and search capability, customizable personal homepage design, front-page photo postings and publishing of detailed friend-find requirements.

*Dating.* A portion of the NetEase Web sites serves as a dedicated dating center where subscribers can make new friends and find someone to go out on dates or do other social activities, such as hiking, sports, games and movies. With this service, registered users post their dating announcements, along with their background and other information, and interested parties can either search online or contact our company through our SMS service to obtain more details about the user. We will then send an SMS message to the user to confirm that they want to have a date with the interested party. We charge a fee for each posting by a male user, but female users may post messages for free. During May 2003, the dating service attracted more than 200,000 new registered users.

*Premium Electronic Greeting Cards.* We believe that we were the first Internet company to offer Chinese Internet users free online greeting cards in Chinese. Subsequently, we began offering premium fee-based electronic greeting cards with enhanced features and no advertisements in March 2002, and we ceased offering free electronic greeting cards. Our greeting cards have different designs for various occasions, including New Year's Day, Chinese New Year, Christmas, birthdays, Valentine's Day, and other celebrations. We make new designs available on a regular basis. Users pay a monthly membership fee for this service of RMB10 which entitles them to send an unlimited number of cards per month. As of May 31, 2003, we had over 125,000 electronic greeting card subscribers.

## ***Our E-commerce Services***

We believe e-commerce will become a rapidly growing sub-sector of China's Internet market, despite the fact that there are a number of obstacles that need to be overcome. These obstacles include a low credit card penetration rate, perceived lack of secure online payment systems and the lack of reliable and efficient product distribution networks. However, we believe that these obstacles will be overcome in time, and that e-commerce will generate significant revenues in the future. For example, as discussed below in Online Games, we introduced a prepaid debit point card in connection with the introduction of our first massively multi-player online game, which we expect will facilitate the usability and growth of all of our fee-based premium services.



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Our e-commerce services focus on partnering with quality vendors to provide the convenience of online shopping to users. Currently, those vendors support their own e-commerce platforms which appear on the NetEase online shopping mall Web site that we maintain. Previously, we also helped those vendors with their e-commerce platforms. As of May 31, 2003, the mall hosted 13 vendors.

Our co-branded auction and trading Web site with EachNet terminated in July 2002. Subsequently, we offered free auction services on the NetEase Web sites but discontinued those services in June 2003.

***Web Directory, Web Search and Classified Ads***

The NetEase Web sites also provide a Web directory, Web search and classified ad services. Our Web directory is based on an open architecture system with over 3,000 volunteer editors working to build a categorized directory of Chinese Web sites. Our Web search is now powered by Baidu, a local Chinese search technology provider. We currently sell classified advertisements and key words exclusively through various local agents throughout China.

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*SMS.* In conjunction with China Mobile, in January 2001, we began offering value-added services through short messaging services (SMS) to allow users to send and receive messages from the Internet. Subsequently, we entered into a similar arrangement with China Unicom. We charge a fee for these services which are added onto the user's China Mobile or China Unicom bill and subsequently collected from the user and paid to us by the applicable wireless operator. These new services have experienced strong growth since their launch. At December 31, 2002, we had more than 17 million registered accounts and sent more than 1.6 billion short messages for the year. We expect that the usage of this service will continue to increase in the near term as the popularity of SMS increases but that there will be a transition to next generation technologies such as multi-media messaging services as they become more widely available, as discussed in next subsection below.

Currently, most of our wireless value-added services are provided to users in the form of SMS. NetEase offers over 200 different SMS and subscription packages with pricing between RMB0.10 to RMB2.00 per SMS message or between RMB5.00 to RMB30.00 per subscription per month. We, through Guangzhou NetEase, receive a percentage of this amount from China Mobile and China Unicom, which they bill and collect on our behalf. During the first nine months of 2003 we received between 72% and 79% of the amounts collected each month by China Mobile and China Unicom from mobile phone users for our wireless value-added services.

Our SMS services and subscription packages allow users, for example, to receive news and information such as stock quotes and e-mails, download ring tones and logos for their mobile phones and participate in matchmaking communities and interactive games. We utilize content from our Internet portal (both user-generated and from our content partners) with our applications developed in-house to offer this wide variety of products and services. Our products and services can be generally classified into four main categories, namely, news and information subscription, community, Internet-related products and services and multi-media downloading:

<u>News and Information Subscription</u>	<u>Community</u>	<u>Internet-related</u>	<u>Multi-Media Downloading</u>
Current news	Matchmaking	E-mail notification	Ring tones
Financial news	SMS girlfriend	E-card notification	Logos
Sports news	SMS pet	Instant messaging	Screensavers
TV guide	Educational products		
Weather forecast	Games & quizzes		

*WAP and Other Emerging Mobile Phone Technologies.* We are also focusing on developing products and services that can be utilized in emerging mobile phone technologies. For example, beginning in late 2002, Guangzhou NetEase derived wireless value-added services revenue under separate cooperative arrangements with China Mobile and China Unicom by providing wireless application protocol (known as WAP) services to mobile users with phones using the GPRS (General Packet Radio Service) and CDMA1X technology standards. More recently, in April 2003, we started to derive revenue from activities related to multi-media messaging services (known as MMS) under a cooperative

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agreement with China Mobile. We expect that our revenue derived from new services we develop that are compatible with these and other new mobile phone technologies will represent a larger portion of our wireless value-added services revenue in the future as these new technologies becomes more widely available.

**Online Games**

Massively Multi-player Online Role-Playing Games. In 2001, we began offering massively multi-player online role-playing games. As part of this initiative, we acquired technology assets from Guangzhou Tianxia Technology Co. Ltd., a China-based game software developer which we believe was the first company to introduce a domestically developed massively multi-player online role-playing game to the China market. We launched our first massively multi-player online role-playing game, Westward Journey Online, in December 2001. In connection with the introduction of this game, we introduced a prepaid debit point card which has facilitated the usability and growth of our online game services and, to a lesser extent, of our other fee-based value-added services. To address the difficulty of making online payments in China, users can buy this card at local stores and other locations in China. The points contained in the card can then be used to pay for our online services, such as playing time for online games. Subsequently, we launched Westward Journey Online Version 2.0 and a massively multi-player online role-playing game licensed from a Korean company, PristonTale, in August 2002. For the month of March 31, 2003, our online games had an average of 85,000 concurrent users and a total of 890,000 unique users.

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### **Partnerships and Strategic Alliances**

We have entered into partnerships and strategic alliances with companies that complement our products and services in a number of areas.

#### *Content Partnerships and Alliances*

With our content partnerships, our users have access to a broad offering of Chinese language content through the NetEase Web sites and our wireless value-added services. Our content partners display their content on one or more of the NetEase Web sites and media channels free of charge or in exchange for a share of revenue, a licensing fee, online advertising, access to original content produced by the NetEase 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 Web sites and to distribute to users of our wireless value-added services. Our content alliances are generally non-exclusive.

#### *Payment Solutions*

We have partnered with several domestic companies to facilitate e-commerce transactions, including China Merchants Bank, Capinfo (formerly China Information Highway Corporation), iPayment and ChinaPay. Through these partnerships, we can provide secure and reliable online payment solutions.

#### *The News Corporation*

In connection with the issuance of our Series B preference shares, we entered into an agreement with News Digital Ventures, an affiliate of The News Corporation Limited, which provided for cooperation between us and The News Corporation. As part of the consideration for the issuance of our Series B preference shares, The News Corporation and its affiliates have agreed to provide us with on-air advertising and promotional inventory with a value of US\$5 million on The News Corporation's media properties, including Channel [V], ESPN Star Sports, Phoenix TV and STAR TV. As of May 31, 2003, we had used US\$3 million of the inventory and agreed to use the remaining inventory by March 28, 2004. In addition, The News Corporation and its affiliates have agreed to spend US\$5 million on online advertising on the NetEase Web sites. As of May 31, 2003, The News Corporation had used approximately US\$1 million of this advertising inventory and agreed to use the remaining amount by March 28, 2004. All other aspects of our strategic cooperation agreement with The News Corporation terminated in March 2003.

### **Sales and Marketing**

#### *Sales Organization*

## Edgar Filing: NETEASE COM INC - Form 20-F/A

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 established an advertising sales force in May 1999.

Guangyitong Advertising sells banner advertisements on the NetEase Web sites, including animated and interactive banner advertisements, button advertisements, sponsorships, text links as well as

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advertising on our electronic newsletters. In addition, we have been appointed by Guangzhou NetEase to solicit advertising customers outside of China for the NetEase Web sites. Together with Guangyitong Advertising, we had 49 advertising sales professionals located in Beijing, Shanghai and Guangzhou as of May 31, 2003. In addition, online advertising on the NetEase Web sites is also sold through online advertising sales networks and advertising agencies. We believe that our focus on 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 Web sites that feature movies or television series, athletic events, music awards, charity concerts and industry exhibitions.

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 advertisements via electronic greeting cards 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.

## ***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. In an effort to control our costs, we reduced the financial and other resources devoted to our marketing and branding efforts in 2001. However, we continue to build brand awareness through proactive public relations and traditional and online advertising, and during 2002, we conducted an increasing number of traditional marketing events promoting specific products and services, such as wireless value-added services, online games and other fee-based premium services. We plan to continue investing in various forms of marketing to further build awareness of our brand.

## **Research and Development**

We believe that an integral part of our future success will depend on our ability to develop and enhance our products and services. Our product development efforts and strategies consist of incorporating new technologies from third parties as well as continuing to develop our own proprietary technology in order to produce user-friendly Internet 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 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, products and services and registered user base through diverse online products and services developed internally. We will seek to continually improve and enhance our existing products and services to respond to rapidly evolving competitive and technological conditions. Two areas of particular focus are the development of our proprietary online games and our wireless value-added services.

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### **Infrastructure and Technology**

Our infrastructure and technology have been designed for reliability, scalability and flexibility and are administered by our technical staff. The NetEase Web sites are made available primarily through network servers co-located in the facilities of China Netcom's Beijing affiliate (this was an affiliate of China Telecom until its reorganization) and China Telecom's Changzhou affiliate. As of May 31, 2003, there were 1,056 such co-located servers, operating with Web server software from Apache and Netscape. We lease dedicated lines with 900 megabits per second capacity from China Netcom's Beijing affiliate as well as shared lines from China Telecom's Changzhou affiliate.

We license and optimize StoryServer from Vignette Corporation to provide efficient and responsive management of the content on www.163.com, the main homepage of the NetEase Web sites. We also license NetGravity's advertisement serving technology to provide internal advertising inventory management, and we have developed our own advertisement tracking system.

Our Web directory is based on an open architecture system with over 3,000 volunteer editors. 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 access all services within the NetEase Web sites. 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.

### **Seasonality**

Historically, advertising and e-commerce revenues 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. Although we have only limited historical data, usage of our wireless value-added services and online games has typically increased around the Chinese New Year holiday and other Chinese holidays, in particular winter and summer school holidays. Our holiday-related electronic greeting cards have been especially popular during those periods.

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### **Competition**

A number of companies offer competitive products or services in China, our main operating market. These include Sina, Sohu, Tom.com, 263.net, Chinadotcom and 21cn.com.

We also face competition from U.S.-based portals such as Yahoo! and Yahoo! Chinese which have translated some of their content from the English language to the Chinese language. We expect that China's entry into the World Trade Organization, and the resulting gradual opening of its telecommunications sector, may facilitate more foreign participation in the Chinese Internet market. 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 Web sites that operate outside our market and offer content in the English language, which may be attractive to a portion of Chinese Internet users.

Further, we face competition from other Web sites that offer online community products and from other e-commerce service providers servicing our market including Sina, Sohu, Tom.com and Tencent.com. Moreover, Sina, Sohu and Tom.com are major providers of wireless value-added services in the China market, and like our company, they also have partnership arrangements with both China Mobile and China Unicom, the two current mobile phone operators in China. Although the number of competitors for SMS services did not grow materially in 2002, there has been a recent consolidation in the industry, resulting in an overall strengthening of competition in 2003.

We are also encountering competition from companies offering massively multi-player online role-playing games that target the China market, such as Shanda Networking, Softworld, Joypark and Waei International (with whom we had a strategic partnership until March 2002). Additionally, the producers of traditional video game consoles, such as Sony's PlayStation 2 and Microsoft's Xbox, offer massively multi-player games to their users, although the consoles and games have not yet been released in China. Some of our existing and potential competitors in these areas have significantly greater financial and marketing resources than we do.

In the future, we expect to face increased competition from new Internet media companies that choose to target general, special interest and/or demographic markets (such as vertical portals). We may encounter indirect competition from providers of Web-based software and other Internet related products. We also compete with traditional forms of media for advertising-related revenue. Further, we compete with domestic and multi-national Internet solutions providers. 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.

We believe the principal competitive factors in the Internet market in China are:

brand recognition;

user-friendliness;

focus on Internet users in China;



development of technology tailored for the Chinese Internet industry;

comprehensiveness, quality and responsiveness of products and services;

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availability of targeted content; and

personalized experience and online community applications, services and technologies.

**Governmental Regulations**

The telecommunications industry, including computer information and Internet access services, is highly regulated by the Chinese government. Regulations issued or implemented by the State Council, the Ministry of Information Industry, or the MII, and other relevant government authorities cover virtually every aspect of telecommunications network operation, including entry into the telecommunications industry, the scope of permissible business activities, interconnection and transmission line arrangements, tariff policy and foreign investment.

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In March 1998, the National People's Congress approved a government restructuring plan that directed the MII to assume, among other things, the regulatory, administrative and other responsibilities of, and rights previously exercised by, the former Ministry of Posts and Telecommunications.

The MII, under the leadership of the State Council, is responsible for, among other things:

formulating and enforcing telecommunications industry policy, standards and regulations;

granting licenses to provide telecommunications and Internet access services;

formulating tariff and service charge policies for telecommunications and Internet access services;

supervising operations of telecommunications and Internet access service providers;

maintaining fair and orderly market competition among operators; and

managing the day-to-day administration of the national telecommunications sector.

In September 2000, China's State Council promulgated the Telecommunications Regulations, or the Telecom Regulations. The Telecom Regulations categorize all telecommunications businesses in China as either infrastructure telecommunications businesses or value-added telecommunications businesses, with Internet content provider (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 Administrative Rules for Foreign Investments in Telecommunications Enterprises, or the Telecom FIE Rules. The Telecom FIE Rules 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 Telecom FIE Rules, foreign investors may now hold an aggregate of no more than 49% of the total equity in any value-added telecommunications business in China. This percentage ceiling is to be increased to 50% by the second anniversary of China's entry into the WTO.

In addition to the regulations promulgated by the central Chinese government, some local governments have also promulgated local rules applicable to Internet companies operating within their respective jurisdictions. In Beijing, where our head office is located, the Beijing Municipal Administrative Bureau of Industry and Commerce, or the Beijing AIC, has promulgated a number of Internet-related rules. In September 2000, the Beijing AIC invalidated a previously issued circular and adopted a new set of rules requiring owners of the domain names of commercial Web sites located within Beijing to conduct both a Web site name registration and a commercial Web site registration with the Beijing AIC. In March 2001, the Beijing AIC also promulgated the Online Advertising Tentative Administrative Measures requiring all ICPs within Beijing which provide online advertising services to obtain an advertising operating license. In addition, the Beijing AIC issued a circular requiring bulletin board services (BBS) providers to obtain approval from the Beijing AIC. Since these local rules or circulars promulgated by the Beijing AIC do not explicitly require a non-Beijing registered Internet company or a non-ICP company to comply with these rules or circulars and it is not clear under the rules that the NetEase Web sites are located within Beijing, we believe that these local rules do not apply to Guangzhou NetEase and NetEase Beijing.



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### ***Regulation of Internet Content Services; Publications***

Subsequent to the State Council's promulgation of the Telecom Regulations in September 2000, MII formulated and implemented a number of Internet-related regulations, including but not limited to the Internet Information Service Administrative Measures, or the ICP Measures, the Internet Electronic Bulletin Board Service Administrative Measures, or the BBS Measures, and the Tentative Administrative Measures Concerning Internet Portals Carrying on the News Displaying Business, or the Internet News Measures. The ICP Measures require that commercial ICP operators must obtain an ICP license from the appropriate telecommunications authorities in order to carry on any commercial ICP operations within China. In addition, the ICP Measures also provide that ICP operators which operate in sensitive and strategic sectors, including news, publishing, education, health care, medicine and medical devices, must obtain additional approvals from the relevant authorities in charge of those sectors as well. The BBS Measures 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. The Internet News Measures require that any ICP operator engaging in any news displaying services must obtain approval for those services from the appropriate government news department.

The Ministry of Health and the State Drug Administration have also adopted regulations regarding the online dissemination of online health- or drug-related information. These regulations require that, among other things, medical, health and drug information must be scientific and accurate and the sources of the information must be identified. Web sites which have received approval to disseminate such information must also publish or reprint health policies, information on epidemics and major health-related incidents and other information in this area in accordance with law. Medical and drug-related advertisements published by such Web sites are also prohibited from exaggerating the efficacy or promoting the medical uses of the advertised products.

In addition, the State News and Publication Bureau, or SNPB, is the government agency responsible for regulating publishing activities in China. On June 27, 2002, MII and SNPB jointly promulgated the Internet Publishing Tentative Administrative Measures, or the Internet Publishing Measures, which took effect on August 1, 2002. The Internet Publishing Measures require Internet publishers to secure approval from SNPB. The term "Internet publishing" is defined as an act of online dissemination whereby Internet information service providers select, edit and process works created by themselves or others (including content from books, newspapers, periodicals, audio and video products, electronic publications, etc. that have already been formally published or works that have been made public in other media) and subsequently post the same on the Internet or transmit the same to users via the Internet for browsing, use or downloading by the public.

Currently, the NetEase Web sites are operated by our affiliated company, Guangzhou NetEase Computer System Co., Ltd., or Guangzhou NetEase. To operate the NetEase Web sites in compliance with all the relevant ICP-related Chinese regulations, Guangzhou NetEase has successfully obtained an ICP license issued by the Guangdong Provincial Telecommunications Bureau dated as of December 14, 2000. On February 15, 2001, the News Office of the Beijing Municipal People's Government approved Guangzhou NetEase's application in respect of its news displaying services on the NetEase Web sites. Our current ICP license also authorizes Guangzhou NetEase to provide bulletin board services. As for special approvals for other online services, Guangzhou NetEase has submitted applications for online dissemination of health- and drug-related information and Internet publishing.

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Under the relevant regulations, ICP operators and Internet publishers are prohibited from posting or displaying any content that:

opposes the fundamental principles determined in China's Constitution;

compromises state security, divulges state secrets, subverts state power or damages national unity;

harms the dignity or interests of the state;

incites ethnic hatred or racial discrimination or damages inter-ethnic unity;

sabotages China's religious policy or propagates heretical teachings or feudal superstitions;

disseminates rumors, disturbs social order or disrupts social stability;

propagates obscenity, pornography, gambling, violence, murder or fear or incites the commission of crimes;

insults or slanders a third party or infringes upon the lawful rights and interests of a third party; or

includes other content prohibited by laws or administrative regulations.

Failure to comply with this content censorship requirement may result in the revocation of ICP licenses and the closing down of the concerned Web sites. To ensure compliance with this regulatory requirement, Guangzhou NetEase has taken all reasonable steps to avoid displaying any of the prohibited content on the NetEase Web sites.

## ***Regulation of Advertisements***

The State Administration of Industry and Commerce, or the SAIC, is the government agency responsible for regulating advertising activities in China. While there are no nation-wide uniform laws or regulations in China specifically governing online advertising businesses, some local government authorities, such as the Beijing AIC, have issued a number of regulations governing online advertising businesses. The SAIC has not expressly asserted or issued any regulatory documents stating that the Internet is considered an advertising medium under its rules, nor has the SAIC extended its jurisdiction to online advertisements. However, we cannot predict what stance the SAIC or any other Chinese governmental agencies may adopt in the future.

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Guangyitong Advertising holds an advertising operating license and operates our online advertising business on an exclusive basis. If the SAIC were to treat our current technological service to Guangyitong Advertising as being an online Advertisement Publisher, we would need to apply to the local SAIC to amend our business license to authorize us to conduct an online advertising business in accordance with the Administrative Regulations on Advertising and the Detailed Implementing Rules thereof. We cannot assure you that such application would be approved by the SAIC. Failure to obtain such approval may result in penalties including:

being banned from engaging in online advertising activities,

confiscation of illegal earnings and

finer.

On the other hand, if an application were approved by the SAIC and we were deemed to be an online Advertisement Publisher, we would be held responsible for examining relevant documents and verifying the content of advertisements we post online.

### ***Regulation of E-Commerce***

At present, there are no specific Chinese laws at the national level governing e-commerce or defining e-commerce activities, and no Chinese government authority has been designated to regulate e-commerce. There are existing regulations governing retail and auction businesses which require companies to obtain licenses in order to engage in these businesses. However, it is unclear whether these existing regulations will be applied to e-commerce. There is no assurance that the Chinese government will not, in the future, promulgate specific regulations governing e-commerce, designate a government agency to regulate e-commerce activities or apply existing retail and auction regulations to e-commerce activities, any of which events could restrict our business activities.

In addition, at least one provincial government has adopted regulations in this area, and other provincial or local governmental agencies may do so in the future. Specifically, in December 2002, Guangdong Province promulgated the Electronic Transactions Regulations which require electronic transaction service providers to obtain governmental approval and regulate electronic signatures, records and contracts. It is not entirely clear whether these regulations apply to Guangzhou NetEase, and, accordingly, we have not sought any approvals under these regulations. However, our ability to operate our business may be adversely affected if the Guangdong provincial authorities determine that the regulations are applicable to Guangzhou NetEase. Further, the adoption of multiple e-commerce regulations by different provincial or local agencies could have a material adverse effect on our business, particularly if such regulations are inconsistent with each other.

### ***Regulation of Wireless Value-Added Services***

Similar to e-commerce activities, there are no specific Chinese laws at the national level governing wireless value-added services, such as our services related to SMS, and no Chinese government authority has been designated to regulate these services. At the moment, most, if not all, providers of SMS-related services have obtained ICP licenses such as the ICP license which our affiliate, Guangzhou NetEase, possesses. However, we cannot be certain that an ICP license will be deemed sufficient by the relevant governmental authorities for the provision of this category of service, and it is possible that new national legislation might be adopted to regulate such services.





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Moreover, one province has adopted regulations on a trial basis that require SMS providers to obtain licenses from or register with the local MII branch office before conducting SMS operations in that province. Due to the uncertainty surrounding the applicability of these regulations, we have not applied for such provincial license. If these regulations are determined to be applicable to our business and/or additional provincial or local regulations arise in this area, our business could be adversely affected, particularly if such regulations are inconsistent with each other or we cannot obtain the requisite approvals.

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### ***Regulation of Online Games***

On May 10, 2003, the Ministry of Culture promulgated the Internet Culture Administration Tentative Measures, or Internet Culture Measures, which will come into effect on July 1, 2003. The Internet Culture Measures require Internet content providers which engage in Internet Culture Activities to submit an application for approval by the Ministry of Culture by September 1, 2003. The term Internet Culture Activities includes, among other things, acts of online dissemination of Internet Cultural Products, such as audio-visual products, gaming products, performances of plays or programs, works of art and cartoons, and the production, reproduction, importation, sale (wholesale or retail), leasing and broadcasting of Internet Cultural Products. In addition, these regulations require a separate review of the content of any online games which are imported into China.

We believe that our provision of online games will necessitate obtaining approval from the Ministry of Culture under the Internet Culture Measures and that any games which we import, such as PristonTale, will have to be reviewed. Because the Internet Culture Measures are so new and have yet to be implemented, we cannot be certain whether we can obtain such approvals or how long the application process will take. In addition, it has been reported that the SNPB will be adopting regulations affecting online games, and we cannot be certain when these regulations will become effective, what form they will take or how they will affect our business.

### ***Foreign Exchange Controls***

Our Chinese subsidiaries are subject to various foreign exchange controls which are discussed in Item 10 in this Form 20-F.

### **Intellectual Property and Proprietary Rights**

We rely primarily on a combination of copyright laws and contractual restrictions to establish and 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.

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 Web sites 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.

We have full legal rights over and have registered the following domain names with Network Solutions, Inc.:

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

www.163.com;

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www.yeah.net;

www.126.com; and

www.nease.net.

China's trademark law adopts a first-to-file system for obtaining trademark rights. As a result, the first applicant to file an application for registration of a mark will preempt all other applicants. Prior use of an unregistered mark is generally irrelevant except for well known marks. 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 travel Web page, dating and friends matching services, chat services, online gaming and our search engine. Guangzhou NetEase has transferred all but two of those marks to us, and we will cause the remaining two marks to be transferred to us shortly. Guangzhou NetEase and NetEase Beijing also have applications pending for several other trademarks, and we will cause Guangzhou NetEase to transfer to us any of its newly registered trademarks. We may not be able to successfully defend or claim any legal rights in those trademarks that Guangzhou NetEase has registered but not yet transferred to us, and those trademarks for which applications have been made but for which the Trademark Office has not issued a registration certificate.

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 similar trademark applications in the United States.

Many parties are actively developing and seeking patent protection for community, e-commerce 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.

## **Legal Proceedings**

Beginning in October 2001, four substantially identical purported class action complaints alleging violations of the federal securities laws were filed in the United States District Court for the Southern District of New York naming our company, several of our current and former officers and directors, and the underwriters of our initial public offering as defendants. In general, the complaints alleged, among other things, that (i) our initial public offering violated the U.S. securities laws because the financial statements accompanying the offering's registration statement misstated our revenue; and (ii) we committed securities fraud by materially misstating our revenue in our 2000 financial statements.

The parties to this litigation entered into a definitive settlement agreement to settle all claims, which was approved and declared final by the District Court on May 16, 2003. The aggregate settlement amount, which was paid to those persons who purchased our American Depositary Shares during the



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period from July 3, 2000 to August 31, 2001, was US\$4.35 million. This settlement has been reflect in our third quarter and full-year financial statements for 2002 as a one-time charge.

**C. Organizational Structure**

The following table sets out the details of our subsidiaries:

Name	Country of Incorporation	Ownership Interest
NetEase Information Technology (Beijing) Co., Ltd.	China	100%
NetEase Information Technology (Shanghai) Co., Ltd.	China	100%
NetEase (U.S.) Inc.	U.S.	100%
NetEase Interactive Entertainment Ltd.	British Virgin Islands	100%

NetEase Interactive Entertainment Limited also has a wholly owned subsidiary, Guangzhou NetEase Interactive Entertainment Limited.

Beijing NetEase Interactive Network Technology Co., Ltd., an 80% owned subsidiary, remained dormant since its establishment and was dissolved on October 11, 2002. In addition, NetEase (U.S.) Inc. was dormant in 2002, and we expect that it will remain so in the near-term.

**D. Property, Plant and Equipment**

Our principal executive offices are currently located at Suite 1901, Tower E3, The Towers, Oriental Plaza, Dong Cheng District, Beijing, People's Republic of China 100738. We lease our principal executive offices at an effective annual rent of approximately US\$0.4 million (RMB2.9 million), including management fees, for 1,592 square meters under a lease that expires in May 2006. We also occupy 756 square meters under a lease in Shanghai that expires in December 2004. Guangzhou NetEase occupies a total of 2,200 square meters under leases that expire in February 2005 and February 2006, respectively. We also have a lease for an office in the United States located in Newark, California. This lease expires in October 2005, but we are negotiating with the landlord for an early termination of it. We believe that we will be able to obtain adequate facilities, principally through the leasing of appropriate properties, to accommodate our future expansion plans.

Our total average bandwidth capacity in 2002 was 1,700 megabits per second, which consisted of the lease of dedicated lines with a total capacity of approximately 900 megabits per second from China Netcom's Beijing affiliate under a contract expiring in September 2003 and the lease of shared lines with a total capacity of approximately 800 megabits per second from China Telecom's Changzhou affiliate under contracts expiring in June 2003, January 2004 and March 2004. Our bandwidth fees were approximately US\$1.9 million for the year ended December 31, 2002 and approximately US\$0.5 million for the first quarter of 2003.

**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 on Form 20-F. This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding our expectations, beliefs, intentions or future*

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*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. Actual results could differ materially from those projected in the forward-looking statements. In evaluating our business, you should carefully consider the information provided under the caption Risk Factors in this annual report on Form 20-F. We caution you that our businesses and financial performance are subject to substantial risks and uncertainties.*

## **Overview**

NetEase is a leading Internet technology company in China. Our innovative online 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 Web sites which are operated by our affiliate. As of May 31, 2003, we had registered approximately 120 million accounts, and our average daily page views exceeded 280 million for the month ended May 31, 2003.

In 2002, we continued to develop our various fee-based premium services and online entertainment services, including wireless value-added services, online games, premium e-mail services for individual users and other subscription-type products. Our fee-based revenue accounted for approximately 85% of our total revenue for the year ended December 31, 2002. We believe that we will continue to rely on advertising revenue as one of our significant revenue sources for the foreseeable future, but we anticipate that the revenue generated by these fee-based premium services and online entertainment services will continue to constitute the major portion of our future revenue.

We achieved a net profit of RMB16.3 million (US\$2.0 million) for the year ended December 31, 2002 and generated positive operating cash flows of RMB26.8 million (US\$3.2 million) during the year. Our accumulated deficit was reduced from RMB454.1 million (US\$54.9 million) as of December 31, 2001 to RMB437.8 million (US\$52.9 million) as of December 31, 2002. These accumulated losses have been funded principally with proceeds from the issuance of our American Depositary Shares at our initial public offering, which was completed in July 2000, and our previous private share offerings.

## **Our Corporate Structure**

NetEase.com, Inc. was incorporated in the Cayman Islands on July 6, 1999 as an Internet technology company in China. As of December 31, 2002, we had four directly wholly owned subsidiaries, NetEase Information Technology (Beijing) Co., Ltd., or NetEase Beijing, NetEase Information Technology (Shanghai) Co., Ltd., or NetEase Shanghai, NetEase (U.S.) Inc., or NetEase US, and NetEase Interactive Entertainment Limited, or NetEase Interactive, which has a direct wholly owned subsidiary, Guangzhou NetEase Interactive Entertainment Limited, or Guangzhou Interactive.

NetEase Beijing and NetEase Shanghai were established in China on August 30, 1999 and May 14, 2000, respectively. NetEase US was established in the United States of America on September 10, 1999. NetEase Interactive was established in the British Virgin Islands on April 12, 2002, and Guangzhou Interactive was established in China on October 15, 2002.

Apart from the above-mentioned wholly owned subsidiaries, we also established a joint venture company in China, Beijing NetEase Interactive Network Technology Co., Ltd., or NetEase INT. NetEase INT was established on November 28, 2000 by our company and NetEase Beijing, which owned 80% and 20%, respectively, of the equity interest in NetEase INT. NetEase INT remained dormant since its establishment and was



dissolved on October 11, 2002.

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As the exclusive Internet technology provider to Guangzhou NetEase Computer System Co. Ltd., or Guangzhou NetEase, we provide a variety of Internet applications, technologies and services to support Guangzhou NetEase's operation of the NetEase Web sites and our e-commerce related services.

Guangzhou NetEase is a limited liability company organized under the laws of China and is controlled and owned by our principal shareholder. Guangzhou NetEase has been approved by the Chinese authorities to operate as an Internet content provider and operates the NetEase Web sites. Guangzhou NetEase's 80% owned subsidiary, Beijing Guangyitong Advertising Co., Ltd., or Guangyitong Advertising, is licensed by the Chinese authorities to operate an advertising business and engages in Internet-related advertising design, production and dissemination.

We have entered into a series of contractual arrangements with Guangzhou NetEase and Guangyitong Advertising with respect to the operation of the NetEase Web sites and the provision of advertising services. Our services to Guangyitong Advertising constitute the majority of our advertising-related operations.

NetEase US remained inactive during the year ended December 31, 2002.

## **Revenues**

Our total revenue increased from RMB28.3 million in 2001 to RMB232.6 million (US\$28.1 million) in 2002. We generate our revenue from advertising services, ecommerce and other services, and software licensing and related integration projects. In mid-1998, we changed our business model from a software developer to an Internet technology company. In July 1999, we began to offer e-commerce platforms and to provide online auction services in China through Guangzhou NetEase, a related party. Thereafter, we operated a co-branded auction Web site with EachNet which was ultimately terminated in July 2002, at which time we restarted our own online auction platform providing free auction services to our registered users until June 2003. In 2001, we also began focusing on fee-based premium services and online entertainment services, including wireless value-added services, online games, premium e-mail services and other subscription-type products. Our focus on these services continued throughout 2002.

Other than revenue from our related parties, Guangzhou NetEase and Guangyitong Advertising, no customer individually accounted for greater than 10% of our total revenue for 2000, 2001 and 2002.

### ***Advertising Services Revenue***

We derive all our advertising services revenue from fees we earn from Guangyitong Advertising, a related party, for services that we provide in connection with advertisements placed on the NetEase Web sites and advertising-related technical consulting services. We have entered into an agreement with Guangyitong Advertising under which we are the exclusive provider of advertising-related technical consulting services to Guangyitong Advertising and under which we receive a service fee. The service fee that we charge includes substantially all of the advertising revenue of Guangyitong Advertising less all of the accrued expenses incurred by Guangyitong Advertising, and net of a 5% business tax, a 3% cultural development fee and any surcharges that apply to these revenues.

*E-commerce and Other Services Revenue*

We currently derive all our e-commerce and other services revenue from fees earned pursuant to a series of agreements with Guangzhou NetEase, a related party, under which we provide Internet portal and e-commerce technologies and advertising services to Guangzhou NetEase in exchange for a service fee. The service fee that we charge includes substantially all of the e-commerce and other services

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revenue recognized by Guangzhou NetEase, net of a 5.5% business tax and any surcharges that apply to these revenues. Prior to 2001, we derived our e-commerce related services revenues from third parties as well as from Guangzhou NetEase.

Guangzhou NetEase earns its e-commerce related services revenue from wireless value-added services, online games and other fee-based premium services.

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

Guangzhou NetEase receives wireless value-added services revenue which are currently predominantly derived from activities related to short messaging services (known as SMS). Guangzhou NetEase derives wireless value-added services revenue principally from providing value-added services through SMS to users such as friends matching, news and information services, ring-tone and logo downloads and various other related products that mobile phone users can access under co-operative arrangements between Guangzhou NetEase and two Chinese mobile phone operators, China Mobile and China Unicom. Recently, there has been a consolidation in the market for products and services for users of SMS, resulting in an overall strengthening of competition in 2003. To maintain and grow our position in this market, we intend to continue improving our existing products and services and developing new ones, but these efforts may not be successful.

We are also focusing on developing products and services that can be utilized in emerging wireless technologies. For example, beginning in July 2002, Guangzhou NetEase also derived wireless value-added services revenue under a separate cooperative arrangement with one of the Chinese mobile phone operators by providing wireless application protocol (known as WAP) services to mobile phone users with phones using the General Packet Radio Service (known as GPRS) or CDMA1X wireless standards. More recently, in April 2003, we started to offer products and services for users of multi-media messaging services (known as MMS) under an additional co-operative agreement with one of the Chinese mobile phone operators. We expect that our revenue derived from new services we develop that are compatible with these and other new wireless technologies will represent a larger portion of our wireless value-added services revenue in the future as these new technologies becomes more widely available. However, we cannot be certain that these new technologies or the products and services we develop for them will be successful, and we expect to see increasing competition in this area.

### ***Online Games***

Guangzhou NetEase receives all its online games revenue from its customers through the sale of prepaid point cards. Customers can purchase prepaid point cards in different locations in China, including Internet cafes, convenience stores, supermarkets and bookstores, etc. Customers can register their point cards in our system and use the points in the cards to play our online games and use our other fee-based services. We develop our own proprietary online games, as well as license games from third party developers. We expect that we will face continued competition as online game providers, mainly from South Korea and to a lesser extent from the U.S., expand their presence in this market or enter it for the first time.

### ***Other Fee-Based Premium Services***

Other fee-based premium services include premium e-mail, friends matching and dating services, personal homepage hosting and online shopping mall.



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### ***Software Licensing and Related Integration Projects Revenue***

Prior to 2000, software licensing and related integration projects revenue consisted of fees received from licensing, integration services and post-contract customer support. We ceased providing licensing and integration services in 1999. In 2002, this category of revenue also included corporate solution services to a customer in connection with the purchase of servers and computer equipment, development of software and custody and maintenance of servers.

Although we continue to perform occasional corporate solutions services for customers upon request, we expect this category of revenue to remain immaterial to our business.

### **Cost of Revenues**

#### ***Advertising, E-commerce and Other Services Costs***

Advertising, e-commerce and other services costs represent those direct costs for operating the NetEase Web sites, which consist primarily of server custody and bandwidth fees, content fees, staff costs, share compensation cost, depreciation and amortization of computers and software and other direct costs.

NetEase Beijing, NetEase Shanghai and Guangzhou NetEase lease bandwidth from China Telecom and China Netcom affiliates. NetEase Beijing and Guangzhou NetEase have network servers co-located in facilities owned by China Telecom's and China Netcom's affiliates, for which they pay custody fees to China Telecom and China Netcom. In addition, as a result of our arrangements with Guangzhou NetEase, we also pay for Guangzhou NetEase's bandwidth lease payments and server custody fees on a monthly basis. These costs are recognized in full as incurred.

Staff costs consist primarily of compensation expenses for our e-commerce and editorial professionals and also for our staff in our online games business department, in particular, a group of employees known as the "Game Masters" who are responsible for the daily co-ordination and regulation of the activities inside our games' virtual worlds.

We depreciate our computer equipment, software and other assets (other than leasehold improvement) on a straight-line basis over their estimated useful lives, which range from one to five years.

#### ***Software Licensing and Related Integration Projects Costs***

We did not incur any direct costs relating to software licensing and related integration projects in 2000, 2001 and 2002.

**Operating Expenses**

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

***Selling; General and Administrative Expenses***

Selling, general and administrative expenses consist primarily of marketing and advertising; salary and welfare expenses and share compensation costs; office rental; legal, professional and consultancy fees; bad debt expenses; recruiting expenses; travel expenses and depreciation charges. 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.

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### ***Research and Development Expenses***

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

### **Share Compensation Cost**

In December 1999, we adopted a stock incentive plan, called the 1999 Stock Option Plan, for our employees, senior management and advisory board. In 2000, we replaced the 1999 Stock Option Plan with a new stock option plan, called the 2000 Stock Option Plan. The 2000 Stock Option Plan was subsequently amended and restated in May 2001. During 2000, 2001 and 2002, we granted options to our employees, directors, consultants, a member of our advisory board and several members of our senior management under the 2000 Stock Option Plan. The vesting periods for these options generally range from two years to four years. In addition, some of the options granted were cancelled as a result of the resignation of these personnel.

For 2002, we recorded share compensation cost of approximately RMB3.8 million (US\$0.5 million). This cost has been allocated to (i) cost of revenue (advertising and e-commerce and other services costs), (ii) selling, general and administrative expenses and (iii) research and development expenses, depending on the functions for which these personnel and employees are responsible.

As of December 31, 2002, deferred compensation cost relating to share option grants in 2002 or prior years amounted to RMB0.5 million (US\$57,336), which is to be amortized and charged to expense in subsequent periods. We may also incur additional share compensation cost in 2003 as a result of the possible recruitment of additional management personnel and the granting of new share options to these personnel and other members of our staff.

### **Income Taxes**

Under the current laws of the Cayman Islands, we are not subject to tax on income or capital gain. However, our revenues are primarily derived from our Chinese subsidiaries. Chinese companies are generally subject to a 30% national enterprise income tax, or EIT, and a 3% local income tax. Our subsidiary, NetEase Beijing, received the relevant approval to be recognized as a New and High Technology Enterprise. According to the approval granted by the Haidian State Tax Bureau in November 2000, NetEase Beijing is entitled to a reduced EIT rate of 15% commencing from the year 2000. In addition, the approval also granted NetEase Beijing with a full exemption from EIT from 2000 to 2002, a 50% reduction in EIT from 2003 to 2005, and a full exemption from the local tax from 2000 onwards. However, these preferential tax treatments may be subject to review by higher authorities. If these preferential tax treatments were not available to NetEase Beijing, then it would be subject to the normal tax rate of 30% EIT and a 3% local tax.

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

Guangzhou NetEase and Guangyitong Advertising are Chinese domestic enterprises and are generally subject to a 33% EIT. However, Guangzhou NetEase was categorized as a small-sized tax payer by the local tax bureau of Guangzhou, China. According to the relevant tax



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circulars issued by the local tax bureau of Guangzhou, Guangzhou NetEase is subject to different EIT rates depending on the nature of its taxable revenues.

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If the activities of NetEase.com, Inc. constitute a permanent establishment in China, the income it earns in China would also be subject to a 30% EIT and 3% local income tax. Income of our company that is not connected to a permanent establishment in China would be subject to a 10% withholding tax on gross receipt from profit, interest, rentals, royalties and other income earned in China. Dividends from NetEase Beijing to our company are exempt from Chinese withholding tax.

We are subject to a business tax on our revenues derived from services which is generally 5%. In addition, we are subject to a value-added tax ranging from 6% to 17% for revenues we earn from the sale of computer hardware purchased on behalf of our customers. During the year ended December 31, 2002, our effective value-added tax rate was 6%. In addition, Guangyitong Advertising is subject to a cultural development fee at 3% on its Internet advertising fees, which effectively reduces the revenues we derive from Guangyitong Advertising.

Subject to the approval of the relevant tax authorities, NetEase Beijing and NetEase Shanghai had total tax loss carryforwards of approximately RMB64.8 million (US\$7.8 million) as of December 31, 2002 for EIT purposes. Approximately RMB23.2 million (US\$2.8 million), RMB29.5 million (US\$3.6 million) and RMB12.1 million (US\$1.5 million) of such losses will expire in 2005, 2006 and 2007, respectively.

The above tax loss carryforwards give rise to potential deferred tax assets totaling RMB19.1 million (US\$2.3 million). As noted below under Critical Accounting Policies and Estimates, a valuation allowance has been provided to partly offset potential deferred tax assets due to the uncertainty surrounding the realizability of such assets.

## **Critical Accounting Policies and Estimates**

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

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

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

#### **Advertising Services Revenue**

Since December 1999, we have recognized advertising services revenue that we earn through our arrangement with Guangyitong Advertising as services are rendered and the service revenues are earned under the advertising agreements, which is the same time Guangyitong Advertising recognizes such revenue.

Guangyitong Advertising derives its advertising fees principally from short-term advertising contracts, though recently we have seen an increasing number of advertisers who are willing to enter into long-term contracts. Revenues from advertising contracts are generally recognized ratably over the period in which the advertisement is displayed and collection of the resulting receivables is probable. Guangyitong Advertising's obligations to the advertisers have traditionally also included guarantees of a minimum number of impressions or times that an advertisement appears in pages viewed by users. These types of advertising contracts are known as CPM contracts. As a result, to the extent that minimum guaranteed impressions were not met within the contractual time period, Guangyitong Advertising deferred recognition of the corresponding revenues until the remaining guaranteed impression levels were achieved. In 2002, we began focusing on entering into advertising contracts which fees are based on the actual time period that the advertisements appear on the NetEase Web sites rather than based on guaranteed minimum impressions. This transition is largely complete, and Guangyitong Advertising currently has only a few CPM contracts in effect. However, it has entered into several cost per action advertising contracts (known as CPA contracts) whereby revenue is received by Guangyitong Advertising when an online user performs a specific action such as purchasing a product from or registering with the advertiser. Revenue for CPA contracts is recognized when the specific action is completed. In 2002, CPA contracts represented only a small portion of our advertising revenue, and we expect that this will continue in the near-term.

#### **E-commerce and Other Services Revenue**

Since December 1999, we have recognized e-commerce and other services revenue that we earn through our arrangements with Guangzhou NetEase as the services are rendered and the services revenues are earned under the e-commerce and other services agreements, which is the same time Guangzhou NetEase recognizes such revenue.

#### **SMS and Other Wireless Value-Added Services**

Wireless value-added services revenue, which represents Guangzhou NetEase's share of the revenues under its cooperative arrangements with China's two mobile phone operators, is recognized by us primarily based on monthly statements received from those operators. The revenue is recognized net of the mobile phone operators' share of revenue and uncollectible amounts because we consider those operators to be the primary obligors in the information transmission and delivery process which is a critical and integral part of our wireless value-added services. In addition, this revenue recognition approach is supported by the fact that the mobile phone operators must approve all products and services pricing and they have significant influence over other terms under our co-operative arrangements with them. Uncollectible amounts mainly represent the mobile phone operators' transmission and billing problems resulting from technical issues with their systems. We are unable to estimate or separately confirm the amount of uncollectibles which is reflected in any particular monthly statement and are totally reliant on the information provided by the mobile phone operators in their monthly statements for purposes of our record keeping.



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### **Online Games**

We recognize revenue at the time when the points on our prepaid point cards are consumed and services are provided.

### **Other Fee-Based Premium Services**

We recognize revenue for these services ratably over the period when the services are provided, except in the case of the following services:

**Online Shopping Mall** - Guangzhou NetEase launched our online shopping mall platform in July 2000. As of May 31, 2003, this online shopping mall had 13 online stores operated by merchant tenants. From the fourth quarter of 2001, most online stores pay Guangzhou NetEase fixed service fees, which Guangzhou NetEase recognizes ratably over the period of the leases of the e-commerce platforms. Additionally, a small portion of the online stores pay Guangzhou NetEase commissions based on that merchant's revenues which are recognized on a monthly basis. Prior to 2002, we also received referral fees from online shopping mall partners of the NetEase Web sites which Guangzhou NetEase recognized when services were rendered. As of May 31, 2003, there were no active referral arrangements for which we were recognizing revenue, but we are currently seeking to enter into new referral arrangements.

**Online Auction** - Prior to October 2000, Guangzhou NetEase earned revenues from services to online auction sellers, whether businesses or consumers, which Guangzhou NetEase recognized ratably over the relevant period. In October 2000, we established a co-branded online trading and auction channel in partnership with EachNet. On June 25, 2002, we entered into an agreement with EachNet to terminate our strategic co-operation agreement and the co-branded Web site. We earned both fixed upfront fees and referral fees from EachNet during the period of co-operation. In July 2002, we re-started our own online auction platform providing free services to our registered users after the termination of the co-branded Web site with EachNet, but we discontinued such services in June 2003.

### **Software Licensing and Related Integration Projects**

Our revenue from software licensing and related integration projects in 2000 and 2001 consisted only of the recognition of deferred revenue which was brought forward for post-contract customer support. We generally provide our customers with post-contract support, for one year or less, on our software products. Such support is generally hotline support and may involve unspecified upgrades or enhancements. These unspecified upgrades or enhancements offered during post-contract customer support arrangements historically have been and are expected to continue to be minimal and infrequent. The estimated costs of providing such support are insignificant. Sufficient vendor-specific evidence does not exist to allocate the revenue from software and related integration projects to the separate elements of such projects. For post-contract support services that are for a period of one year or less, we recognize revenue when the following criteria are met:

persuasive evidence of an arrangement;

delivery has occurred and services have been performed;

the sales amount is fixed or determinable; and

the collectibility is probable.

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We occasionally provide post-contract support services that extend beyond one year. In such event, we would recognize revenue for applicable contracts ratably over the terms of those contracts.

For the corporate solution services we provided in 2002, the revenue was recognized at the completion of the respective services.

## **Barter Transactions**

Revenue from barter transactions primarily relate to advertising and decreased in 2000, 2001 and 2002 as a result of the development of our business. As our business grew and our cash resources improved, we were able to enter into more cash transactions and became less reliant on barter transactions in providing or receiving services. Prior to January 20, 2000, barter transactions were recorded at the estimated fair market value of the services received or estimated fair market value of the services provided, whichever was more readily determinable. Effective from January 20, 2000, we adopted the consensus reached in Emerging Issue Task Force, or EITF, Issue No. 99-17, to account for barter transactions. According to EITF Issue No. 99-17, revenue and expense should be recognized at fair value from an advertising barter transaction only if the fair value of the advertising surrendered in the transaction is determinable based on the entity's own historical practice of receiving cash, marketable securities, or other consideration that is readily convertible to a known amount of cash for similar advertising from buyers unrelated to the counterparty in the barter transaction. In 2000 and 2001, the recognized revenues and expenses derived from barter transactions were RMB0.7 million (US\$0.1 million) for each of those years. There was no revenue and expense derived from barter transactions in 2002. We also engaged in some advertising barter transactions in 2000, 2001 and 2002 for which the fair value is not determinable within the limits of EITF Issue No. 99-17, and therefore no revenues or expenses derived from these barter transactions were recognized. These transactions primarily involved exchanges of advertising services rendered by us for advertising, promotional benefits and information content provided by the counterparties.

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

### **Deferred Tax Valuation Allowance**

Management judgment is required in determining our provision for income taxes, deferred tax assets and liabilities and the extent to which deferred tax assets can be recognized. We make a valuation allowance to reduce deferred tax assets to the amount which is more likely than not to be realized. There can be no assurance that NetEase Beijing and NetEase Shanghai will be able to utilize all the net operating loss carryforwards before their expiration.

### **Allowances for Doubtful Accounts**

We maintain allowances for doubtful accounts receivable based on various information, including aging analysis of accounts receivable balances, historical bad debt rates, repayment patterns and credit worthiness of customers and industry trend analysis. We also make specific provisions for bad debts if there is strong evidence showing that the debts are likely to be irrecoverable. The Group has adopted a general provisioning policy for doubtful accounts for its trade receivable balances. The Group provides for 80%, in the case of direct customers, and 50%, in the case of advertising agents, of the outstanding trade receivable balances overdue for more than 6 months. The Group provides for 100% in the case of all parties for outstanding trade receivable balances overdue for more than a year. In addition to the general provisions for trade receivables, the Group also makes specific bad account provisions for problem account receivable balances.





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### **Litigation Reserve**

No material litigation reserve existed as of December 31, 2002 because management believed, and continues to believe, that the ultimate resolution of the claims described below under the heading Outstanding Litigation and Contingent Liabilities will not result in any material financial impact on our company.

### **Material Commitments**

As of December 31, 2002, we had lease commitments for office rentals of RMB4.7 million (US\$0.6 million), RMB3.7 million (US\$0.4 million) and RMB2.4 million (US\$0.3 million) payable in 2003, 2004 and 2005, respectively. In addition, we had lease commitments for server custody fees and other capital expenditure commitments of RMB10.3 million (US\$1.2 million) and RMB0.5 million (US\$0.1 million), respectively, payable in 2003.

### **Outstanding Litigation and Contingent Liabilities**

In January 2003, Guangzhou NetEase was named in a copyright infringement lawsuit in China, and the plaintiffs have claimed damages of US\$1.0 million. We intend to vigorously defend our position and believe the ultimate resolution of the matter will not have a material financial impact on our company.

**Table of Contents****Consolidated Results of Operations**

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

	For the year ended December 31,					
	2000		2001		2002	
	RMB	%	RMB	%	RMB	%
<b>Revenues:</b>						
Advertising services from related parties	30,067,477	91.2	14,163,952	50.0	34,209,376	14.7
E-commerce and other services (including revenues of RMB1,094,859, RMB14,103,151 and RMB197,357,067 (US\$23,835,395) from a related party in 2000, 2001 and 2002, respectively)	2,455,834	7.4	14,103,151	49.9	197,357,067	84.9
Software licensing and related integration projects	450,350	1.4	33,218	0.1	1,002,025	0.4
<b>Total revenues</b>	<b>32,973,661</b>	<b>100.0</b>	<b>28,300,321</b>	<b>100.0</b>	<b>232,568,468</b>	<b>100.0</b>
Sales and value-added taxes	(2,476,444)	(7.5)	(2,274,784)	(8.0)	(11,627,216)	(5.0)
<b>Net revenues</b>	<b>30,497,217</b>	<b>92.5</b>	<b>26,025,537</b>	<b>92.0</b>	<b>220,941,252</b>	<b>95.0</b>
<b>Cost of revenues:</b>						
Advertising, e-commerce and other services (including cost reimbursements to a related party of RMB2,098,127, RMB796,454 and RMB22,737,436 (US\$2,746,067) in 2000, 2001 and 2002, respectively)	(38,738,335)	(117.4)	(60,058,488)	(212.3)	(69,769,449)	(30.0)
Share compensation cost*	(1,171,084)	(3.6)			(1,908,125)	(0.8)
<b>Total cost of revenues</b>	<b>(39,909,419)</b>	<b>(121.0)</b>	<b>(60,058,488)</b>	<b>(212.3)</b>	<b>(71,677,574)</b>	<b>(30.8)</b>
<b>Gross profit (Loss on revenues)</b>	<b>(9,412,202)</b>	<b>(28.5)</b>	<b>(34,032,951)</b>	<b>(120.3)</b>	<b>149,263,678</b>	<b>64.2</b>
<b>Operating expenses:</b>						
Selling, general and administrative expenses (including cost reimbursements to a related party of RMB3,124,247, RMB1,884,823 and RMB5,542,383 (US\$669,370) in 2000, 2001 and 2002, respectively)	(162,922,561)	(494.1)	(181,560,624)	(641.5)	(92,785,244)	(39.9)
Assets impairment loss			(2,766,543)	(9.8)	(746,857)	(0.3)
Research and development expenses (including cost reimbursements to a related party of RMBnil, RMBnil and RMB1,346,824 (US\$162,660) in 2000, 2001 and 2002, respectively)	(9,525,436)	(28.9)	(11,169,454)	(39.5)	(13,808,360)	(5.9)
Share compensation cost*	(12,668,476)	(38.4)	(2,357,758)	(8.3)	(1,898,733)	(0.8)
Class action settlement					(36,005,385)	(15.5)
<b>Total operating expenses</b>	<b>(185,116,473)</b>	<b>(561.4)</b>	<b>(197,854,379)</b>	<b>(699.1)</b>	<b>(145,244,579)</b>	<b>(62.4)</b>
<b>Operating profit (loss)</b>	<b>(194,528,675)</b>	<b>(589.9)</b>	<b>(231,887,330)</b>	<b>(819.4)</b>	<b>4,019,099</b>	<b>1.8</b>
<b>Other income (expenses):</b>						

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Investment impairment loss			(8,924,381)	(31.5)		
Interest income	27,858,710	84.5	17,571,187	62.1	7,562,322	3.3
Interest expense	(2,589,735)	(7.9)	(9,882,874)	(35.0)	(1,401,041)	(0.6)
Other, net	(9,099)		(40,516)	(0.1)	3,725,370	1.6

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	For the year ended December 31,					
	2000		2001		2002	
	RMB	%	RMB	%	RMB	%
Profit (loss) before tax	(169,268,799)	(513.3)	(233,163,914)	(823.9)	13,905,750	6.1
Income tax benefit					2,395,888	1.0
Net profit (loss)	(169,268,799)	(513.3)	(233,163,914)	(823.9)	16,301,638	7.1
* Share compensation cost						
Advertising, e-commerce and other services cost of revenues	(1,171,084)	(3.6)			(1,908,125)	(0.8)
Selling, general and administrative expenses	(7,437,230)	(22.6)	(204,423)	(0.7)	(1,522,369)	(0.6)
Research and development expenses	(5,231,246)	(15.8)	(2,153,335)	(7.6)	(376,364)	(0.2)
Total	(13,839,560)	(42.0)	(2,357,758)	(8.3)	(3,806,858)	(1.6)

**Year Ended December 31, 2002 Compared to Year Ended December 31, 2001**

In 2002, revenue from advertising services, e-commerce and other services and software licensing and related integration projects constituted 14.7%, 84.9% and 0.4%, respectively, of our total revenue. This compares with 50.0%, 49.9% and 0.1%, respectively, of our total revenue in 2001. Our revenue from e-commerce and other services increased significantly during 2002 mainly as a result of the substantial increase in revenue generated from our wireless value-added services and to a lesser extent from our online games. Our advertising services revenue also increased during 2002 due to the expansion of our sales team and a general increase in demand for online advertising in China during 2002. Our software licensing and related integration projects revenue remained low in 2002, as we had previously ceased providing licensing and integration services in 1999 but continued to earn fees for post-contract customer support and also earned a small amount of fees for corporate solution services in 2002.

The rise in e-commerce and other services revenue as a percentage of our total revenue to 84.9% in 2002 resulted from the fact that the growth in such revenue significantly exceeded the growth in our advertising services revenue during that period. We expect that our revenue from e-commerce and other services will continue to constitute the major portion of our total revenue but that advertising services revenue will also continue to be one of the significant sources of our future revenue.

**Revenues**

Total revenues increased by 721.8% to RMB232.6 million (US\$28.1 million) in 2002 from RMB28.3 million in 2001. Advertising services revenues increased by 141.5% to RMB34.2 million (US\$4.1 million) in 2002 from RMB14.2 million in 2001, primarily as a result of the expansion of our sales team from 27 employees to 41 employees and a general increase in demand for online advertising in China during 2002. In particular, we gained several new China-based advertising clients, including leading mobile phone and car manufacturers, and were able to increase the number of advertising contracts which are long-term (one year or more) in 2002. Average revenue per advertiser increased from approximately RMB36,000 (US\$4,300) in the first quarter to RMB69,000 (US\$8,300) in the fourth quarter of 2002. The number of contracted advertisers using the NetEase Web sites increased from 174 in 2001 to 280 in 2002, with revenues from our top ten advertisers comprising 23.2% of our total advertising services revenues in 2002 as compared to 40.3% in 2001. 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.

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Based on our recent experience, we also expect that as advertisers generally become more familiar with online advertising, they will be increasingly willing to enter into longer term contracts of up to six months or more.

Revenues from e-commerce and other services increased by 1299.4% to RMB197.4 million (US\$23.8 million) in 2002 from RMB14.1 million in 2001, mainly as a result of the substantial increase in revenue generated from our wireless value-added services and to a lesser extent from our online games. In addition, revenues from our other fee-based services, including dating and friends matching, e-mail services and other premium services, also increased during 2002.

**Wireless Value-Added Services and Other Fee-Based Premium Services** - The substantial increase in revenue generated from our wireless value-added services was primarily due the increase in the overall popularity of SMS in China and in the range and popularity of our proprietary products and services among the expanding population of mobile phone users in China. We started the development of our wireless business in 1999 and launched our SMS.163.com Web page and first fee-based services in February 2001. At that time, the number and variety of products and services offered were very limited and included ring-tone and logo downloading and a few other services. As of May 31, 2003, we offered more than 200 different products and services, which can be classified into four main categories, namely, news and information subscription, multi-media downloading, community and communication and Internet-related products and services.

The increase in revenue in 2002 from our other fee-based premium services (excluding online games), including premium e-mail, dating and friends matching and personal homepage hosting, was primarily due to the commercialization of our dating and friends matching services at the beginning of the year (these services were provided to our users free of charge in 2001 and prior periods), and to a lesser extent, due to the increase in the number of paying subscribers of our other fee-based services in 2002.

Our wireless value-added services and other fee-based premium services together represented approximately 81.2% (2001: 100%) of our total e-commerce and other services revenue in 2002. The major portion of this amount was derived from our wireless value-added services in both 2002 and 2001.

**Online Games** - Our online games accounted for approximately 18.8% (2001: nil) of our total e-commerce and other services revenue in 2002. In 2001, we acquired all the assets of a China-based online game software development company and started the development of massively multi-player online role-playing games, or MMORPGs, at the beginning of 2001. We launched our first MMORPG, Westward Journey Online, for beta testing in December 2001, and started charging our users for their playing time in January 2002. Subsequently, we launched Westward Journey Online Version 2.0 and a MMORPG licensed from a Korean company, PristonTale, in August 2002.

Prior to 2000, software licensing and related integration projects revenues consisted of fees received from licensing, integration services and post-contract customer support. We ceased providing licensing and integration services in 1999. Our revenues in 2001 consisted only of the recognition of deferred revenue which was brought forward for post-contract customer support. In 2002, this category of revenue also included corporate solution services to a customer in connection with the purchase of servers and computer equipment, development of software and custody and maintenance of servers. We cannot predict whether we will continue to earn revenues from similar transactions in the foreseeable future, but we expect that we will provide these or other similar services to customers upon request. Such revenue totaled RMB1.0 million (US\$121,000) in 2002, compared to RMB33,000 in 2001.

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### **Cost of Revenues**

Our cost of revenues increased by 19.3% to RMB71.7 million (US\$8.7 million) in 2002 from RMB60.1 million in 2001, primarily due to the expansion of our online games business in 2002. A substantial portion of this increase was due to franchise and revenue share fees related to the PristonTale and Westward Journey Online games and, to a lesser extent, increased staff costs of our online games team.

As a result of the strong revenue growth in 2002, we achieved a gross profit of RMB149.3 million (US\$18.0 million) in 2002 as compared to a loss on revenues of RMB34.0 million in 2001. Our gross margins increased from 30.8% in the first quarter to 72.7% in the fourth quarter in 2002. The gross margin for the year ended December 31, 2002 was 64.2%.

The significant improvement in gross margins was driven by economies of scales as revenue continued to increase with a relatively stable cost of revenues. In 2001, bandwidth costs increased due to an increase in our purchases of bandwidth in order to support higher Internet traffic during that year. Several factors contributed to the decrease in bandwidth costs in 2002 despite the fact that the volume of our communication traffic increased during the same period. The decrease was due to cheaper location facilities for our servers and a general decline in average annual bandwidth costs per unit from RMB19,500 per megabit per second in 2000 to RMB18,400 per megabit per second in 2001 to RMB7,500 (US\$906) per megabit per second in 2002, accompanied by an increase in the total average bandwidth capacity from 800 megabits per second in 2000 to 1000 megabits per second in 2001 to 1700 megabits per second in 2002.

Staff costs consisted primarily of compensation expenses for our online game and other e-commerce and editorial professionals and comprised 27.8% of our total cost of revenues in 2002, compared with 15.2% in 2001. The increase was mainly due to the increase in the number of employees during 2002, in particular for the online games business department, which increased from 62 employees to 95 employees. We expect that staff costs as a percentage of our total cost of revenues will remain stable in the near-term.

Depreciation and amortization of computers and software comprised 24.9% of our total cost of revenues in 2002, compared with 22.6% in 2001. The increase was mainly due to the increase in the number of servers from 486 servers to 663 servers and to a lesser extent the increase in personal computer equipment during 2002. As we have spent or plan to spend approximately RMB21.0 million (US\$2.5 million) towards the purchase of additional servers and switches in 2003, we expect our depreciation expenses to increase in 2003.

### **Operating Expenses**

Total operating expenses decreased by 26.6% to RMB145.2 million (US\$17.5 million) in 2002 from RMB197.9 million in 2001. Operating expenses as a percentage of total revenues decreased from 699.1% in 2001 to 62.5% in 2002. The decrease in 2002 was mainly due to the fact that the substantial fees charged by third parties in 2001 as discussed in the next paragraph did not recur in 2002.

Selling, general and administrative expenses decreased by 48.1% to RMB94.3 million (US\$11.4 million) in 2002 from RMB181.8 million in 2001, primarily due to expenses of more than RMB50.0 million (US\$6.0 million) for legal and professional fees and consultancy fees in 2001 which substantially decreased in 2002, and to a lesser extent due to our cost control measures in 2002.





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In 2001, we incurred approximately RMB42.5 million in legal and professional fees in relation to an inquiry by the U.S. Securities and Exchange Commission, the class action complaints described below, the appeal of a delisting action initiated by Nasdaq and the investigation in the second and third quarters of 2001 into the circumstances that led us to restate our 2000 financial statements. In 2002, we incurred a significantly lower amount of legal and professional fees of about RMB17.6 million (US\$2.1 million) because the matters listed above were either resolved or required significantly less attention, resulting in a lower consumption of legal and professional services.

The total amount of consultation fees incurred decreased from RMB21.7 million in 2001 to RMB0.8 million (US\$0.1 million) in 2002 as we ceased to engage in those discussions in June 2001. In 2001, we also incurred approximately RMB21.7 million of consultation fees on matters relating to potential acquisitions of our business by interested parties, public relations, tax issues and business strategy and management matters.

The decrease in other selling, general and administrative expenses in 2002 was a result of a combination of factors, including (a) a one-time bad debt charge in 2001 for two non-recurring items amounting to RMB8.4 million (US\$1.0 million), (b) a one-time charge of compensation expenses in the form of severance paid to several executive officers and a senior employee who were separated from our company prior to the expiration of their employment contracts, amounting to RMB4.4 million (US\$0.5 million) and (c) the implementation of the following cost control measures:

In 2001, we recorded bad debt expenses for a RMB6.4 million bad debt provision for subscription receivables and RMB2.0 million provision for amount due from a related party, Ding Bo.

In 2001, we incurred a one-time charge of RMB4.4 million in compensation expenses in the form of severance paid to three executive officers and one senior manager who were separated from our company prior to the expiration of their employment contracts; and

Implementation of cost control measures also contributed to lower selling, general and administrative expenses in 2002, including: (i) strict monitoring of expenditures generally, as a result of which marketing spending decreased from RMB26.0 million in 2001 to RMB6.8 million (US\$0.8 million) in 2002, and certain business expenses, such as expenses for overseas traveling and local transportation, recruitment and training, business conferences and entertainment, decreased by RMB4.4 million (US\$0.5 million) from RMB9.3 million in 2001 to RMB4.9 million (US\$0.6 million) in 2002; and (ii) commencing periodic review of loan aging analysis with respect to loans made to third parties and following up with targeted efforts to seek payment by our customers and debtors which resulted in the required provision for bad debt decreasing from RMB5.1 million in 2001 to RMB3.3 million (US\$0.4 million) in 2002.

In 2002, we also paid RMB36.0 million (US\$4.35 million) into an escrow account for the settlement of all claims brought in connection with the class action lawsuit in the United States which is described under **Outstanding Litigation and Contingent Liabilities** above. This amount was released from escrow and paid to the plaintiffs at the time the court declared the settlement final.

The asset impairment loss in 2002 represented the unamortised portion of the costs incurred in the acquisition of an electronic payment gateway system which we ceased using.

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Research and development expenses increased by 6.5% to RMB14.2 million (US\$1.7 million) in 2002 from RMB13.3 million in 2001, primarily due to an increase in the number of programmers and technicians recruited in 2002 to assist our online games business.

### **Allowances for Doubtful Accounts**

As of December 31, 2001, the gross accounts receivable balance before the allowance for doubtful accounts was RMB11.7 million. After providing for an allowance for doubtful accounts in the amount of RMB5.4 million, the net balance of accounts receivable was RMB6.3 million. The allowance for doubtful accounts with a balance of RMB7,447,775 as of December 31, 2001 is the sum of the RMB5.4 million provision for bad and doubtful accounts and a RMB2.0 million provision for the amount due from Bo Ding, a related party.

Within the provision for accounts receivable balance of RMB5.4 million as of December 31, 2001, approximately RMB2.9 million are specific provisions and the remaining RMB2.5 million are general provisions made in accordance with our general provisioning policy.

Out of the total accounts receivable balance of RMB11.7 million as of December 31, 2001, approximately RMB5.4 million has been provided for as bad debt, RMB5.0 million has been settled and the remaining balance of RMB1.3 million was provided for as bad debt expenses in 2002.

In 2001, we made a full provision of RMB1,999,251 for the loan to Bo Ding which was then in default. The advance was written off in 2002 by offsetting with the corresponding balance in allowance for doubtful accounts.

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

The amount of additional provision made for bad and doubtful debts was decreased from RMB7.1 million for fiscal year 2001 to RMB3.2 million for fiscal year 2002. This was mainly due to the strengthening of our debt collection efforts, including litigation actions taken against debtors with long overdue balances.

The percentage of doubtful debts allowance as a percentage of total receivables as of year-end date was also significantly decreased in 2002 as compared with 2001. This was mainly due to the fact that a larger portion of total receivables was due from China Mobile and China Unicom in 2002 when compared with 2001 as a result of the development of our SMS business. The total amounts due from these two mobile operators were RMB2 million and RMB45.8 million as of December 31, 2001 and 2002 respectively. No provision for such accounts receivables balances was made because of the current nature of such balances.

As of December 31, 2001 and 2002, our receivable balances were due from Guangzhou NetEase and Guangyitong Advertising because they have historically not been consolidated into NetEase.com. NetEase.com makes corresponding bad debt provisions when those affiliated companies do so in their books of accounts.

Since NetEase.com relies on Guangzhou NetEase and Guangyitong Advertising to collect monies from their customers to realize its revenue earned from providing consulting services, NetEase.com also assists these two unconsolidated affiliates to manage their receivable balances. As of December 31, 2001, Guangzhou NetEase and Guangyitong Advertising had only one customer with a balance exceeding 10% of the total accounts receivable balance, namely China Mobile which owed the Group approximately RMB2.0 million in the form of SMS revenue payable. As of December 31, 2002, Guangzhou NetEase and Guangyitong Advertising had two customers with receivable balances exceeding 10% of the total accounts receivable balance, namely China Mobile and China Unicom which owed Guangzhou NetEase approximately RMB22.9 million (US\$2.8 million) and RMB22.9 million (US\$2.8 million) in the form of SMS revenue receivable, respectively, representing 32% and 32% of the total outstanding accounts receivable balance then outstanding. All of the balances owed by China Mobile and China Unicom mentioned in this paragraph had been fully settled before December 31, 2002.

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

Other income and expenses in 2002 mainly consisted of interest income and expenses. We repaid RMB84 million (US\$10.1 million) in short-term bank borrowings during 2002, and as a result, both our interest income and interest expenses dropped significantly in 2002 as compared to 2001. The decrease in the net interest income in 2002 as compared with 2001 was also due to the reduction of interest rates during 2002. Other net income of RMB3.7 million (US\$0.4 million) in 2002 represented the write-back of certain provisions for expenses and claims payable for certain arbitration.

#### **Deferred Tax Valuation Allowance**

We experienced our first net profits for the year ended December 31, 2002, reporting operating profits for each of the quarters since the second quarter of 2002. For the year ended December 31, 2002, we considered all relevant factors that are material to our business, including positive indicators (such as an improved profitability outlook, an indication of market acceptance of our content, and industry statistics signaling continued growth in the market for our services) and certain negative indicators (such as an increase in competition and industry risk such as our dependency on relationships with the mobile telephone operators in China), and determined that it was more likely than not that we would be able to take advantage of part of our tax loss carryforwards from the prior three fiscal years before their expiration. Accordingly, we decreased our deferred tax valuation allowance from RMB39.1 million as of December 31, 2001 to RMB16.7 million as of December 31, 2002.

#### ***Year Ended December 31, 2001 Compared to Year Ended December 31, 2000***

In 2001, revenues from advertising services, e-commerce and other services and software licensing and related integration projects constituted 50.0%, 49.9% and 0.1%, respectively, of our total revenues. This compares with 91.2%, 7.4% and 1.4%, respectively, of our total revenues in 2000. Our advertising services revenues decreased significantly during 2001 primarily due to the softening of the Internet advertising market in China which led to a decrease in the demand for advertising on the NetEase Web sites, and the intense market competition which affected the general pricing in the Internet advertising market in China. Conversely, revenues from our e-commerce and other services increased significantly during 2001 mainly as a result of the fixed upfront fees and referral fees that we earned from EachNet in connection with the operation of our co-branded trading and auction Web site (which has since been terminated) and the other revenues generated from fee-based services including wireless value-added services, e-mail services and other premium services. Finally, in 2001 our software licensing and related integration projects revenue further decreased as we continued to earn fees for post-contract customer support.

#### **Revenues**

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Total revenues decreased by 14.2% to RMB28.3 million (US\$3.4 million) in 2001 from RMB33.0 million in 2000. Advertising services revenues decreased by 52.9% to RMB14.2 million (US\$1.7 million) in 2001 from RMB30.1 million in 2000, primarily as a result of the softening of the Internet advertising market in China which led to a decrease in demand for advertising on the NetEase Web sites, and the intense market competition which affected the general pricing in the Internet advertising market in China. Average revenue per advertiser decreased from approximately RMB96,000 (US\$11,600) in the first quarter to RMB46,000 (US\$5,500) in the fourth quarter of 2001. The number of contracted advertisers using the NetEase Web sites decreased from 231 in 2000 to 174 in 2001, with revenues from our top ten advertisers comprising 40.3% of our total advertising services revenues in 2001 as compared to 34.4% in 2000.

Revenues from e-commerce and other services increased by 474.3% to RMB14.1 million (US\$1.7 million) in 2001 from RMB2.5 million in 2000, mainly as a result of the amortization of the upfront service fee recognized in 2001 of RMB1.0 million (US\$0.1 million) and quarterly referral fees of approximately RMB3.3 million (US\$0.4 million) that we earned from EachNet. As mentioned previously, our relationship with EachNet has terminated. In addition, the increase in total revenues from fee-based services in 2001, predominantly from wireless value-added services and to a lesser extent from premium e-mail and other services, totaled RMB6.7 million (US\$0.8 million).

We ceased providing software licensing and integration services in 1999. Our revenues in 2000 and 2001 in this revenue category consisted only of the recognition of deferred revenue which was

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brought forward for post-contract customer support and totaled RMB33,000 (US\$4,000) in 2001, compared to RMB450,000 in 2000.

### **Cost of Revenues**

Our cost of revenues increased by 50.5% to RMB60.1 million (US\$7.3 million) in 2001 from RMB39.9 million in 2000, primarily due to the overall expansion of our business, including in particular the increase in Internet connection costs, such as server related and bandwidth costs to support the large increase in traffic on the NetEase Web sites, offset in part by a decrease in staff costs. The average daily page views on the NetEase Web sites in December 2001 was approximately 174 million as compared to approximately 70 million in December 2000. As a result, our loss on revenues increased to RMB34.0 million (US\$4.1 million) in 2001 from RMB9.4 million in 2000.

Staff costs consisted primarily of compensation expenses for our e-commerce and editorial professionals and comprised 15.2% of our total cost of revenues in 2001, compared with 20.8% in 2000. The decrease was mainly due to the reduction in the number of employees during 2001.

Depreciation and amortization of computers and software comprised 22.6% of our total cost of revenues in 2001, compared with 17.2% in 2000. The increase was mainly due to the increase in the number of servers during 2001.

### **Operating Expenses**

Total operating expenses increased by 6.9% to RMB197.9 million (US\$23.9 million) in 2001 from RMB185.1 million in 2000. Operating expenses as a percentage of total revenues increased from 561.4% in 2000 to 699.1% in 2001. The increase in 2001 was mainly due to the substantial fees charged by third parties as discussed in the next paragraph.

Selling, general and administrative expenses increased by 6.7% to RMB181.8 million (US\$22.0 million) in 2001 from RMB170.4 million in 2000, primarily due to certain expenses of more than RMB50 million (US\$6.0 million) for legal and professional fees and consultancy fees in 2001.

The asset impairment loss for 2001 represents a provision for impairment loss on the software costs and other assets directly relating to the development of an online game of RMB2.8 million (US\$0.3 million). The impairment loss relating to the online game assets was estimated on the basis of the difference between the carrying value of the assets as of December 31, 2001 and the present value of the future cash flows which are likely to be generated from the operation of the online game.

Research and development expenses decreased by 9.7% to RMB13.3 million (US\$1.6 million) in 2001 from RMB14.8 million in 2000, primarily due to a decrease in share compensation costs as a result of the resignation of certain management staff in our technical department during 2001.

**Other Income (Expenses)**

Other income and expenses in 2001 mainly consisted of the one time non-recurring provisions for the impairment of our investments in a convertible note issued by Ladynow.com Corporation Limited, a corporation in which we invested, and convertible preference shares issued by EachNet of RMB2.1 million (US\$0.3 million) and RMB6.9 million (US\$0.8 million), respectively, and net interest income of RMB7.7 million (US\$0.9 million). The provision for the Ladynow convertible note was necessitated by Ladynow's cessation of operations in 2001. In turn, the EachNet shares were sold back to EachNet in 2002, and the impairment charge for our investment in EachNet in 2001 represents the difference between

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our original cost of investment and the consideration received for the resale. The decrease in the net interest income in 2001 as compared with 2000 was due to the decrease in our cash balance and the reduction of interest rates during 2001.

**Quarterly Results of Operations Data**

The following table sets forth selected unaudited quarterly consolidated statements of operations data for each of the four fiscal quarters for the year ended December 31, 2002 in Renminbi. Our management believes this data has been prepared substantially on the same basis as the consolidated audited financial statements, including all necessary adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of such data. Operating results for any quarter are not necessarily indicative of results for any future quarter. You should read the quarterly data for the four quarters set forth below for the year ended December 31, 2002 in conjunction with our consolidated financial statements and the related notes included elsewhere in this annual report.

	Quarter Ended			
	March 31, 2002  (Unaudited)  RMB	June 30, 2002  (Unaudited)  RMB	September 30, 2002  (Unaudited)  RMB	December 31, 2002  (Unaudited)  RMB
Revenues:				
Advertising services	3,946,530	8,029,230	9,779,126	12,454,490
E-commerce and other services	19,968,083	30,337,297	63,999,662	83,052,025
Software licensing and related integration projects	39,385	118,154	618,138	226,348
<b>Total revenues</b>	<b>23,953,998</b>	<b>38,484,681</b>	<b>74,396,926</b>	<b>95,732,863</b>
Sales and value-added taxes	(1,197,700)	(1,924,880)	(3,694,693)	(4,809,943)
<b>Net revenues</b>	<b>22,756,298</b>	<b>36,559,801</b>	<b>70,702,233</b>	<b>90,922,920</b>
Cost of revenues:				
Advertising, e-commerce and other services	(14,894,747)	(14,107,720)	(19,940,627)	(20,826,355)
Share compensation cost	(477,032)	(477,032)	(477,032)	(477,029)
<b>Total cost of revenues</b>	<b>(15,371,779)</b>	<b>(14,584,752)</b>	<b>(20,417,659)</b>	<b>(21,303,384)</b>
<b>Gross profit</b>	<b>7,384,519</b>	<b>21,975,049</b>	<b>50,284,574</b>	<b>69,619,536</b>
Operating expenses:				
Selling, general and administrative expenses	(22,202,753)	(21,962,075)	(21,903,299)	(26,717,117)
Asset impairment loss		(746,857)		
Research and development expenses	(3,565,372)	(3,884,600)	(2,714,442)	(3,643,946)
Share compensation cost	(645,657)	(597,764)	(358,700)	(296,612)
Class action settlement			(36,005,385)	
<b>Total operating expenses</b>	<b>(26,413,782)</b>	<b>(27,191,296)</b>	<b>(60,981,826)</b>	<b>(30,657,675)</b>
<b>Operating profit (loss)</b>	<b>(19,029,263)</b>	<b>(5,216,247)</b>	<b>(10,697,252)</b>	<b>38,961,861</b>
Other income (expenses):				
Interest income	1,949,086	2,281,729	1,719,807	1,611,700

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Interest expense	(996,735)	(212,382)	(191,924)	
Other, net	283,199	3,185,235	145,506	111,430
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Profit (loss) before tax	(17,793,713)	38,335	(9,023,863)	40,684,991
Income tax benefit				2,395,888
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net profit (loss)	(17,793,713)	38,335	(9,023,863)	43,080,879
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>



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Our revenues and results of operations have varied significantly in the past and may fluctuate in the future due to a combination of factors, including, among others:

the ability of the NetEase Web sites to attract and retain users;

our ability to successfully implement our e-commerce strategies;

our ability to develop new fee-based premium services;

the receptiveness by users to such fee-based premium services;

demand for advertising on the Internet in general and on the NetEase Web sites in particular;

our ability to update and develop our Internet portal systems and infrastructure;

technical difficulties that users may experience on the NetEase Web sites;

competition in Internet markets, including our competitors' performance in each of the above aspects;

growth and acceptance of the Internet in China;

changes in Chinese governmental regulations; and

general economic conditions in China.

## **Liquidity and Capital Resources**

Our capital requirements relate primarily to financing:

our working capital requirements, such as bandwidth and server custody fees, staff costs, sales and marketing expenses and research and development, and

costs associated with the expansion of our business, such as the purchase of servers.

## **Operating Activities**

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Cash provided by operating activities was RMB26.8 million (US\$3.2 million) in 2002 and cash used in operating activities was RMB185.7 million and RMB124.7 million in 2001 and 2000, respectively. In 2002, cash provided by operating activities consisted primarily of our operating profit adjusted for an increase in salary and welfare payable, taxes payable, and offset in part by an increase in amount due from related parties, deferred tax assets and a decrease in accounts payable. In 2001, cash used in operating activities consisted primarily of our operating loss adjusted for a decrease in accrued liabilities and amount due to related parties and an increase in due from related parties, offset in part by an increase in accounts payable, salary and welfare payable and a decrease in prepayments and other current assets. In 2000, cash used in operating activities consisted primarily of our operating loss adjusted for an increase in prepayments and other current assets and amount due from related parties, offset in part by increases in accounts payable, salary and welfare payable and other accrued liabilities.

### **Investing Activities**

Cash provided by investing activities was RMB42.7 million (US\$5.2 million) in 2002, and cash used in investing activities was RMB67.3 million in 2001 and RMB53.0 million in 2000. In 2002, cash provided by investing activities mainly consisted of the decrease in temporary cash investments and the proceeds from the disposal of our investment in convertible preference shares of EachNet, a private Internet-based auction company, which was offset in part by the cash used in the purchase of fixed assets. The decrease in temporary cash investments resulted from our repayment of bank loans as discussed below under Financing Activities. In 2001, cash used in investing activities mainly consisted of the placing of term deposits which had a maturity of more than three months and the purchase of fixed assets, which accounted for 67.7% and 31.4%, respectively, of total cash used in investing activities. In 2000, cash used in investing activities consisted primarily of the purchase of fixed assets and investment in

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convertible preference shares, which accounted for 64.1% and 31.2%, respectively, of total cash used in investing activities. Our investment in convertible preference shares coincided with our entering into an agreement to operate our co-branded trading and auction Web site with EachNet which, as previously noted, has been terminated. These shares were subsequently sold in 2002 back to EachNet for an aggregate net loss of approximately RMB6.9 million (US\$0.8 million).

## **Financing Activities**

Cash used in financing activities was RMB78.1 million (US\$9.4 million) in 2002. Cash used in financing activities was RMB22.3 million in 2001 and cash provided by financing activities was RMB904.9 million in 2000. A substantial portion of our cash is kept in US dollars. In 2002, the cash used in financing activities mainly consisted of the repayment of bank loans of RMB84 million (US\$10.1 million), which was offset in part by the proceeds from the issuance of ordinary shares upon the exercise of share options and the partial collection of a subscription receivable for the Series B preference shares issued in 2000 of RMB3.9 million (US\$0.5 million) and RMB2.0 million (US\$0.2 million), respectively. In 2001, the cash used in financing activities mainly consisted of the repayment of bank loans of RMB152.4 million (US\$18.4 million) which was offset in part by proceeds from other bank loans totaling RMB123.8 million (US\$15.0 million) and the receipt in 2001 of additional net proceeds from our issuance of Series B preference shares in 2000 of RMB6.3 million (US\$0.8 million). In 2000, the increase in cash provided by financing activities was primarily due to the net proceeds from our issuance of Series B preference shares in 2000 of RMB283.5 million and our initial public offering in July 2000 of RMB508.7 million and proceeds from bank loans totaling RMB112.6 million. We borrow Renminbi for our working capital purposes.

We had no material commitments for capital expenditures as of December 31, 2002. Up to March 31, 2003, we spent approximately RMB4.1 million (US\$0.5 million) for servers and computer equipment, and as our business grows, we plan to spend an additional approximately RMB16.9 million (US\$2.0 million) in 2003 towards purchases of additional servers and switches in order to accommodate the expected increase in traffic on the NetEase Web sites.

Our net losses have been funded by our cash resources (in particular the proceeds from our initial public offering in July 2000) and to a lesser extent from cash generated from revenue growth. Although we have been striving to enhance our revenues and stabilize or decrease our operating expenses, we cannot be certain these efforts will be successful in future periods which could accelerate the depletion of our cash resources. In particular, as noted previously, our selling, general and administrative expenses have remained relatively high due primarily to staff costs and, in certain prior periods, to legal, professional and consultancy fees, while our revenues from advertising services have been uneven in the last several years. Further, although our revenues from e-commerce and other services have grown significantly recently, we have only a limited track record offering these services and cannot be certain that we will be able to maintain or grow such revenue. Nonetheless, given our positive cash flows in recent quarters, we believe that such cash and revenues will be sufficient for us to meet our obligations for the foreseeable future.

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### **Research and Development**

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

We have utilized and will continue to utilize the products and services of third parties to enhance our platform of technologies and services to provide competitive and diverse Internet services to our users. We also have utilized and will continue to utilize third-party advertisement serving technologies. In addition, we plan to continue to expand our technologies, products and services and registered user base through diverse online community products and services developed internally. We will seek to continually improve and enhance our existing products and services to respond to rapidly evolving competitive and technological conditions. For the years 2000, 2001 and 2002, we spent RMB14.8 million, RMB13.3 million and RMB14.2 million (US\$1.7 million), respectively, on research and development activities.

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

#### ***Interest Rate Risk***

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

#### ***Foreign Currency Risk***

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

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

## **Recent Accounting Pronouncements**

In November 2002, EITF reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. We believe that the adoption of this standard will have no material impact on our financial statements.

In December 2002, the Financial Accounting Standards Board, or FASB, issued Statements of Financial Accounting Standards, or SFAS No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure. SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also requires that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. Additionally, SFAS No. 148 requires disclosure of the pro forma effect in interim financial statements. The transition and annual disclosure requirements of SFAS No. 148 are effective for fiscal years ending after December 15, 2002. The interim disclosure requirements are effective for interim periods beginning after December 15, 2002. We have adopted the disclosure provisions of SFAS No.148 as of December 31, 2002.

In November 2002, the FASB issued FASB Interpretation No. 45, Guarantors Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others (FIN 45). FIN 45 elaborates on the disclosures to be made by a guarantor about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The initial recognition and initial measurement provisions under FIN 45 are applicable prospectively to guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for interim or annual periods ending after December 15, 2002 and have been included in the consolidated financial statements. We believe that the adoption of the related accounting measurement and recognition provisions will not have a material impact on our financial statements.

In January 2003, the FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of APB No. 50 (FIN 46). FIN 46 provides guidance on the identification of and financial reporting for entities over which control is achieved through means other than voting rights. This Interpretation requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among parties involved. The Interpretation applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003 to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. We have not yet completed our assessment of the accounting effects from FIN 46 upon adoption. Based upon our initial analysis, it is possible that Guangyitong Advertising and/or Guangzhou NetEase may be subject to the requirements of FIN 46 and that we may be required to consolidate or disclose information about these entities. Disclosures regarding the nature, purpose, size, and activities of these identified entities, along with the nature of our involvement and when that involvement began, have already been included throughout the

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footnotes to our consolidated financial statements, particularly in Notes 1 and 6. We do not believe that consolidation of these entities will have a material impact on our net profit, but we are not able to estimate the maximum exposure to loss as a result of our involvement with these entities at the present time. Historically, we have not incurred any net losses as a result of our involvement in these entities.

**Trend Information**

Other than as disclosed elsewhere in this annual report, we are not aware of any trends, uncertainties, demands, commitments or events from the period of inception to December 31, 2002 that are reasonably likely to have a material effect on our net revenues, income, profitability, liquidity or capital resources, or that caused the disclosed financial information to be not necessarily indicative of future operating results or financial conditions.

**Table of Contents****PART III****Item 18. Financial Statements**

The consolidated financial statements for NetEase.com, Inc. and its subsidiaries are included at the end of this amendment no. 2.

**Item 19. Exhibits****Exhibit****Number****Document**

1.1*	Amended and Restated Memorandum of Association of NetEase.com, Inc. (incorporated by reference to Exhibit 3.1 from Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)
1.2*	Amended and Restated Articles of Association of NetEase.com, Inc. (incorporated by reference to Exhibit 3.2 from Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)
1.3*	Amendment to Amended and Restated Articles of Association of NetEase.com, Inc. dated as of June 5, 2003 (incorporated by reference to Exhibit 1.3 from the company's Annual Report on Form 20-F for the year ended December 31, 2002 filed with the Securities and Exchange Commission on June 27, 2003)
2.1*	Specimen American Depositary Receipt of NetEase.com, Inc. (incorporated by reference to Exhibit 4.1 from Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)
2.2*	Specimen Stock Certificate of NetEase.com, Inc. (incorporated by reference to Exhibit 4.2 from Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)
3.1*	Shareholder Voting Rights Trust Agreement dated May 12, 2000 among William Lei Ding, Bo Ding and NetEase Information Technology (Beijing) Co., Ltd. (incorporated by reference to Exhibit 10.40 from Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)
4.1*	1999 Stock Incentive Plan and Form of Stock Option Agreement (incorporated by reference to Exhibit 10.1 from the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)
4.2*	Amended and Restated 2000 Stock Incentive Plan and Form of Stock Option Agreement (including standard and non-standard form) (incorporated by reference to Exhibit 4.2 from the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the Securities and Exchange Commission on August 31, 2001)
4.3*	Employment Agreement dated August 13, 1999 between NetEase.com, Inc. and William Lei Ding (incorporated by reference to Exhibit 10.2 from the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)

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- 4.4\* Addendum to Employment Agreement between NetEase.com, Inc. and William Ding dated May 1, 2003(incorporated by reference to Exhibit 4.4 from the company s Annual Report on Form 20-F for the year ended December 31, 2002 filed with the Securities and Exchange Commission on June 27, 2003)
- 4.5\* Employment Agreement dated April 1, 2002 between NetEase.com, Inc. and Denny Lee (incorporated by reference to Exhibit 4.5 from the company s Annual Report on Form 20-F for the year ended December 31, 2002 filed with the Securities and Exchange Commission on June 27, 2003)
- 4.6\* Employment Agreement dated September 11, 2001 between NetEase.com, Inc. and Ted Sun (incorporated by reference to Exhibit 4.6 from the company s Annual Report on Form 20-F for the year ended December 31, 2001 filed with the Securities and Exchange Commission on June 21, 2002)
- 4.7\* Employment Agreement dated June 25, 2003 between NetEase.com, Inc. and Michael Tong (incorporated by reference to Exhibit 4.7 from the company s Annual Report on Form 20-F for the year ended December 31, 2002 filed with the Securities and Exchange Commission on June 27, 2003)
- 4.8\* Asset Purchase Agreement dated September 1, 1999 between Guangzhou NetEase Computer System Co., Ltd. and NetEase Information Technology (Beijing) Co., Ltd. (incorporated by reference to Exhibit 10.4 from the company s Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)
- 4.9\* Supplemental Agreement to Asset Purchase Agreement dated as of September 24, 1999 between Guangzhou NetEase Computer System Co., Ltd. and NetEase Information Technology (Beijing) Co., Ltd. (incorporated by reference to Exhibit 10.5 from the company s Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)
- 4.10\* Domain Name License Agreement dated February 3, 2000 between NetEase.com, Inc. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.7 from the company s Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)
- 4.11\* Copyright License Agreement dated February 3, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.8 from the company s Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)
- 4.12\* Trademark License Agreement dated February 3, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.9 from the company s Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)
- 4.13\* Supplemental Agreement (to Copyright License Agreement, Domain Name License Agreement and Exclusive Technical Services Master Agreement) dated April 27, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.10 from Amendment No. 1 to the company s Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)



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- 4.14\* Exclusive Technical Services Master Agreement dated February 3, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.11 from the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)
- 4.15\* Notice of Renewal dated April 2, 2001 relating to the Copyright License Agreement, the Trademark License Agreement and the Exclusive Technical Services Master Agreement, each dated February 3, 2000 and made between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 4.14 from the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the Securities and Exchange Commission on August 31, 2001)
- 4.16\* Exclusive Consulting and Services Agreement dated February 3, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Beijing Guangyitong Advertising Co., Ltd. (incorporated by reference to Exhibit 10.12 from the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)
- 4.17\* Notice of Renewal dated April 2, 2001 relating to the Exclusive Consulting and Services Agreement dated February 3, 2000 and made between NetEase Information Technology (Beijing) Co., Ltd. and Beijing Guangyitong Advertising Co., Ltd. (incorporated by reference to Exhibit 4.16 from the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the Securities and Exchange Commission on August 31, 2001)
- 4.18\* Exclusive Advertising Agency Agreement dated February 3, 2000 between Guangzhou NetEase Computer System Co., Ltd. and NetEase.com, Inc. (incorporated by reference to Exhibit 10.13 from the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)
- 4.19\* Notice of Renewal dated April 2, 2001 relating to the Exclusive Advertising Agency Agreement dated February 3, 2000 between Guangzhou NetEase Computer System Co., Ltd. and NetEase.com, Inc. (incorporated by reference to Exhibit 4.18 from the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the Securities and Exchange Commission on August 31, 2001)
- 4.20\* Trademark Transfer Agreement dated March 29, 2000 between Guangzhou NetEase Computer System Co., Ltd. and NetEase Information Technology (Beijing) Co., Ltd. (incorporated by reference to Exhibit 10.14 from Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)
- 4.21\* Online Advertising Agreement dated February 15, 2000 between Guangzhou NetEase Computer System Co., Ltd. and Beijing Guangyitong Advertising Co., Ltd. (incorporated by reference to Exhibit 10.15 from the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)
- 4.22\* Notice of Renewal dated April 2, 2001 relating to the Online Advertising Agreement dated February 15, 2000 and made between Guangzhou NetEase Computer System Co., Ltd. and Beijing Guangyitong Advertising Co., Ltd. (incorporated by reference to Exhibit 4.21 from the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the Securities and Exchange Commission on August 31, 2001)
- 4.23\* Amended and Restated Investors' Rights Agreement, dated March 28, 2000 among NetEase.com, Inc., Baring Asia Private Equity Investments XI Limited, The Goldman Sachs

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- Group, Inc., Softbank China Venture Investments No. 1 Limited, Best Alliance Profits Limited and Shining Globe International Limited (incorporated by reference to Exhibit 10.16 from the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)
- 4.24\* Tenancy Agreement dated October 31, 2002 between NetEase Information Technology (Beijing) Co., Ltd. and Beijing Oriental Plaza Co., Ltd. (incorporated by reference to Exhibit 4.24 from the company's Annual Report on Form 20-F for the year ended December 31, 2002 filed with the Securities and Exchange Commission on June 27, 2003)
- 4.25\* Strategic Cooperation Agreement dated March 23, 2000 between NetEase.com, Inc. and News Digital Ventures (incorporated by reference to Exhibit 10.23 from the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on March 27, 2000)
- 4.26\* Amendment No. 1 dated June 22, 2000 to the Strategic Cooperation Agreement between NetEase.com, Inc. and News Digital Ventures (incorporated by reference to Exhibit 4.26 from the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the Securities and Exchange Commission on August 31, 2001)
- 4.27\* Amendment No. 2 dated September 1, 2000 to the Strategic Cooperation Agreement between NetEase.com, Inc. and News Digital Ventures (incorporated by reference to Exhibit 4.27 from the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the Securities and Exchange Commission on August 31, 2001)
- 4.28\* Letter Agreement dated as of February 24, 2003 regarding the Strategic Cooperation Agreement between NetEase.com, Inc. and News Digital Ventures (incorporated by reference to Exhibit 4.28 from the company's Annual Report on Form 20-F for the year ended December 31, 2002 filed with the Securities and Exchange Commission on June 27, 2003)
- 4.29\* Supplemental Agreement dated May 10, 2000 (amending the Domain Name License Agreement) between NetEase.com, Inc. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.37 from Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)
- 4.30\* Agreement dated May 11, 2000 between NetEase Information Technology (Beijing) Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.41 from Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)
- 4.31\* Operating Agreement dated May 10, 2000 among NetEase Information Technology (Beijing) Co., Ltd., Beijing Guangyitong Advertising Co., Ltd., Bo Ding and William Lei Ding (incorporated by reference to Exhibit 10.42 from Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)
- 4.32\* Supplemental Agreement dated May 12, 2000 (supplementing the Online Advertising Agreement dated February 15, 2000) between Guangzhou NetEase Computer System Co., Ltd. and Beijing Guangyitong Advertising Co., Ltd. (incorporated by reference to Exhibit 10.47 from Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)
- 4.33\* Supplemental Agreement dated May 15, 2000 (supplementing the Domain Name License Agreement dated February 3, 2000) between NetEase.com, Inc. and Guangzhou NetEase

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Computer System Co., Ltd. (incorporated by reference to Exhibit 10.48 from Amendment No. 1 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on May 15, 2000)

4.34\* Letter of Agreement, dated June 6, 2000, among William Lei Ding, Bo Ding and NetEase.com, Inc. (incorporated by reference to Exhibit 10.49 from Amendment No. 2 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on June 15, 2000)

4.35\* Supplemental Agreement dated June 15, 2000 (supplementing the Online Advertising Agreement dated February 15, 2000), between Beijing Guangyitong Advertising Co., Ltd. and Guangzhou NetEase Computer System Co., Ltd. (incorporated by reference to Exhibit 10.50 from Amendment No. 2 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on June 15, 2000)

4.36\* Supplemental Agreement dated June 15, 2000 (supplementing the Exclusive Consulting and Services Agreement dated February 3, 2000), between NetEase Information Technology (Beijing) Co., Ltd. and Beijing Guangyitong Advertising Co., Ltd. (incorporated by reference to Exhibit 10.51 from Amendment No. 2 to the company's Registration Statement on Form F-1 (file no. 333-11724) filed with the Securities and Exchange Commission on June 15, 2000)

4.37\* Trademark Assignment Agreement dated August 17, 2001 between Guangzhou NetEase Computer System Co., Ltd. and NetEase Information Technology (Beijing) Co., Ltd and its Supplemental Agreement dated August 27, 2001 (incorporated by reference to Exhibit 4.53 from the company's Annual Report on Form 20-F for the year ended December 31, 2000 filed with the Securities and Exchange Commission on August 31, 2001)

8.1\* Subsidiaries of NetEase.com, Inc. (incorporated by reference to Exhibit 8.1 from the company's Annual Report on Form 20-F for the year ended December 31, 2002 filed with the Securities and Exchange Commission on June 27, 2003)

10.1 Translation of Monternet SMS Cooperation Agreement effective as of May 1, 2003 between Beijing China Mobile Communications Company Limited and Guangzhou Netease Computer System Co., Ltd.

10.2 Translation of Cooperation Agreement dated April 22, 2003 between China Unicom Co., Ltd. and Guangzhou Netease Computer System Co., Ltd.

10.3 Translation of Supplemental Agreement on Mobile Data Service dated as of July 29, 2003 between China Unicom Co., Ltd. and Guangzhou Netease Computer System Co., Ltd.

12.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer

12.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer

23.1 Consent of PricewaterhouseCoopers, Independent Public Accountants

23.2\* Consent of Maples and Calder Asia

23.3\* Consent of Commerce & Finance Law Office

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99.1\* CEO Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

99.2\* CFO Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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\* previously filed  
filed herewith on pages 60 and 61

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**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F/A and that it has duly caused and authorized the undersigned to sign this amendment no. 2 to the annual report on its behalf.

**NETEASE.COM, INC.**

Date: July 7, 2004

By: /s/ DENNY LEE  
Denny Lee

Chief Financial Officer\*

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\* Our Acting Chief Executive Officer, Ted Sun, is currently on temporary medical leave of absence.

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**CERTIFICATION**

I, Michael Tong, Executive Director of NetEase.com, Inc.,\* certify that:

1. I have reviewed this amendment no. 2 to annual report on Form 20-F/A of NetEase.com, Inc.;

2. Based on my knowledge, this amendment no. 2 to annual report on Form 20-F/A does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this amendment no. 2 to annual report on Form 20-F/A;

3. Based on my knowledge, the financial statements, and other financial information included in this amendment no. 2 to annual report on Form 20-F/A, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this amendment no. 2 to annual report on Form 20-F/A;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this amendment no. 2 to annual report on Form 20-F/A is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the Evaluation Date); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies and material weaknesses in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

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b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this amendment no. 2 to annual report on Form 20-F/A whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Dated: July 7, 2004

By: /s/ Michael Tong  
Michael Tong

Executive Director

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\* Our Acting Chief Executive Officer, Ted Sun, is currently on temporary medical leave of absence, and our Executive Director has made this Certification in his absence.

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**CERTIFICATION**

I, Denny Lee, Chief Financial Officer of NetEase.com, Inc., certify that:

1. I have reviewed this amendment no. 2 to annual report on Form 20-F/A of NetEase.com, Inc.;

2. Based on my knowledge, this amendment no. 2 to annual report on Form 20-F/A does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this amendment no. 2 to annual report on Form 20-F/A;

3. Based on my knowledge, the financial statements, and other financial information included in this amendment no. 2 to annual report on Form 20-F/A, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this amendment no. 2 to annual report on Form 20-F/A;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this amendment no. 2 to annual report on Form 20-F/A is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this amendment no. 2 to annual report on Form 20-F/A (the Evaluation Date); and

c) presented in this amendment no. 2 to annual report on Form 20-F/A our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies and material weaknesses in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and



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b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this amendment no. 2 to annual report on Form 20-F/A whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Dated: July 7, 2004

By: /s/ Denny Lee  
Denny Lee

Chief Financial Officer

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Reports of Independent Public Accountants

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

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of operations and comprehensive income, of shareholders' equity and of cash flows expressed in Chinese Renminbi ( RMB ) present fairly, in all material respects, the financial position of NetEase.com, Inc. as of December 31, 2002, and the results of its operations and its cash flows for the year ended December 31, 2002, in conformity with generally accepted accounting principles in the United States of America. These financial statements are the responsibility of NetEase.com, Inc.'s management; our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with generally accepted auditing standards in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion. The financial statements of NetEase.com, Inc. as of December 31, 2001 and for each of the two years ended December 31, 2000 and 2001 were audited by other independent accountants who have ceased operations. Those independent accountants expressed an unqualified opinion on those financial statements in their report dated April 2, 2002.

/s/ PricewaterhouseCoopers

Beijing, People's Republic of China April 7, 2003.

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The following report is a copy of a report previously issued by Arthur Andersen . Hua Qiang and has not been reissued by Arthur Andersen . Hua Qiang

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

We have audited the accompanying consolidated balance sheets of NetEase.com, Inc. (a Cayman Islands corporation) as of December 31, 2000 and 2001 and the related consolidated statements of operations and comprehensive loss, shareholders' equity and cash flows for the years ended December 31, 1999, 2000 and 2001 expressed in Chinese Renminbi ( RMB ). These financial statements are the responsibility of NetEase.com, Inc.'s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of NetEase.com, Inc. as of December 31, 2000 and 2001 and the results of its operations and its cash flows for the years ended December 31, 1999, 2000 and 2001 in conformity with generally accepted accounting principles in the United States of America.

Without qualifying our opinion, we draw attention to Note 17 to the consolidated financial statements which indicates that the Company and certain of its current and former officers and directors are defendants of four substantially identical purported class action complaints alleging violations of the federal securities laws and committing securities fraud in the United States District Court for the Southern District of New York. At the present time, the Company cannot estimate what damages, if any, may be payable in connection with this litigation. The ultimate resolution of this matter may have a material adverse impact on the results of operations in the period in which it is resolved.

ARTHUR ANDERSEN . HUA QIANG Beijing, People's Republic of China April 2, 2002

**Table of Contents****Consolidated Balance Sheets**

		December 31,	December 31,	December 31,
	Note	2001	2002	2002
		RMB	RMB	US\$
<b>Assets</b>				
Current assets:				
Cash		479,608,534	560,069,711	67,641,269
Restricted cash	4	90,308,448	1,208,305	145,931
Temporary cash investments		45,521,300		
Prepayments and other current assets	5	9,136,362	6,110,689	738,006
Due from related parties, net of allowance for doubtful accounts of RMB 7,447,775 and RMB 8,703,307 (US\$1,051,124) at December 31, 2001 and 2002, respectively	6	2,290,204	22,448,509	2,711,173
<b>Total current assets</b>		<b>626,864,848</b>	<b>589,837,214</b>	<b>71,236,379</b>
Non-current rental deposit		1,087,487	1,065,912	128,733
Investment in convertible preference shares	7	9,701,293		
Property, equipment and software, net	8	36,356,088	26,379,182	3,185,892
Deferred asset		783,352		
Deferred tax assets	11		2,395,888	289,358
<b>Total assets</b>		<b>674,793,068</b>	<b>619,678,196</b>	<b>74,840,362</b>
<b>Liabilities &amp; Shareholders' Equity</b>				
Current liabilities:				
Short-term bank loans	9	84,000,000		
Accounts payable		13,116,442	3,814,614	460,702
Salary and welfare payable	10	9,936,211	16,023,380	1,935,191
Taxes payable	11	1,772,931	8,252,950	996,733
Deferred revenue			165,115	19,941
Accrued liabilities	12	10,937,950	10,398,385	1,255,844
<b>Total current liabilities</b>		<b>119,763,534</b>	<b>38,654,444</b>	<b>4,668,411</b>
Commitments and contingencies	18			
Shareholders' equity:				
Ordinary shares, US\$0.0001 par value:				
1,000,000,000,000 shares authorized, 3,024,175,192 shares issued and outstanding as of December 31, 2001, and 3,100,162,537 shares issued and outstanding as of December 31, 2002				
	14	2,503,626	2,566,543	309,969
Additional paid-in capital	14	1,044,889,829	1,049,651,354	126,769,488
Less: Subscriptions receivable	13	(35,100,568)	(33,113,848)	(3,999,257)
Deferred compensation	15	(3,344,574)	(474,739)	(57,336)
Translation adjustments		217,327	228,910	27,646
Accumulated deficit		(454,136,106)	(437,834,468)	(52,878,559)
<b>Total shareholders' equity</b>		<b>555,029,534</b>	<b>581,023,752</b>	<b>70,171,951</b>
<b>Total liabilities and shareholders' equity</b>		<b>674,793,068</b>	<b>619,678,196</b>	<b>74,840,362</b>



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

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**Table of Contents****Consolidated Statements of Operations and Comprehensive Income (Loss)**

	Note	For the year ended December 31,			
		2000	2001	2002	2002
		RMB	RMB	RMB	US\$
<b>Revenues:</b>					
Advertising services from related parties	6	30,067,477	14,163,952	34,209,376	4,131,567
E-commerce and other services (including revenues of RMB 1,094,859, RMB 14,103,151 and RMB 197,357,067 (US\$23,835,395) from a related party in 2000, 2001 and 2002, respectively)	6, 16	2,455,834	14,103,151	197,357,067	23,835,395
Software licensing and related integration projects		450,350	33,218	1,002,025	121,018
		<u>32,973,661</u>	<u>28,300,321</u>	<u>232,568,468</u>	<u>28,087,980</u>
Sales and value-added taxes		(2,476,444)	(2,274,784)	(11,627,216)	(1,404,253)
<b>Net revenues</b>		<u>30,497,217</u>	<u>26,025,537</u>	<u>220,941,252</u>	<u>26,683,727</u>
<b>Cost of revenues:</b>					
Advertising, e-commerce and other services (including cost reimbursements to a related party of RMB 2,098,127, RMB 796,454 and RMB 22,737,436 (US\$2,746,067) in 2000, 2001 and 2002, respectively)	6	(38,738,335)	(60,058,488)	(69,769,449)	(8,426,262)
Share compensation cost*		(1,171,084)		(1,908,125)	(230,450)
<b>Total cost of revenues</b>		<u>(39,909,419)</u>	<u>(60,058,488)</u>	<u>(71,677,574)</u>	<u>(8,656,712)</u>
<b>Gross profit (Loss on revenues)</b>		<u>(9,412,202)</u>	<u>(34,032,951)</u>	<u>149,263,678</u>	<u>18,027,015</u>
<b>Operating expenses:</b>					
Selling, general and administrative expenses (including cost reimbursements to a related party of RMB 3,124,247, RMB 1,884,823 and RMB 5,542,383 (US\$669,370) in 2000, 2001 and 2002, respectively)	6	(162,922,561)	(181,560,624)	(92,785,244)	(11,205,948)
Asset impairment loss			(2,766,543)	(746,857)	(90,200)
Research and development expenses (including cost reimbursements to a related party of RMB nil, RMB nil and RMB 1,346,824 (US\$162,660) in 2000, 2001 and 2002 respectively)	6	(9,525,436)	(11,169,454)	(13,808,360)	(1,667,676)
Share compensation cost*		(12,668,476)	(2,357,758)	(1,898,733)	(229,316)
Class action settlement				(36,005,385)	(4,348,476)
<b>Total operating expenses</b>		<u>(185,116,473)</u>	<u>(197,854,379)</u>	<u>(145,244,579)</u>	<u>(17,541,616)</u>
<b>Operating profit (loss)</b>		<u>(194,528,675)</u>	<u>(231,887,330)</u>	<u>4,019,099</u>	<u>485,399</u>
<b>Other income (expenses):</b>					
Investments impairment loss			(8,924,381)		
Interest income		27,858,710	17,571,187	7,562,322	913,324
Interest expense		(2,589,735)	(9,882,874)	(1,401,041)	(169,208)
Other, net		(9,099)	(40,516)	3,725,370	449,924
<b>Profit (Loss) before tax</b>		<u>(169,268,799)</u>	<u>(233,163,914)</u>	<u>13,905,750</u>	<u>1,679,439</u>

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Income tax benefit	11			2,395,888	289,358
Net profit (loss)		(169,268,799)	(233,163,914)	16,301,638	1,968,797
Other comprehensive income (loss) Currency translation adjustments		(348,586)	565,913	11,583	1,399
Comprehensive income (loss)		(169,617,385)	(232,598,001)	16,313,221	1,970,196

For the year ended December 31,

	Note	2000	2001	2002	2002
		RMB	RMB	RMB	US\$
Net earnings (loss) per share, basic	17	(0.07)	(0.08)	0.01	0.01
Net earnings (loss) per ADS, basic		(6.78)	(7.74)	0.53	0.06
Net earnings (loss) per share, diluted	17	(0.07)	(0.08)	0.01	0.01
Net earnings (loss) per ADS, diluted		(6.78)	(7.74)	0.52	0.06
Weighted average number of ordinary shares outstanding, basic	17	2,497,467,200	3,013,419,400	3,051,395,100	3,051,395,100
Weighted average number of ADS outstanding, basic		24,974,672	30,134,194	30,513,951	30,513,951
Weighted average number of ordinary shares outstanding, diluted	17	2,497,467,200	3,013,419,400	3,127,837,900	3,127,837,900
Weighted average number of ADS outstanding, diluted		24,974,672	30,134,194	31,278,379	31,278,379
<b>* Share compensation cost</b>					
Cost of revenues - advertising, e-commerce and other services	15	(1,171,084)		(1,908,125)	(230,450)
Selling, general and administrative expenses		(7,437,230)	(204,423)	(1,522,369)	(183,861)
Research and development expenses		(5,231,246)	(2,153,335)	(376,364)	(45,455)
		(13,839,560)	(2,357,758)	(3,806,858)	(459,766)

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



**Table of Contents****Consolidated Statements of Shareholders Equity**

	Convertible preference shares		Ordinary shares		Additional paid-up capital	Subscriptions receivable	Deferred compensation	Retained earnings		Total shareholders equity
	Share	Amount	Share	Amount				(Accumulated deficit)	Translation adjustments	
		RMB		RMB				RMB	RMB	
Balance as of December 31, 1999	3,000,000	248,367	2,004,500,000	1,659,447	197,604,001		(11,743,182)	(51,703,393)		136,065,240
Series B preference shares issued for cash at US\$15.62 per share	2,560,556	211,976			330,940,024	(41,390,508)				289,761,492
Cost of issuance of Series B preference shares					(6,246,516)					(6,246,516)
Ordinary shares issued for cash at US\$0.155 per share in initial public offering			450,000,000	372,560	577,094,666	(6,439,401)				571,027,825
Cost of initial public offering					(62,289,780)					(62,289,780)
Automatic conversion of Series A preference shares to ordinary shares	(3,000,000)	(248,367)	300,000,000	248,367						
Automatic conversion of Series B preference shares to ordinary shares	(2,560,556)	(211,976)	256,055,600	211,976						
Share compensation cost					39,402,963		(25,563,403)			13,839,560
Net loss								(169,268,799)		(169,268,799)
Translation adjustments									(348,586)	(348,586)
Balance as of December 31, 2000			3,010,555,600	2,492,350	1,076,505,358	(47,829,909)	(37,306,585)	(220,972,192)	(348,586)	772,540,436
Collection of subscriptions						6,289,940				6,289,940

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receivable for  
Series B  
preference  
shares issued  
in 2000

Ordinary  
shares issued  
to a senior  
officer of the  
Company as  
compensation  
(see Note 14)

11,250,000

9,315

1,334,529

(739,265)

604,579

Ordinary  
shares issued  
for services to  
be provided  
by certain  
employees  
(see Note 14)

2,369,592

1,961

799,160

(555,914)

245,207

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**Table of Contents****Consolidated Statements of Shareholders Equity (cont d.)**

	Convertible preference shares		Ordinary shares		Additional paid-up capital	Subscriptions receivable	Deferred compensation	Retained earnings (Accumulated deficit)	Translation adjustments	Total shareholders equity
	Share	Amount	Share	Amount						
		RMB		RMB						
Share compensation cost					(33,749,218)		35,257,190			1,507,972
Provision for uncollectible subscriptions receivable						6,439,401				6,439,401
Net loss								(233,163,914)		(233,163,914)
Translation adjustments									565,913	565,913
Balance as of December 31, 2001			3,024,175,192	2,503,626	1,044,889,829	(35,100,568)	(3,344,574)	(454,136,106)	217,327	555,029,534
Collection of subscriptions receivable for Series B preference shares issued in 2000						1,986,720				1,986,720
Ordinary shares issued to a senior officer of the Company as compensation (see Note 14)			11,250,000	9,315	(9,315)		604,729			604,729
Ordinary shares issued for services to be provided by certain employees (see Note 14)			15,959,245	13,214	625,056		467,631			1,105,901
Ordinary shares issued upon exercise of employee options			48,778,100	40,388	3,847,031					3,887,419
Share compensation cost					298,753		1,797,475			2,096,228
Net profit								16,301,638		16,301,638
Translation adjustments									11,583	11,583
Balance as of December 31, 2002			3,100,162,537	2,566,543	1,049,651,354	(33,113,848)	(474,739)	(437,834,468)	228,910	581,023,752

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

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**Table of Contents****Consolidated Statements of Cash Flows**

	For the year ended December 31,			
	2000	2001	2002	2002
	RMB	RMB	RMB	US\$
<b>Cash flows from operating activities:</b>				
Net profit (loss)	(169,268,799)	(233,163,914)	16,301,638	1,968,797
<b>Adjustments for:</b>				
Depreciation	8,117,140	17,334,794	21,797,267	2,632,520
Share compensation cost	13,839,560	2,357,758	3,806,858	459,766
Provision for doubtful debts	1,584,452	7,105,038	3,254,783	393,090
Write down of investment in convertible note		2,069,475		
Write down of investment in convertible preference shares		6,854,906		
Write down of property, equipment and software		2,766,543	746,857	90,200
Provision for uncollectible subscriptions receivable		6,439,401		
Decrease in accounts receivable	4,706,696	684,888		
(Increase) decrease in prepayments and other current assets	(6,056,428)	5,689,171	3,025,673	365,420
Increase in due from related parties	(5,194,687)	(3,526,047)	(23,413,088)	(2,827,668)
(Increase) decrease in deferred assets	(673,407)	(109,945)	783,352	94,608
Increase in deferred tax assets			(2,395,888)	(289,358)
Increase (decrease) in accounts payable	6,420,224	5,553,994	(9,301,828)	(1,123,409)
(Decrease) increase in deferred revenue	(1,035,112)	(558,739)	165,115	19,941
Increase in salary and welfare payable	4,862,634	3,204,174	6,087,169	735,165
(Decrease) increase in taxes payable	(410,760)	765,827	6,480,019	782,610
Increase (decrease) in accrued liabilities	18,083,907	(7,843,607)	(539,565)	(65,165)
Increase (decrease) in due to related parties	371,279	(1,313,229)		
<b>Net cash provided by (used in) operating activities</b>	<b>(124,653,301)</b>	<b>(185,689,512)</b>	<b>26,798,362</b>	<b>3,236,517</b>
<b>Cash flows from investing activities:</b>				
(Increase) decrease in temporary cash investments		(45,521,300)	45,521,300	5,497,742
Purchase of property, equipment and software	(33,970,794)	(21,095,334)	(12,567,218)	(1,517,781)
Increase in investment in convertible note	(827,810)	(1,241,665)		
Investment in convertible preference shares	(16,556,199)			
Proceeds from disposal of convertible preference shares			9,701,293	1,171,654
(Increase) decrease in non-current deposit	(1,682,710)	595,223	21,575	2,606
<b>Net cash provided by (used in) investing activities</b>	<b>(53,037,513)</b>	<b>(67,263,076)</b>	<b>42,676,950</b>	<b>5,154,221</b>
<b>Cash flows from financing activities:</b>				
Proceeds from short-term bank loans	112,600,000	123,800,000		
Repayment of short-term bank loans		(152,400,000)	(84,000,000)	(10,144,928)
Proceeds from issuance of ordinary shares, net of RMB 62,289,780 issuance costs and RMB 6,439,401 subscriptions receivable in 2000	508,738,045			

**Table of Contents****Consolidated Statements of Cash Flows (cont d.)**

	For the year ended December 31,			
	2000	2001	2002	2002
	RMB	RMB	RMB	US\$
Proceeds from issuance of Series A and Series B preference shares, net of issuance costs of RMB 6,246,516 and RMB 41,390,508 subscriptions receivable in 2000	283,514,976			
Proceeds from issuance of ordinary shares upon exercise of employee options			3,887,419	469,495
Collection of subscriptions receivable for Series B preference shares issued in 2000		6,289,940	1,986,720	239,942
Net cash provided by (used in) financing activities	904,853,021	(22,310,060)	(78,125,861)	(9,435,491)
Effect of exchange rate changes on cash	(348,586)	565,913	11,583	1,399
Net increase (decrease) in cash	726,813,621	(274,696,735)	(8,638,966)	(1,043,354)
(Increase) decrease in restricted cash	(136,052,705)	45,744,257	89,100,143	10,760,887
Cash, beginning of year	117,800,096	708,561,012	479,608,534	57,923,736
Cash, end of year	708,561,012	479,608,534	560,069,711	67,641,269
Supplemental disclosures of cash flow information:				
Cash paid during the year for income taxes				
Cash paid during the year for interest	1,159,275	8,726,640	1,057,225	127,684
Supplemental schedule of non-cash investing and financing activities:				
Compensation costs, arising from transfer of ordinary shares and issuance of stock options in the Company to employees and some non-employees of the Company (see Notes 14 and 15)				
	13,839,560	2,357,758	3,806,858	459,766

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

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Notes to The Consolidated Financial Statements (Amounts expressed in renminbi ( RMB ), unless otherwise stated)

### 1. Organization and Nature of Operations

#### The Group

The accompanying consolidated financial statements include the financial statements of NetEase.com, Inc. (the Company) and its controlled entities which consist of NetEase Information Technology (Beijing) Co., Ltd. (NetEase Beijing), NetEase Information Technology (Shanghai) Co., Ltd. (NetEase Shanghai), NetEase (U.S.) Inc. (NetEase US), NetEase Interactive Entertainment Limited (NetEase Interactive) and Guangzhou NetEase Interactive Entertainment Limited (Guangzhou Interactive). The Company and these controlled entities are hereinafter collectively referred to as the Group.

The Company was incorporated in the Cayman Islands on July 6, 1999. As of December 31, 2002, the Company had four directly wholly owned subsidiaries, NetEase Beijing, NetEase Shanghai, NetEase US and NetEase Interactive. NetEase Beijing and Netease Shanghai were established in the People's Republic of China (China) by the Company on August 30, 1999 and May 14, 2000, respectively. Netease US was established in the United States of America on September 10, 1999. NetEase Interactive was established in the British Virgin Islands (the BVI) by the Company on April 12, 2002. Guangzhou Interactive was established in China on October 15, 2002 by NetEase Interactive.

The Group is principally engaged in developing and providing Internet-related advertising, e-commerce and other services, and software licensing services. The Group's businesses were previously conducted by Guangzhou NetEase Computer System Co., Ltd. (Guangzhou NetEase), a limited liability company established in China controlled by the principal shareholder of the Company. Pursuant to a reorganization under common control transaction which took place in September 1999 and related agreements, NetEase Beijing took over the business previously owned by Guangzhou NetEase.

The Group conducts its business within one industry segment - the business of developing and providing Internet-related advertising, e-commerce and other services, and software licensing services in China. The industry in which the Group operates is subject to a number of industry-specific risk factors, including, but not limited to, rapidly changing technologies; significant numbers of new entrants; dependence on key individuals; competition from similar products from larger companies; customer preferences; the need for the continued successful development, marketing, and selling of its products and services; the need for financing; and the need for positive cash flows from operations.

The Group is currently targeting the Chinese market. The Chinese government regulates Internet access, the distribution of news and other information and the provision of commerce through strict business licensing requirements and other governmental regulations, which include, among others, those restricting foreign ownership in Chinese companies providing Internet access, information and other online Internet services. Management is of the opinion that the Group's businesses comply with existing Chinese laws and regulations. However, the interpretation and application of current or proposed requirements and regulations may have an adverse effect on the Group's businesses, financial condition and results of operations.

The Group has a limited operating history and as a result, the Group is subject to risks associated with early stage companies in new and rapidly evolving markets. As of December 31, 2002, the Group had an accumulated deficit of approximately RMB437.8 million.

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### Agreements with Guangzhou NetEase

The Group entered into a series of agreements with Guangzhou NetEase effective from year 2000. Under these agreements, the Group provides its Internet portal and e-commerce technologies and advertising services to Guangzhou NetEase, and Guangzhou NetEase operates the NetEase Web sites. These services include:

use of domain names;

use of copyrighted Web page layout;

use of registered trademarks;

use of equipment; and

provision of technical and consulting services.

Under these agreements, substantially all of the income received by Guangzhou NetEase will be paid to NetEase Beijing. In addition, NetEase Beijing agreed to bear the operating costs of Guangzhou NetEase. Guangzhou NetEase is a related party because it is also controlled by the principal shareholder of the Company. The Group's businesses are dependent upon Guangzhou NetEase which operates the NetEase Web sites. Under the agreements with Guangzhou NetEase, the Group is to receive payments from Guangzhou NetEase for the technologies and services it provides. The effect of the accounting is that revenues that the Group records related to transactions with Guangzhou NetEase will not exceed the revenues that Guangzhou NetEase derives from unrelated parties. Transactions with Guangzhou NetEase are disclosed as related party transactions.

### Agreements with Guangyitong Advertising Co., Ltd. ( Guangyitong Advertising )

NetEase Beijing also entered into a series of agreements with Guangyitong Advertising and the ultimate owners of Guangyitong Advertising effective from year 2000. These agreements include:

a ten-year irrevocable proxy given by the ultimate owners of Guangyitong Advertising which allows NetEase Beijing to exercise all of the shareholder voting rights of Guangyitong Advertising;

an operating agreement providing for the following:

Guangyitong Advertising will appoint only those individuals nominated by NetEase Beijing as its senior management personnel;

the major decisions of Guangyitong Advertising have to be approved by NetEase Beijing, including those relating to financing; transfer of ownership interests, significant acquisitions, disposals or pledges of assets; and amendment and assignment of

contracts;

NetEase Beijing has a commitment to purchase the assets and business of Guangyitong Advertising at their net book value once it obtains the approval from the Chinese Government to do so under Chinese law; and

NetEase Beijing will issue guarantees for the benefit of Guangyitong Advertising when considered necessary for Guangyitong Advertising's operations;

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a ten-year exclusive consulting and technical services agreement providing for the following:

NetEase Beijing is the exclusive provider of technical consulting and related services to Guangyitong Advertising for all the advertisements which Guangyitong Advertising will receive and publish on the NetEase Web sites; and

NetEase Beijing will charge Guangyitong Advertising a monthly fee for the above services. The service fee may be unilaterally adjusted by NetEase Beijing such that NetEase Beijing may receive all of the profits and cash flows of Guangyitong Advertising;

an undertaking by the principal shareholder of the Company and the ultimate owners of Guangyitong Advertising that they will not vote in any shareholders' or directors' meetings of the Company on any amendments or supplements to the agreements with Guangyitong Advertising except as directed by the Company's board of directors.

Under these agreements, Guangyitong Advertising is fully dependent on the technical consulting and other services provided by NetEase Beijing to operate its online advertising business. Substantially all of the net profit earned by Guangyitong Advertising will be paid to NetEase Beijing. Guangyitong Advertising is a related party because it is also 80% owned by the principal shareholder of the Company. The financial statements of Guangyitong Advertising are not consolidated with those of the Group because of the majority equity interest that the principal shareholder of the Company has both in the Company and Guangyitong Advertising. Transactions with Guangyitong Advertising are disclosed as related party transactions.

## 2. Principal Accounting Policies

### Basis of consolidation

The consolidated financial statements include the financial statements of the Company and its controlled entities. All significant transactions and balances between the Company and its controlled entities have been eliminated upon consolidation.

### Basis of presentation

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

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

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

recognition of compensation costs arising from transfer of ordinary shares in the Company by the principal shareholder to certain members of senior management;

recognition of compensation cost arising from grants of stock options and

shares to the Company's employees, directors, consultants and advisory board members;

basis for revenue recognition; and

tax effects related to the above adjustments and recognition of deferred tax assets.

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### Revenue recognition

The Group has adopted the provisions of the Staff Accounting Bulletin 101, Revenue Recognition, in its accounting policy on revenue recognition.

### Advertising services

The Group derives its advertising services revenues principally from the fees earned from services provided to Guangyitong Advertising, a related party (see Note 6).

The agreements entered into between NetEase Beijing and Guangyitong Advertising (see Note 1) allow NetEase Beijing to unilaterally adjust the amount of fees NetEase Beijing is entitled to from the technical consulting and related services provided to Guangyitong Advertising such that all of the advertising revenues recognized by Guangyitong Advertising based on the recognition policy described below, less all of the accrued expenses incurred by Guangyitong Advertising, will fully accrue to NetEase Beijing. Therefore, the Group recognizes advertising services revenues from Guangyitong Advertising as the service revenues are earned based on the related service agreement (see Note 1) at the same time as Guangyitong Advertising recognizes its advertising revenues.

Guangyitong Advertising derives its advertising fees principally from short-term advertising contracts. Revenues from advertising contracts are generally recognized ratably over the period in which the advertisement is displayed and only if collection of the resulting receivables is probable. Guangyitong Advertising's obligations may also include guarantees of a minimum number of impressions or times that an advertisement appears in pages viewed by users. To the extent that minimum guaranteed impressions are not met within the contractual time period, Guangyitong Advertising defers recognition of the corresponding revenues until the remaining guaranteed impression levels are achieved.

Revenues from barter transactions primarily relate to advertising services provided in the years ended 2000 and 2001. Effective from January 20, 2000, Guangyitong Advertising has adopted the consensus reached in Emerging Issue Task Force (EITF) 99-17 to account for barter transactions. According to EITF 99-17, revenue and expense should be recognized at fair value from a barter transaction involving advertising services provided by Guangyitong Advertising only if the fair value of the advertising services surrendered in the transaction is determinable based on the entity's own historical practice of receiving cash, marketable securities, or other consideration that is readily convertible to a known amount of cash for similar advertising from buyers unrelated to the counterparty in the barter transaction. During the years ended December 31, 2000, 2001 and 2002, the recognized revenues and expenses derived from barter transactions were approximately RMB0.7 million, RMB0.7 million and RMBnil, respectively. During the years ended December 31, 2000, 2001 and 2002, Guangyitong Advertising also engaged in certain advertising barter transactions for which the fair value is not determinable within the limits of EITF 99-17 and therefore no revenues or expenses derived from these barter transactions were recognized. These transactions primarily involved exchanges of advertising services rendered by Guangyitong Advertising for advertising, promotional benefits, information content, consulting services, and software provided by the counterparties.

### E-commerce and other services

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The Group currently derives all its e-commerce and other services revenues from fees earned from services provided to Guangzhou NetEase, a related party (see Note 6). The Company derives e-commerce and other services revenues from technical services provided to Guangzhou NetEase which operates the

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NetEase Web sites for transactions conducted through the Internet. The agreements entered into between NetEase Beijing and Guangzhou NetEase (see Note 1) allow NetEase Beijing to unilaterally adjust the amount of fees NetEase Beijing is entitled to from the technical services provided to Guangzhou NetEase such that all of the e-commerce and other services revenues recognized by Guangzhou NetEase based on the recognition policy described below will fully accrue to NetEase Beijing.

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

The Group sells prepaid debit point cards through Guangzhou NetEase to the end customers who may use the points on such cards for services provided by the Group. The Group recognizes the related revenue when the registered points are consumed for the Group's services, such as online games or email services.

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

Guangzhou NetEase recognizes its revenues from e-commerce and other services when the services are provided.

The Group recognizes services revenues from Guangzhou NetEase at the same time as Guangzhou NetEase recognizes its e-commerce and other services revenues.

Services provided to third parties during 2000 also included various short-term service contracts for construction of Web sites and market surveys, etc. Revenue was recognized upon completion of the respective total contract and acceptance by the customer.

Software and related integration projects

Software and related integration projects include the elements of licensing, services, and postcontract customer support ( PCS ). PCS, generally for one year or less and occasionally beyond one year, are generally in the form of hotline support and may involve unspecified upgrades or enhancements. These unspecified upgrades or enhancements offered during PCS arrangements historically have been and are expected to

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continue to be minimal and infrequent. The estimated costs of providing PCS are insignificant. Sufficient vendor-specific objective evidence does not exist to allocate the revenues from software and related integration projects to the separate elements of such projects.

In accordance with American Institute of Certified Public Accountants ( AICPA ) Statement of Position ( SOP ) 97-2, revenues from software licensing and related integration projects under which the Group provides PCS for one year or less are recognized when the following criteria are met:

persuasive evidence of an arrangement;

delivery has occurred and services have been performed;

the sales amount is fixed or determinable; and

collectibility is probable.

Revenues from those projects under which the Group provides PCS that extend beyond one year are recognized ratably over the respective terms of the contracts. Warranty on the hardware in the related integration projects is substantially assumed by the original equipment vendors.

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### Deferred revenue

Deferred revenue represents prepayments by customers for services yet to be completed as of the balance sheet dates.

### Cost of revenues

Costs of advertising, e-commerce and other services, including cost reimbursements to Guangzhou NetEase under the agreements with Guangzhou NetEase described in Note 1, consist primarily of staff costs of those departments directly involved in providing advertising and e-commerce and other services, depreciation and amortization of computers and software, server custody fees, bandwidth and other direct costs of providing these services. These costs are charged to the statement of operations as incurred.

Material direct costs incurred in the development of platforms for providing these services consist primarily of computer software developed or acquired. They are capitalized and amortized in accordance with AICPA SOP 98-1 and costs incurred prior to the application development stage are expensed as incurred.

### Cash

Cash represents cash on hand and demand deposits placed with banks or other financial institutions. Included in the cash balance as of December 31, 2001 and 2002 are amounts denominated in United States dollars totaling US\$56.3 million and US\$50.7 million respectively (equivalent to approximately RMB466.0 million and RMB419.9 million respectively).

### Temporary cash investments

As of December 31, 2002, there were no temporary cash investments. As of December 31, 2001, temporary cash investments represented time deposits placed with banks or other financial institutions with original maturities over three months.

### Financial instruments

Financial instruments of the Group primarily consist of temporary cash investments, due from related parties, investment in convertible preference shares, short-term bank loans and accounts payable. As of the balance sheet dates, their estimated fair value approximated their carrying value.

### Property, equipment and software

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

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

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Costs of computer software developed or obtained for internal use are accounted for in accordance with AICPA SOP 98-1, under which direct costs incurred to develop the software during the application development stage and to obtain computer software from third parties that can provide future benefits are capitalized.

### Impairment of long-lived assets

Prior to January 1, 2002, the Group evaluated the recoverability of long-lived assets in accordance with Statement of Financial Accounting Standards ( SFAS ) No.121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of . As of January 1, 2002, the Group has adopted SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets which addresses the financial accounting and reporting for the recognition and measurement of impairment losses for long-lived assets. In accordance with these standards, the Group recognizes impairment of long-lived assets in the event the net book value of such assets exceeds the future undiscounted cash flows attributable to such assets.

Investment in convertible note totalling RMB2.1 million, representing an advance made to a private company operating as a provider of women focused content on the Internet, was fully written off to the statement of operations during the year ended December 31, 2001 as a result of the closure of the private company in 2001.

### Advertising expenses

The Group recognizes advertising expenses in accordance with AICPA SOP 93-7 Reporting on Advertising Costs . As such, the Group expenses the costs of producing advertisements at the time production occurs, and expenses the cost of communicating advertising in the period in which the advertising space or airtime is used. Advertising expenses totaled approximately, RMB61.6 million, RMB14.7 million and RMB2.4 million during the years ended December 31, 2000, 2001 and 2002, respectively.

### Foreign currency translation

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

Translations of amounts from RMB into United States dollars ( USD ) for the convenience of the reader were calculated at the noon buying rate of US\$1.00 = RMB8.2800 on December 31, 2002 in The City of New York for cable transfers of RMB as certified for customs purposes by the Federal Reserve Bank of New York. No representation is made that the RMB amounts could have been, or could be, converted into United States dollars at that rate on December 31, 2002, or at any other certain rate.

### Stock-based compensation

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

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Stock-based employee compensation cost of RMB13.8 million, RMB2.4 million and RMB3.8 million in 2000, 2001 and 2002, respectively, is expensed. The following table illustrates the effect on net income and earnings per share if the Group had applied the fair value recognition provisions of the Financial Accounting Standards Board ( FASB ) No. 123, Accounting for Stock-Based Compensation , to stock-based employee compensation.

	For the year ended December 31,		
	2000	2001	2002
Net income (loss):			
As reported	(169,268,799)	(233,163,914)	16,301,638
Less: Additional Stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(622,882)	(8,057,740)	(223,046)
Pro forma	(169,891,681)	(241,221,654)	16,078,592
Basic net earnings (loss) per ordinary share:			
As reported	(0.07)	(0.08)	0.01
Pro forma	(0.07)	(0.08)	0.01
Diluted net earnings (loss) per ordinary share:			
As reported	(0.07)	(0.08)	0.01
Pro forma	(0.07)	(0.08)	0.01

## Income taxes

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

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

In accordance with SFAS No. 128, Computation of Earnings Per Share, basic EPS is computed by dividing net profit (loss) attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period. Diluted EPS is calculated by dividing net profit (loss) by the weighted average number of ordinary and dilutive ordinary equivalent shares outstanding during the period. Ordinary equivalent shares consist of the ordinary shares issuable upon the conversion of the convertible preference shares (using the if-converted method) and ordinary shares issuable upon the exercise of outstanding stock options (using the treasury stock method). Ordinary equivalent shares in the diluted EPS computation are excluded in net loss periods as their effect would be anti-dilutive. A total of 50,164,600, 66,845,749 and 24,972,000 stock options in 2000, 2001 and 2002, respectively were excluded from the computation of diluted earnings (loss) per share because either (i) the option's exercise price was greater than the average market price of the ordinary shares, or (ii) the inclusion of the options would have been anti-dilutive because the Company experienced a net loss during the year.



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

### Statutory reserves

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

NetEase Beijing, NetEase Shanghai and Guangzhou Interactive have been in an accumulated loss position according to their PRC Statutory Accounts and no appropriations to statutory reserves have been made.

### Related parties

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

### Recent accounting pronouncements

In November 2002, EITF reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The Group believes that the adoption of this standard will have no material impact on its financial statements.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure. SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also requires that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. Additionally, SFAS No. 148 requires disclosure of the pro forma effect in interim financial statements. The transition and annual disclosure requirements of SFAS No. 148 are effective for fiscal years ending after December 15, 2002. The interim disclosure requirements are effective for interim periods beginning after December 15, 2002. The Group has adopted the disclosure provisions of SFAS No.148 as of December 31, 2002.





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In November 2002, the FASB issued FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others* (FIN 45). FIN 45 elaborates on the disclosures to be made by a guarantor about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The initial recognition and initial measurement provisions under FIN 45 are applicable prospectively to guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for interim or annual periods ending after December 15, 2002 and have been included in the consolidated financial statements. The Group believes that the adoption of the related accounting measurement and recognition provisions will not have a material impact on its financial statements.

In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of APB No. 50*, (FIN 46). FIN 46 provides guidance on the identification of and financial reporting for entities over which control is achieved through means other than voting rights. This Interpretation requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among parties involved. The Interpretation applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. The Group has not yet completed its assessment of the accounting effects from FIN 46 upon adoption. Based upon the Group's initial analysis, it is possible that Guangyitong Advertising and/or Guangzhou Netease may be subject to the requirements of FIN 46, and that the Group may be required to consolidate or disclose information about these entities. Disclosures regarding the nature, purpose, size, and activities of these identified entities, along with the nature of the Group's involvement and when that involvement began, have already been included throughout the footnotes to the consolidated financial statements, particularly in Notes 1 and 6. The Group does not believe that consolidation of these entities will have a material impact on its net income but it is not able to estimate the maximum exposure to loss as a result of its involvement with these entities at present time. Historically, the Group has not incurred any net losses as a result of its involvement in these entities.

The Group relies exclusively on the contractual arrangements with Guangzhou NetEase and Guangyitong Advertising to operate its business. Although many of the Chinese laws and regulations are subject to extensive interpretive powers of the governmental agencies and commissions, and uncertainty exists as to whether the Chinese government will take formal actions to change the applicable laws and regulations or informal actions to prohibit or restrict the Group's business activities based on interpretation of existing laws and regulations, the Group believes that its present operations are structured to comply with Chinese law and the Group does not believe that these governmentally imposed uncertainties are so severe that they cast doubt on the Group's ability to enforce its contractual arrangements with Guangzhou NetEase and Guangyitong Advertising and with the ultimate owners of Guangzhou NetEase and Guangyitong Advertising.

### 3. Concentrations

#### Dependence on mobile phone operators

SMS revenues, which represent a substantial portion of the e-commerce and other services revenue of Guangzhou NetEase, are derived from co-operative arrangements with the two mobile phone operators in China. If the strategic relationship with either mobile phone operator is terminated or scaled-back, or if the mobile phone operators alter the fee sharing percentages, it will be difficult, if not impossible, to find appropriate replacement partners with the requisite licenses and permits, infrastructure and customer base to offer the service, which would adversely affect the Group's businesses.

#### Bandwidth and server custody service provider

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

### Dependence on Guangzhou NetEase

The Group relies exclusively on Guangzhou NetEase, which has the approval to operate as an Internet content provider, for the operation of the NetEase Web sites.

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## Dependence on Guangyitong Advertising

All of the Group's advertising services revenues are derived from Guangyitong Advertising which has the approval to operate online advertising.

## Credit risk

The Group is principally engaged in developing and providing Internet-related advertising, e-commerce and other services to businesses primarily in China. The Group generally does not require collateral for its accounts receivable.

## 4. Restricted Cash

As of December 31, 2002, restricted cash represents USD denominated deposits in the amounts of US\$0.1 million pledged as security money for renting office space. As of December 31, 2001, restricted cash represented USD denominated deposits pledged for renting office space and the Group's RMB denominated short-term bank loans of US\$0.1 million and US\$10.8 million respectively.

## 5. Prepayments and Other Current Assets

	<b>December 31, 2001</b>	<b>December 31, 2002</b>
Prepayments	2,692,651	2,608,169
Interest receivable	2,854,722	352,826
Employee advances	100,535	375,069
Low-value consumables	1,712,813	884,400
Rental deposits	636,222	1,657,212
Other	1,139,419	233,013
<b>Total</b>	<b>9,136,362</b>	<b>6,110,689</b>

## 6. Related Party Transactions

During the years ended December 31, 2000, 2001 and 2002 the Group derived approximately RMBnil, RMB0.3 million and RMBnil, respectively, of advertising fees from shareholders of the Company.

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During the years ended December 31, 2000, 2001 and 2002, the Group derived approximately RMB30.1 million, RMB14.2 million and RMB34.2 million, respectively, of advertising services revenues from Guangyitong Advertising, a related company which is controlled by the principal shareholder of the Company, for advertising-related technical consulting services performed.

During the years ended December 31, 2000, 2001 and 2002, the Group derived approximately RMB1.1 million, RMB14.1 million and RMB197.4 million, respectively, of e-commerce and other services revenues from Guangzhou NetEase, a related company which is controlled by the principal shareholder of the Company.

During the years ended December 31, 2000 and 2001 and 2002, the Group reimbursed Guangzhou NetEase a total of approximately RMB5.2 million, RMB2.7 million and RMB29.6 million, respectively,

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for the costs of revenue and operating expenses associated with the NetEase Web sites.

Due from related parties mainly represents amounts receivable from Guangyitong Advertising and Guangzhou NetEase for services performed and temporary advances to officers of the Group. The balances with these two entities were unsecured, interest-free and repayable on demand.

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

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

As of December 31, 2001 and 2002, the amounts due from related parties included amounts denominated in USD of US\$0.5 million and US\$0.2 million respectively (equivalent to approximately RMB3.9 million and RMB1.3 million respectively). All other related party balances are denominated in RMB.

The breakdown of the amount due from related parties and advance payments from third party trade debtors are as follows:

	<u>2001</u>	<u>2002</u>
Third parties trade account receivables as of December 31,	11,714,168	71,132,435
Less: Provision for bad and doubtful debts	(5,448,524)	(8,703,307)
	<u>6,265,644</u>	<u>62,429,128</u>
Advance payments received from third party trade debtors		
Advertising	(5,596,592)	(4,734,563)
Point Cards		(23,535,674)
Other E-commerce related services	(2,901,268)	(3,343,092)
	<u>(8,497,860)</u>	<u>(31,613,329)</u>
Sub-total	(8,497,860)	(31,613,329)
Amounts due from William Ding	1,936,652	1,258,149
Amounts due from Bo Ding	1,999,251	
Less: Provision	(1,999,251)	
	<u>1,936,652</u>	<u>1,258,149</u>
Sub-total	1,936,652	1,258,149
Other net assets (liabilities) of Guangyitong Advertising and Guangzhou NetEase	<u>2,585,768</u>	<u>(9,625,439)</u>

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Amounts due from related parties as of December 31,	2,290,204	22,448,509
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Movements of the allowance for doubtful accounts for the years ended December 31, 2001 and 2002 are as follows:

	Balance at	Charged to cost	Write-off of receivable balances and corresponding	Balance at
	January 1	and expenses	provisions	December 31
<b>2001</b>	342,737	7,105,038		7,447,775
<b>2002</b>	7,447,775	3,254,783	1,999,251	8,703,307

7. Investment in Convertible Preference Shares

	December 31, 2001	December 31, 2002
Investment, at cost	16,556,199	
Less: Investment impairment loss	(6,854,906)	
Net book value	9,701,293	

As of December 31, 2001, investment in convertible preference shares represented an investment in 705,816 preference shares in a private Internet-based auction company at US\$2.8336 per share.

According to a board resolution dated March 14, 2002 and an agreement entered into between the Company and the private auction company dated March 18, 2002, the private auction company repurchased from the Company all of the 705,816 convertible preference shares the Company acquired at a consideration of approximately US\$1.2 million which is equivalent to approximately RMB9.7 million. Since the carrying value of the investment had already been written down to its net realizable value as of December 31, 2001, no gain or loss resulted from the disposal.

The Group had entered into a strategic co-operation agreement with the private auction company pursuant to which the Group and the private auction company established a co-branded auction Web site on the NetEase Web sites. According to the agreement, the Group was entitled to (i) a non-refundable upfront fee and (ii) quarterly referral fees which are based on the number of click-throughs to the co-branded site with a minimum fee level on a quarterly basis. The agreement was for a term of two years commencing from the date of launch of the co-branded Web site on September 10, 2000. On June 25, 2002, both parties signed an agreement to terminate this strategic co-operation agreement whereby both parties agreed that apart from the non-refundable upfront fee and the four quarterly referral fees that had already been received by the Group, an additional US\$38,000 would be paid by the private auction company to the Group.

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## 8. Property, Equipment and Software

	December 31, 2001	December 31, 2002
Computers	43,937,710	50,163,071
Furniture and office equipment	2,262,944	2,167,062
Software	12,899,639	16,200,568
Vehicles		358,705
Leasehold improvements	3,782,693	5,813,941
	62,882,986	74,703,347
Less: Accumulated depreciation	(26,526,898)	(48,324,165)
Net book value	36,356,088	26,379,182

## 9. Short-term Bank Loans

As of December 31, 2002, there were no short-term bank loans. As of December 31, 2001, short-term bank loans consisted of:

Lender	Period	Annual interest rate	Outstanding principal as of December 31, 2001
China Merchants Bank-loan A	March 2001 to March 2002	5.85%	24,000,000
China Merchants Bank-loan B	April 2001 to April 2002	5.85%	32,000,000
China Merchants Bank-loan C	May 2001 to May 2002	5.85%	28,000,000
			84,000,000

The above loans A and C totaling RMB52.0 million were secured by bank deposits of US\$6.5 million, and the loan B of RMB32.0 million was secured by a bank deposit of US\$4.3 million.

These short-term bank loans were drawn for working capital purposes.

## 10. Employee Benefits

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The full-time employees of those companies within the Group which are established in China are entitled to staff welfare benefits including medical care, welfare subsidies, unemployment insurance and pension benefits, etc. These companies are required to accrue for these benefits based on certain percentages of the employees' salaries in accordance with the relevant regulations. The total provision for such employee benefits amounted to RMB6.2 million, RMB9.6 million and RMB9.8 million for the years ended December 31, 2000, 2001 and 2002, respectively. These companies are also required to make contributions to the state-sponsored pension and medical plans out of the amounts accrued for medical and pension benefits. These contributions for the years ended December 31, 2000, 2001 and 2002 amounted to approximately RMB3.6 million, RMB6.3 million and RMB8.4 million, respectively. The

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Chinese government is responsible for the medical benefits and ultimate pension liability to these employees.

11. Taxation

Income taxes

Cayman Islands

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

British Virgin Islands

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

China

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

NetEase Shanghai and Guangzhou Interactive are both subject to EIT at the rate of 30% plus a local tax of 3%.

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

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	For the year ended December 31,		
	2000	2001	2002
EIT statutory rate	(33.0%)	(33.0%)	33.0%
Permanent differences (primarily the expenses incurred by the Company which are not deductible for EIT purposes)			
Professional fees	1.9%	8.5%	42.0%
Salaries of the Company's senior officers	1.9%	3.1%	40.8%
Class action settlement			87.7%
Depreciation			32.7%
Advertising			9.8%
Technical services			13.0%
Other	7.2%	6.7%	14.7%
Non-deductible share compensation costs	2.7%	0.3%	9.0%
Effect of lower tax rate applicable to hi-tech enterprises	6.7%	6.2%	(168.9%)
Effect of tax holidays applicable to hi-tech enterprises			(140.8%)
Additional valuation allowance on tax loss carry-forwards	12.6%	8.2%	9.8%
Effective EIT rate			(17.2%)

As of December 31, 2001, and 2002, the tax impact of significant temporary differences between the tax and financial statement bases of assets and liabilities that gave rise to deferred tax assets were principally related to the following:

	December 31, 2001	December 31, 2002
Loss carryforwards	39,147,456	19,132,653
Valuation allowance	(39,147,456)	(16,736,765)
Net deferred tax assets		2,395,888

Subject to the approval of the relevant tax authorities, the Group had loss carryforwards of approximately RMB64.8 million as of December 31, 2002 for EIT purposes. Approximately RMB23.2 million, RMB29.5 million and RMB12.1 million of these loss carryforwards will expire in 2005, 2006 and 2007, respectively. A valuation allowance has been provided on the loss carryforwards of the Group due to the uncertainty surrounding the realizability of such assets. There is no assurance that the Group will be able to utilize the loss carryforwards before their expiration.

Income tax benefit shown in the consolidated statement of operations for the year ended December 31, 2002 resulted from the recognition of deferred tax assets arising from tax loss carryforwards for which less than full valuation allowance was made because certain of these tax carryforwards are expected to be utilized in the foreseeable future.



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

## Business tax ( BT )

The Group is subject to BT on the provision of taxable services in China, transfer of intangible assets and the sale of immovable properties in China. The tax rates range from 3% to 20% of the gross receipts, depending on the nature of the revenues. The applicable BT rate for the Group's revenues is generally 5%. In addition, Guangyitong Advertising is subject to a cultural development fee at 3% on its Internet advertising fees, which effectively reduces the revenues the Group derives from Guangyitong Advertising.

## Taxes payable

	December 31, 2001	December 31, 2002
	<u>2001</u>	<u>2002</u>
BT	1,313,896	4,337,428
Individual income taxes for employees	459,035	3,848,253
Other		67,269
	<u>1,772,931</u>	<u>8,252,950</u>

## 12. Accrued Liabilities

	December 31, 2001	December 31, 2002
	<u>2001</u>	<u>2002</u>
Accrued advertising expenses	978,027	808,420
Accrued information fees	1,787,468	1,276,551
Accrued professional fees	3,854,513	3,428,678
Other	4,317,942	4,884,736
	<u>10,937,950</u>	<u>10,398,385</u>

## 13. Subscriptions Receivable

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Subscriptions receivable represents the amount receivable from a shareholder for subscription for the Company's series B preference shares (see Note 14). During the year ended December 31, 2001, the Company also made an allowance for doubtful subscriptions receivable amounting to approximately RMB6.4 million. Such subscriptions receivable arose from advances to certain shareholders for subscription for the Company's shares in 2000.

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### 14. Capital Structure

#### Ordinary shares

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

In November 1999, in consideration for certain members of the senior management joining the Group, the principal shareholder of the Company agreed to transfer a total of 26,271,300 of his ordinary shares in the Company for services to be rendered by certain of those individuals over three years starting from January 1, 2000. The total estimated fair value of these shares, valued at US\$0.05 per share at the date of grant, is recognized as deferred compensation which is to be amortized over the related vesting periods.

In addition, in March 2000 the principal shareholder of the Company transferred an additional approximately 1,900,000 ordinary shares to certain employees, for which the Company recorded compensation costs of approximately RMB2.5 million in 2000.

On March 31, 2000, the ordinary shares in the Company were split on a one-hundred-for-one basis. The effects of the share split have been reflected in the financial statements on a retroactive basis for all the periods presented.

In June 2000, the Company sold 4,500,000 ADS, representing 450,000,000 ordinary shares, in an underwritten initial public offering for net proceeds of approximately US\$64.9 million, before offering expenses. Simultaneously with the closing of the public offering, all 3,000,000 shares of Series A preference shares and 2,560,556 shares of Series B preference shares were converted to ordinary shares on a basis of 100 ordinary shares for one preference share (see below).

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

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

According to a board resolution dated January 23, 2002, the Company agreed to provide two newly hired members of senior management of the Company with 12,322,868 ordinary shares in the Company over a period of 7 months. The total estimated fair value of those shares of RMB0.7

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million (valued at US\$0.006492 per share) at the date of the agreement is recognized as deferred compensation which is being amortized over the related vesting periods.

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Convertible preference shares

Series A preference shares

The Series A preference shares were convertible on a basis of 100 ordinary shares for one preference share. These preference shares were automatically converted upon closing of the public offering of the ordinary shares in the Company in 2000.

The Series A preference shares carried certain preferences on dividend payment and return of capital in case of a winding up of the Company. Written consent of the holders of more than 50% of these preference shares had to be obtained for any acquisition, merger, reorganization, substantial disposal of assets, alteration of capital amounts, disposal of interest in any subsidiary or associate company, and liquidation or winding-up of the Company.

Series B preference shares

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

The Series B preference shares had the same conversion features as the Series A preference shares. The Series B preference shares had an aggregate liquidation preference equal to the total consideration for which they were issued. They carried the same preferences as those of Series A preference shares on dividend payment but had certain preferences over Series A preference shares on return of capital in case of a winding up of the Company. These preference shares were automatically converted upon closing of the public offering of the ordinary shares in the Company in 2000.

The Company also entered into a strategic co-operation agreement with the shareholder of its Series B preference shares which provided for, among other things, advertising spending of US\$5.0 million from the shareholder over the next three years, cross licensing of Internet tools and technologies, licensing of content information, and other co-operative marketing and promotional events on commercial terms to be agreed between the two parties (see Note 19).

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

15. Stock Option Plans



1999 Stock Option Plan

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

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### Employees

Options for the employees vest upon completion of the first full year of service by the respective employees from the date they first joined the Group and expire at the end of the fifth year of their respective service periods.

Of the 3,735,000 ordinary shares granted to employees in 1999 at an exercise price of US\$0.070 per share, options to acquire 740,000, 1,560,000 and 140,000 ordinary shares were cancelled in 2000, 2001 and 2002, respectively, as a result of the resignation of certain employees. Accordingly, options to acquire 1,295,000 ordinary shares remained outstanding as of December 31, 2002.

### Senior management

Options for the members of the Company's senior management become exercisable at the rate of 20% on the vesting commencement date which was September 1, 1999, 20% upon completion of one full year and 30% upon completion of each of the next two full years thereafter. These options will also vest upon the founder of the Group ceasing to be the principal shareholder of the Group.

Of the 115,225,000 ordinary shares granted to senior management in 1999 at an exercise price of US\$0.065 per share, options to acquire 46,858,200, 52,235,300 and 16,131,500 ordinary shares were cancelled in 2000, 2001 and 2002 respectively, as a result of the resignation of certain members of the Company's senior management. Accordingly, no options remained outstanding as of December 31, 2002.

### Advisory board

The Company also granted options to its advisory board members. Twenty percent of these options vested on the date of appointment, which was the end of 1999, and 10% would vest each quarter over the next two years.

Of the 3,000,000 ordinary shares granted to the advisory board members in 1999 at an exercise price of US\$0.065 per share, options to acquire 400,000, 1,600,000 and 1,000,000 ordinary shares were cancelled in 2000, 2001 and 2002, respectively, as a result of the resignation of the advisory board members. Accordingly, no options remained outstanding as of December 31, 2002.

### 2000 Stock Option Plan

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

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

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### Employees

During the year ended December 31, 2000, the Company granted options to acquire a total of 64,720,000 ordinary shares to the Company's employees at an exercise price ranging from US\$0.063 to US\$0.156 per share. Options for those employees who joined the Group in 1999 vest over a period of three years beginning with the completion of the second full year of service by the respective employees. Options for other employees vest over a period of four years beginning with the completion of one full year from the date of grant.

Out of the options granted to employees in 2000, options to acquire 21,755,000, 17,350,000 and 3,838,000 ordinary shares were cancelled in 2000, 2001 and 2002, respectively, as a result of the resignation of certain employees. Options to acquire 21,777,000 ordinary shares remained outstanding as at December 31, 2002.

During the year ended December 31, 2001, the Company granted options to acquire a total of 24,059,000 ordinary shares to the Company's employees at an exercise price of approximately US\$0.022 per share. These options vest over a period of four years beginning with the completion of one full year from the date of grant.

Out of the options granted to employees in 2001, options to acquire 9,366,000 and 1,958,000 ordinary shares were cancelled in 2001 and 2002, respectively, as a result of the resignation of certain employees, and options to acquire 834,200 ordinary shares were exercised in 2002. Options to acquire 11,900,800 ordinary shares remained outstanding as at December 31, 2002.

During the year ended December 31, 2002, the Company granted options to acquire a total of 51,510,000 ordinary shares to the Company's employees at exercise prices ranging from US\$0.007 to US\$0.021 per share. Options for those employees who joined the Company before April 4, 2001 vest over a period of three years beginning with the completion of one full year of service by the respective employees. Options for other employees vest over a period of three years beginning from the date of grant.

Out of the options granted to employees in 2002, options to acquire 5,699,000 ordinary shares were cancelled in 2002 as a result of the resignation of certain employees, and options to acquire 5,407,000 ordinary shares were exercised in 2002. Options to acquire 40,404,000 ordinary shares remained outstanding as at December 31, 2002.

### Senior management

During the year ended December 31, 2000, the Company granted options to acquire a total of 163,424,300 ordinary shares to certain new members of the Company's senior management at exercise prices ranging from US\$0.043 to US\$0.156 per share. These options generally vest over a period of three to four years beginning with the completion of one full year from (i) February 1, 2000, (ii) the date of employment or (iii) the date of offer of employment. The compensation costs were calculated based upon the estimated fair value of the Company's ordinary shares ranging from US\$0.03 per share to US\$0.156 per share during the period from February to December 2000.

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Out of the options granted to senior management in 2000, options to acquire 33,600,000, 92,218,800 and 37,605,500 ordinary shares were cancelled in 2000, 2001 and 2002, respectively, as a result of the resignation of certain members of the Company's senior management. No options remained outstanding as at December 31, 2002.

During the year ended December 31, 2001, the Company also granted options to acquire a total of

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92,225,000 ordinary shares to certain members of the Company's senior management at exercise prices ranging from US\$0.006 to US\$0.155 per share.

Out of the options granted to senior management in 2001, options to acquire 54,175,000 and 5,513,100 ordinary shares were cancelled in 2001 and 2002, respectively, as a result of the resignation of certain members of the Company's senior management, and options to acquire 32,536,900 ordinary shares were exercised in 2002. No options remained outstanding as at December 31, 2002.

During the year ended December 31, 2002, the Company also granted options to acquire a total of 59,000,000 ordinary shares to certain members of the Company's senior management at exercise prices ranging from US\$0.007 to US\$0.015 per share. Options for those senior management who joined the Company before April 4, 2001 vest over a period of three years beginning with the completion of one full year of service by the respective members. Options for other management members vest over a period of three years beginning from the date of grant.

Out of the options granted to senior management in 2002, options to acquire 10,000,000 ordinary shares were exercised in 2002. Options to acquire 49,000,000 ordinary shares remained outstanding as at December 31, 2002.

### Director and consultants

During the year ended December 31, 2000, the Company granted options to acquire a total of 1,200,000 ordinary shares to a director and options to acquire a total of 850,000 ordinary shares to two consultants. These options generally vested over a period of two years beginning on February 1, 2000. The exercise price of these options is US\$0.100 per share. Deferred compensation costs related to these option grants to the director and two consultants in 2000 were approximately RMB1.5 million. The estimated fair value of the options granted to the director and the consultants was estimated on the date of grant using the Black-Scholes option pricing model. The following assumptions were used for the grants: risk-free interest rate of 2.97%; estimated fair value of US\$0.10 per ordinary share; expected dividend yield of 0% for all periods; expected life of five years; and expected volatility of 155% for all periods.

Of these grants to the directors and the consultants, options to acquire 1,200,000 and 700,000 ordinary shares, respectively, remained outstanding as at December 31, 2002. Options to acquire 150,000 ordinary shares granted to one consultant were cancelled in 2000 as a result of the resignation of that consultant.

### Advisory board

In June 2000, the Company granted options to acquire a total of 1,500,000 ordinary shares to a member of the Company's advisory board at an exercise price of US\$0.155 per share. These options vested over a two-year period commencing from the date of grant. Deferred compensation costs related to these option grants was approximately RMB1.8 million, estimated on the date of grant using the Black-Scholes option pricing model. The following assumptions were used for the grants: risk-free interest rate of 2.97%; estimated fair value of US\$0.155 per ordinary share; expected dividend yield of 0% for all periods; expected life of five years; and expected volatility of 155%. In addition, in August 2000, the Company granted options to acquire a total of 2,000,000 ordinary shares to the same advisory board member at an exercise price of US\$0.05 per share to replace the 1,500,000 shares of option granted in June 2000. The terms of the new grants were the same as those of the grants made in June 2000. In this connection, the options to acquire 1,500,000 ordinary shares granted in June 2000 were modified and therefore the modification was subject to an additional compensation cost of approximately RMB0.04 million. Deferred compensation cost related to the

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remaining newly issued 500,000 share options was approximately RMB0.2 million, estimated on the date of grant using the Black-Scholes option pricing

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model. The following assumptions were used for the grants: risk-free interest rate of 2.97%; estimated fair value of US\$0.05 per ordinary share; expected dividend yield of 0% for all periods; expected life of five years; and expected volatility of 155%.

All the above options were cancelled in 2000 and 2001 (3,250,000 in 2000 and 250,000 in 2001, respectively) as a result of the resignation of the advisory board member.

**Deferred Compensation Costs**

In connection with all the above option grants to the employees, senior management, directors, consultants, and advisory board members in 2000, the Company recorded deferred share compensation costs of approximately RMB48.5 million in 2000 and RMBnil in 2001 and RMBnil in 2002, which were to be amortized and charged to expense starting from the grant date and through the end of the vesting periods of the underlying options.

In 2002, approximately RMB2.1 million (2000: RMB13.8 million; 2001: RMB1.5 million) of the deferred compensation costs were amortized and charged to expense and approximately RMB0.1 million (2000: RMB9.8 million; 2001: RMB33.6 million) of the deferred compensation costs were reversed against the additional paid in capital as a result of the resignation of employees, senior management, consultants and advisory board members.

**Summary Information**

Information relating to stock options outstanding is as follows:

	For the year ended December 31,					
	2000		2001		2002	
	Option shares	Weighted average exercise price	Option shares	Weighted average exercise price	Option shares	Weighted average exercise price
	US\$		US\$		US\$	
Outstanding at beginning of year	121,960,000	0.065	248,901,100	0.091	136,430,000	0.074
Granted	233,694,300	0.105	116,284,000	0.017	110,510,000	0.008
Cancelled	(106,753,200)	0.091	(228,755,100)	0.064	(71,885,100)	0.096
Exercised					(48,778,100)	0.010
Outstanding at year end	248,901,100	0.091	136,430,000	0.074	126,276,800	0.028



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As of December 31, 2002, options to purchase 32,010,775 ordinary shares were exercisable. Under the stock option plans, options to purchase 451,662,024 ordinary shares were available for future grant. The fair value of ordinary shares on the dates of stock option grants was determined by management based on the recent issuance of preference shares, consideration of significant milestones achieved by the Group and other market considerations. Options outstanding and exercisable by price range as of December 31, 2002 were as follows:

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Exercise Price	Options Outstanding at December 31, 2002			Options Exercisable at December 31, 2002	
	Number Outstanding	Weighted Average Remaining Contractual	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
		Life			
		Years			US\$
US\$0.007 US\$0.009	82,684,000	3.16	0.007	16,908,000	0.007
US\$0.012 US\$0.015	4,220,000	4.49	0.015		
US\$0.021	2,500,000	4.39	0.021		
US\$0.022	11,900,800	4.08	0.022	1,738,400	0.022
US\$0.070 US\$0.075	3,295,000	2.82	0.073	2,295,000	0.072
US\$0.100	17,767,000	3.21	0.100	9,505,375	0.100
US\$0.155 US\$0.156	3,910,000	3.32	0.156	1,564,000	0.156
	<b>126,276,800</b>	<b>3.32</b>	<b>0.028</b>	<b>32,010,775</b>	<b>0.047</b>

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

	For the year ended December 31,					
	2000		2001		2002	
Risk free interest rate	2.50%	3.30%	2.97%	3.30%	2.91%	
Expected life (in years)	5 10		5 10		5	
Expected dividend yield	0%		0%		0%	
Volatility	142%	155%	122%	155%	104%	108%
Weighted average estimated fair value of the underlying shares on the date of option grants (US\$)	0.128		0.085		0.008	

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## 16. Revenues From E-commerce and Other Services

The following is the summarized information of revenues from e-commerce and other services:

	<u>2000</u>	<u>2001</u>	<u>2002</u>
Wireless value-added services and other fee-based services	2,455,834	14,103,151	160,303,651
Online games			37,053,416
<b>Total</b>	<b>2,455,834</b>	<b>14,103,151</b>	<b>197,357,067</b>

Revenue from wireless value-added services represents revenue earned by the Group for providing technical services to Guangzhou NetEase in relation to its wireless business. Guangzhou NetEase derives SMS revenues from providing value-added services such as friends matching, news and information services, ring-tone and logo downloads and various other related products to mobile phone users in China.

Revenue from other fee-based services represents revenue earned by the Group for providing technical services to Guangzhou NetEase in relation to various value-added services provided by the NetEase Web sites, including dating and friends matching, mail box, personal homepage hosting and online shopping mall, etc.

Revenue from online games represents revenue earned by the Group for providing technical services to Guangzhou NetEase in relation to its online game business. Guangzhou NetEase operates various online games platforms and derives revenue from providing service to its registered game players.

## 17. Net Earnings (Loss) Per Share

The following table sets forth the computation of basic and diluted net earnings (loss) per share for the years ended December 31, 2000, 2001 and 2002:

	<u>2000</u>	<u>2001</u>	<u>2002</u>
<b>Numerator:</b>			
Net profit (loss) attributable to ordinary stockholders	(169,268,799)	(233,163,914)	16,301,638
<b>Denominator:</b>			
Weighted average number of ordinary shares outstanding, basic	2,497,467,200	3,013,419,400	3,051,395,100
Dilutive effect of employee stock options			76,442,800

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Weighted average number of ordinary shares outstanding, diluted	2,497,467,200	3,013,419,400	3,127,837,900
Anti-dilutive effect of stock options	50,164,600	66,845,749	24,972,000
Net earnings (loss) per share, basic	(0.07)	(0.08)	0.01
Net earnings (loss) per share, diluted	(0.07)	(0.08)	0.01

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## 18. Commitments and Contingencies

## Commitments

As of December 31, 2002, future minimum lease and capital commitments were as follows:

	<u>Office rental commitments</u>	<u>Server custody fee commitments</u>	<u>Capital commitments</u>	<u>Total</u>
2003	4,719,333	10,309,500	450,000	15,478,833
2004	3,697,039			3,697,039
2005	2,365,763			2,365,763
	<u>10,782,135</u>	<u>10,309,500</u>	<u>450,000</u>	<u>21,541,635</u>

In the years ended December 31, 2000, 2001 and 2002, the Company incurred rental expenses in the amounts of approximately RMB6.9 million, RMB8.8 million, and RMB7.4 million, respectively.

## Insurance coverage

As of December 31, 2002, the Group had insurance coverage of approximately RMB39.2 million on its property, equipment and software.

As of December 31, 2002, the Company also maintained insurance coverage, which is subject to various restrictions and limitations, for certain claims which are brought against the Company, certain subsidiaries, the attorneys and underwriters for the Company's initial public offering and directors, officers and employees of the Company. The aggregate coverage for all the above mentioned parties under this policy is US\$10.0 million, and the policy expires on June 15, 2003.

## Litigation

## Class Actions

Beginning in October 2001, four substantially identical purported class action complaints alleging violations of the federal securities laws were filed in the United States District Court for the Southern District of New York naming the Company, certain of its current and former officers and directors, and the underwriters of the Company's initial public offering as defendants.

These complaints were subsequently consolidated into a single action. In general, the complaints allege, among other things, that (i) the Company's initial public offering violated the securities laws because the financial statements accompanying the offering's registration statement misstated the Company's revenue; and (ii) the Company committed securities fraud by materially misstating the Company's revenue in its 2000 financial statements.

On August 29, 2002, the parties to the above-referenced litigation entered into a memorandum of understanding for the settlement of this litigation. Subsequently, the plaintiffs in this litigation conducted confirmatory discovery to determine if the settlement is fair, reasonable and adequate. The discovery has been completed, and on January 31, 2003, the parties entered into a stipulation and agreement of settlement.

The court preliminarily approved this settlement on February 25, 2003, and all persons who purchased the

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Company's ADSs during the period from July 3, 2000 to August 31, 2001 were certified as a single class. Subsequently, notice was sent to the class, and the court will hold a hearing before it gives final approval to the settlement. The aggregate settlement amount for all claims in this litigation is US\$4.35 million, which amount has been paid by the Company into an escrow account pending such final court approval and charged to the statement of operations for the year ended December 31, 2002.

If the settlement is not approved by the court or is otherwise terminated by its terms, then, among other consequences, the parties shall revert to their litigation positions as of August 29, 2002. Potential members of the class no longer have the right to opt out of this settlement and pursue their own claims. The Company cannot predict if this settlement will be given final approval.

**Copyright Infringement Lawsuit**

In January 2003, Guangzhou NetEase was named in a copyright infringement lawsuit in China and the plaintiffs claimed damages of US\$1.0 million. The Group intends to vigorously defend its position. Based on the legal advice it has obtained, the Group believes the ultimate resolution of this matter will not have a material financial impact on the Group.

**19. Segment information**

In the third quarter of fiscal 2003, the Group changed the manner of reporting internal departmental information. As such, the Group has restated its 2002 segment disclosures to conform with the change in segments that occurred in the third quarter of 2003. The following are the breakdowns of revenue for the years ended December 31, 2000, 2001 and 2002 and cost of revenue for the year ended December 31, 2002. No comparative information of the breakdown of cost of revenue was presented for the years ended December 31, 2000 and 2001. The Group does not allocate any operating costs or assets to its business segments as management does not use this information to measure the performance of the operating segments.

	<u>2000</u>	<u>2001</u>	<u>2002</u>
<b><u>Revenue</u></b>			
Advertising services	28,015,943	12,656,519	32,498,907
Online games			35,200,743
Wireless value-added and other fee-based services	2,481,275	13,369,018	153,241,602
<b>Total net revenue</b>	<b><u>30,497,217</u></b>	<b><u>26,025,537</u></b>	<b><u>220,941,252</u></b>
<b><u>Cost of revenue</u></b>			
Advertising services			(26,622,426)
Online games			(15,530,501)
Wireless value-added and other fee-based services			(29,524,647)
<b>Total</b>	<b><u>(39,909,419)</u></b>	<b><u>(60,058,488)</u></b>	<b><u>(71,677,574)</u></b>

Gross Profit (loss on revenues)

Advertising services			5,876,481
Online games			19,670,242
Wireless value-added and other fee-based services			(123,716,955)
Total	(9,412,202)	(34,032,951)	149,263,578

20. Subsequent Events

In March 2003, the Company entered into a supplemental agreement to the strategic co-operation agreement with the purchaser of its Series B preference shares described in Note 14. Pursuant to the supplemental agreement, the purchaser of Series B preference shares and its affiliates is obligated to spend the US\$4.0 million on online advertising on the NetEase Web sites by March 28, 2004. All other aspects of the strategic co-operation agreement terminated in March 2003.

(Unaudited)

On May 16, 2003, the court gave its final approval to the definitive settlement agreement entered into between the parties to the litigation referred to in Note 18 Litigation, Class Actions above which provides for a final settlement amount of US\$4.35 million.