SHANDA INTERACTIVE ENTERTAINMENT LTD
Form 20-F
June 29, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 20-F

(Mark One)

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

OR

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

For the fiscal year ended December 31, 2005

OR

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

For the transition period from__________to__________.

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

Date of event requiring this shell company report__________.
For the transition period from__________to__________.

Commission file number: 000-50705

SHANDA INTERACTIVE ENTERTAINMENT LIMITED
(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)

No. 1 Office Building
No. 690 Bibo Road
Pudong New Area
Shanghai 201203, People s Republic of China
(Address of principal executive offices)

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

(Title of each class)	(Name of each exchange on which registered)
None	None

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

American Depositary Shares, each representing 2 ordinary shares, par value $0.01 per share
(Title of each class)

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

None

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: 141,982,766 ordinary shares, par value $0.01 per share.

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

o Yes þ No

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

o Yes þ No

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

þ Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

o Large accelerated filer þ Accelerated filer o Non-accelerated filer

Indicate by check mark which financial statement item the registrant has elected to follow:

o Item 17 þ Item 18

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

o Yes þ No

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Introduction

CONVENTIONS WHICH APPLY TO THIS FORM

Except where the context otherwise requires and for purposes of this form only:

- we, us, our company and our refer to Shanda Interactive Entertainment Limited, its predecessor entities and subsidiaries, and, in the context of describing our operations, also include our PRC-incorporated affiliates, including Shanghai Shanda Networking Co., Ltd., or Shanda Networking, Nanjing Shanda Networking Co., Ltd., or Nanjing Shanda, and Hangzhou Bianfeng Networking Co., Ltd., or Hangzhou Bianfeng;

- in certain instances, Shanda Networking, Nanjing Shanda, and Hangzhou Bianfeng are referred to collectively as our PRC operating companies ;

- in certain instances, Shanda Networking is referred to as Shanghai Shanda Internet Development Co., Ltd. , which is an alternative English translation of its Chinese name;

- China or PRC refers to the People s Republic of China, excluding Taiwan, Hong Kong and Macau; and

- all references to RMB or Renminbi are to the legal currency of China and all references to U.S. dollars, dollars and US$ are to the legal currency of the United States.

This form contains translations of Renminbi amounts into U.S. dollars at specified rates solely for the convenience of the reader. Unless otherwise noted, all translations from Renminbi to U.S. dollars were made at the noon buying rate in The City of New York for cable transfers in Renminbi per U.S. dollar as certified for customs purposes by the Federal Reserve Bank of New York, or the noon buying rate, as of December 30, 2005 which was RMB8.0702 to US$1.00. We make no representation that the Renminbi amounts referred to in this form could have been or could be converted into U.S. dollars at any particular rate or at all. On June 26, 2006, the noon buying rate was RMB 7.9995 to US$1.00.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This form contains forward-looking statements that are based on our current expectations, assumptions, estimates and projections about us and our industry. All statements other than statements of historical fact in this form are forward-looking statements. These forward-looking statements can be identified by words or phrases such as may , will , expect ,

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anticipate , estimate , plan , believe , is/are likely to or other similar expressions. The forward-looking statements included in this form relate to, among others:

- our goals and strategies;
- our future business development, financial condition and results of operations;
- our projected revenues, earnings, profits and other estimated financial information;
- expected changes in our margins and certain costs or expenditures;
- expected acceptance of our new revenue model;
- our plans to expand and diversify the sources of our revenues;
- expected changes in the respective shares of our revenues from particular sources;
- our plans for staffing, research and development and regional focus;
- the projected economic lifespan of our current games, and our plans to launch games and to develop new games in-house or license additional games from third parties, including the timing of any such launches, development or licenses;
- our plans to launch new products, including the new EZ series products, EZ content and services, movies and music content;
- our plans for strategic partnerships with other businesses;
- our acquisition strategy, and our ability to successfully integrate past or future acquisitions with our existing operations;
- our estimates of earn-out payments and other obligations relating to our acquisitions and investments;
- the development of other delivery platforms for online games and other interactive entertainment content and services, including the new EZ series products, online game consoles and mobile phones;
- competition in the PRC online game industry;
- the outcome of ongoing, or any future, litigation or arbitration;
- the outcome of our annual PFIC evaluations;
- the expected growth in the number of Internet and broadband users in China, growth of personal computer penetration and developments in the ways most people in China access the Internet;

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changes in PRC governmental preferential tax treatment and financial incentives we currently qualify for and expect to qualify for; and

PRC governmental policies relating to media and the Internet and Internet content providers and to the provision of advertising over the Internet.

These forward-looking statements involve various risks and uncertainties. Although we believe that our expectations expressed in these forward-looking statements are reasonable, we cannot assure you that our expectations will turn out to be correct. Our actual results could be materially different from and worse than our expectations. Important risks and factors that could cause our actual results to be materially different from our expectations are generally set forth in the Risk Factors section of Item 3 and elsewhere in this form.

The forward-looking statements made in this form relate only to events or information as of the date on which the statements are made in this form. We undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date on which the statements are made or to reflect the occurrence of unanticipated events.

Item 1. Identity of Directors, Senior Management and Advisors

Not Applicable

Item 2. Offer Statistics and Expected Timetable

Not Applicable

Item 3. Key Information

A. SELECTED FINANCIAL DATA

The following summary consolidated financial information has been derived from our consolidated financial statements included elsewhere in this annual report and from consolidated financial statements previously filed with the United States Securities and Exchange Commission, or the SEC. The summary consolidated financial information for those periods and as of those dates should be read in conjunction with those statements and the accompanying notes and the discussion set forth in Item 5, Operating and Financial Review and Prospects .

Our consolidated financial statements are prepared and presented in accordance with generally accepted accounting principles in the United States, or U.S. GAAP, reflect our recent reorganization, and have been prepared as if our current corporate structure had been in existence throughout the relevant periods.

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	For the year ended December 31,					
	2001	2002	2003	2004	2005	
	RMB	RMB	RMB	RMB	RMB	US$[1]
	(in thousands)					
Consolidated Statements of Operations and Comprehensive Income Data						
Net revenues:						
Online game net revenues:						
MMORPGs	3,871	326,127	580,315	994,664	1,255,341	155,552
Casual			8,313	214,513	402,968	49,933
Other revenues	681	94	11,352	89,548	238,302	29,529
Total net revenues	4,552	326,221	599,980	1,298,725	1,896,611	235,014
Cost of revenue	(1,970)	(122,081)	(233,701)	(471,184)	(614,427)	(76,134)
Gross profit	2,582	204,140	366,279	827,541	1,282,184	158,880
Operating expenses	(8,917)	(41,516)	(153,106)	(316,579)	(660,285)	(81,818)
Income (loss) operations	(6,335)	162,624	213,173	510,962	621,899	77,062
Interest income and investment income	205	1,112	13,531	63,171	23,127	2,866
Amortization of convertible debt issuance cost				(3,524)	(18,492)	(2,291)
Other income (expense), net	(18)	(1,371)	61,152	83,656	174,903	21,672
Income (loss) before income tax benefits (expenses), equity in loss of affiliated companies, minority interests extraordinary gain	(6,148)	162,365	287,856	654,265	801,437	99,309
Income tax benefits (expenses)	87	(23,077)	(18,647)	(38,941)	(96,711)	(11,984)
Equity in loss of affiliated companies				(4,180)	(544,268)	(67,441)
Minority interests	4,781		3,641	(1,661)	4,825	597
Extraordinary gain arising from acquisition of a company	4,516					

Net income	3,236	139,288	272,850	609,483	165,283	20,481

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	For the year ended December 31,					
	2001	2002	2003	2004	2005	
	RMB	RMB	RMB	RMB	RMB	US$[1]
	(in thousands except for per share data)					
Earnings per Share Data:						
Accretion for preferred shares			(24,963)			
Income attributable to preferred shareholders			(48,358)	(82,479)		
Income attributable to ordinary shareholders	3,236	139,288	199,529	527,004	165,283	20,481
Earnings per share, basic	0.03	1.39	2.14	4.32	1.17	0.14
Earnings per share, diluted	0.03	1.39	2.07	4.05	1.13	0.14
Earnings per ADS[2], basic	0.06	2.78	4.28	8.64	2.34	0.28
Earnings per ADS[2], diluted	0.06	2.78	4.14	8.10	2.26	0.28

	As of December 31,					
	2001	2002	2003	2004[4]	2005	
	RMB	RMB	RMB	RMB	RMB	US$[1]
	(in thousands)					
Consolidated Balance Sheets Data:						
Cash and cash equivalents	7,791	177,040	598,922	3,123,971	949,622	117,670
Working capital[3]	1,841	99,080	459,445	3,200,918	2,742,420	339,821
Total assets	16,300	404,695	928,978	4,291,164	4,470,453	553,945
Total liabilities	9,353	258,629	303,661	2,774,386	2,829,205	350,574
Minority interests			2,716	6,879	3,389	420
Total shareholders equity	6,947	146,066	622,601	1,509,899	1,637,859	202,951

1 Translations of RMB amounts into U.S. dollars were made at a rate of RMB8.0702 to US$1.00, the noon buying rate in New York City for cable transfers as certified for

customs purposes by the Federal Reserve Bank of New York on December 30, 2005.

[2] Each ADS represents two ordinary shares.

[3] Working capital represents total current assets less total current liabilities.

[4] Certain reclassifications have been made to the consolidated financial statements of the year ended December 31, 2004 to conform to the current year presentation.

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EXCHANGE RATE INFORMATION

The following table sets forth information regarding the noon buying rates in Renminbi and U.S. dollars for the periods indicated.

	Renminbi per U.S. Dollar Noon Buying Rate			
	Average	High	Low	Period End
2001	8.2770	8.2786	8.2676	8.2766
2002	8.2770	8.2800	8.2669	8.2800
2003	8.2770	8.2800	8.2272	8.2769
2004	8.2770	8.2773	8.2765	8.2765
2005	8.1826	8.2765	8.0702	8.0702

	Renminbi per U.S. Dollar Noon Buying Rate	
	High	Low
December 2005	8.0808	8.0702
January 2006	8.0702	8.0596
February 2006	8.0616	8.0415
March 2006	8.0505	8.0167
April 2006	8.0248	8.004
May 2006	8.03	8.0005

Source: Federal Reserve Bank of New York

On June 26, 2006, the noon buying rate was RMB7.9995 to US$1.00.

B. CAPITALIZATION AND INDEBTEDNESS

Not Applicable

C. REASONS FOR THE OFFER AND USE OF PROCEEDS

Not Applicable

D. RISK FACTORS

Risks Relating to our Business

We are substantially dependent on two online games, which accounted for approximately 63.4% of our net revenues in 2005 and which may have a finite commercial lifespan.

We are dependent upon The Legend of Mir II, or Mir II, and The World of Legend, or Woool, for the majority of our revenue. In 2005, Mir II and Woool accounted for approximately 35.3% and 28.1% of our net revenues, respectively. These and other online games may, however, have finite commercial lifespans. We believe that Mir II, which we commercially launched in the fourth quarter of 2001, has already entered the mature stages of its lifecycle. Woool, which we commercially

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launched in the fourth quarter of 2003, may also be entering the mature stages of its lifecycle. We believe that the revenue generated by Mir II and Woool will generally continue to decline but may fluctuate in absolute amounts as the games continue to age and as we and our competitors release new games on the market. Nonetheless, we expect to continue to derive a substantial portion of our net revenues from Mir II and Woool through at least 2006. Accordingly, our business, financial condition and results of operations would be materially and adversely affected by any occurrence that leads to a more rapid decline in revenue generated by Mir II and Woool, including but not limited to:

any reduction in purchases of in-game items or value-added services by Mir II or Woool users or any decrease in the popularity of either game in the China market due to intensifying competition or other factors;

loss of our rights to operate either of these games due to a termination of necessary licenses or other reasons;

failure to make improvements, updates or enhancements to Mir II or Woool in a timely manner; or

any lasting or prolonged server interruption due to network failures or other factors or any other adverse developments specific to Mir II or Woool.

If we are unable to consistently license or develop additional successful online games, our business, financial condition and results of operations may be materially and adversely affected.

In order to maintain our long-term profitability and operational success, we must continually license or develop new online games that are attractive to our users to replace our existing online games as they reach the end of their commercial lifespan, which we believe is typically four to five years for successful online games, and two to three years for most other online games.

Our ability to license successful online games will depend on our ability to identify games that will appeal to our users, the availability of such games at acceptable costs, our ability to compete effectively to attract the licensors of such games, and our ability to obtain government approvals required for the licensing and operation of such games. It is, however, difficult at the testing phase to determine which online games will appeal to our users. In addition, many of the games that are licensed by overseas developers were not designed specifically for China s online game market, further complicating the task of identifying or implementing games that will appeal to our users. Moreover, due to increased competition among online game operators in China, upfront license fees for licensed games have increased and some licensors are demanding guaranteed minimum royalty payments. We may be unable to fully recover upfront and minimum royalty licensing costs if a licensed game is not popular among users. In 2006, for example, we expect to commercially launch Dungeons and Dragons Online, an MMORPG based upon a well-known American role playing board game. Dungeons and Dragons Online is not, however, as well-known in China as in the United States and the online version of the game, which was designed primarily for the North American market, may not be popular among Chinese online game players.

Our ability to internally develop successful online games will depend on our ability to anticipate changing consumer tastes and preferences, to adopt new technologies, to attract, retain and motivate talented online game developers and to effectively execute online game development plans. Internal online game development requires substantial initial investment prior to commercial launch of the games as well as a significant commitment of future resources to produce upgrades and expansion packs. As with the licensing costs for third-party games, we may be unable to fully recover development costs if the games are not popular among users.

We cannot be certain that the games we license from third parties or internally develop will be attractive to users, will be viewed by the regulatory authorities as complying with content restrictions, will be launched as scheduled or will be able to compete with games operated by our competitors. If we are not able to consistently license or develop online games with continuing appeal to users, our future profitability and growth prospects will decline.

If we are unable to maintain stable relationships with the overseas licensors of our online games, we may experience difficulties in the continued operation of our existing licensed games, the extension of existing licenses and the granting of licenses for new games.

We need to maintain stable working relationships with our overseas licensors in order to ensure the continued smooth operation of our licensed online games and our continued access to new online game licenses. In 2005, we derived approximately 55.1% of our net revenues from online games that were licensed from third parties. We are dependent upon our licensors for the provision of technical support necessary for the operation of the licensed games as well as expansion packs and upgrades that help to sustain interest in a game among online users. In addition, certain marketing activities often require the consent of our licensors. Moreover, certain of our licenses may be terminated upon the occurrence of certain events, such as our material breach of the license. If a licensed game is successful during its initial term of operation, we may be required to negotiate with our licensors to extend that term of operation. Our ability to maintain stable working relationships with our overseas licensors also influences our ability to license new online games developed by the same or other licensors. If we are unable to maintain stable relationships with our overseas licensors, our financial condition and results of operations may be materially and adversely affected.

We or our licensors may be subject to intellectual property infringement claims, which may force us to incur substantial legal expenses and, if determined adversely against us or our licensors, may materially disrupt our business. In particular, we are currently subject to copyright infringement and unfair competition claims by Wemade and Actoz with respect to Woool, which if determined adversely against us, could cause us to stop operating Woool.

We cannot be certain that internally developed or licensed online games and other interactive entertainment content do not and will not infringe upon patents, copyrights, trademarks or other intellectual property rights held by third parties. Of the twelve games that we commercially operated as of December 31, 2005, six are internally developed and six are licensed form third parties. In connection with our EZ initiative, we also cooperate with numerous service and content providers that supply interactive entertainment content, such as movies, music, news and information. We or any of our licensors may become subject to legal proceedings and claims from time to time relating to the intellectual property of others. If we or our licensors are found to have violated the intellectual property rights of others, we may be required to pay damages and be enjoined from using such intellectual property, and we may incur new or additional licensing fees if we wish to continue using the infringing content, or be forced to develop or license alternatives. In addition, we may incur substantial expenses in defending against these third party infringement claims, regardless of their merit.

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On October 8, 2003, Wemade Entertainment Co., Ltd. (Wemade) filed claims against us in the Beijing First Intermediate People s Court, or the Beijing Court, with respect to our operation of Woool. Wemade has alleged, among other things, that Woool copied Mir II and elements of the Legend of Mir III, or Mir III, which is another online game that Wemade developed, thereby infringing Wemade s copyrights in these games. In addition, Wemade has alleged that our operation of Woool violates the PRC Anti-Unfair Competition Law. In particular, Wemade has alleged that the Chinese name for Woool, which includes two characters from the Chinese name for Mir II, misleads users and that we previously encouraged users to switch from Mir II to Woool by permitting the transfer of game characters developed in Mir II to Woool. Wemade has requested the Beijing Court to, among other things, order us to stop our operation of Woool, and to pay its legal fees and related costs incurred in connection with this litigation. On May 24, 2004, the Beijing Court informed us that Actoz Soft Co., Ltd. (Actoz) had been joined as a co-plaintiff in these proceedings. On October 14, 2005, the Beijing Court completed a series of hearings in connection with this matter and the parties are now awaiting a decision from the Beijing Court.

If the Beijing court determines that we have violated the Mir II or Mir III copyrights, we may be required to pay damages as well as the plaintiffs legal fees and related costs, each of which may be material. In addition, we may be required to modify portions of Woool or to completely cease operation of Woool, which accounted for approximately 28.1% of our net revenues in 2005. Furthermore, if the Beijing Court determines that we have violated the PRC Anti-Unfair Competition Law, we may be required to modify the Chinese name for Woool. Any lapse in our right to operate Woool in China, or any modifications to the game itself, as a result of this litigation, may have a material adverse effect on our business, financial condition and results of operations.

Negative publicity in China regarding online games could lead to additional government regulations that may have a material and adverse impact on our business, financial condition and results of operations.

The media in China has reported incidents of violent crimes allegedly inspired by online games, including theft of online game virtual items among users. In addition, incidences of excessive online game playing and allegations that online games distract students and interfere with their education have also been reported in the media. This negative publicity regarding the online game industry has led to several regulatory initiatives and could lead to additional regulation in the future. For example, in July 2005, the Ministry of Culture and the Ministry of Information Industry jointly issued an opinion which requires online game operators to develop systems and softwares for indentity certification, to implement anti-addiction modifications to game rules and to restrict players under eighteen years of age from playing certain games. In August 2005, for example, the State Administration of Press and Publications, or SAPP, proposed an online game anti-addiction system that would have reduced and eliminated experience points that a user can accumulate after three and five hours of consecutive playing, respectively. In March 2006, SAPP amended its proposal to require players to register with their real names and identity card numbers and to apply the anti-addiction system only to players under eighteen years of age. Although the proposal has not yet been formally adopted and compliance is not yet compulsory for online game operators, these and other regulations may be implemented in response to negative publicity and such regulations could have a material and adverse impact on our business, financial condition and results of operations.

We face significant competition which could reduce our market share and adversely affect our business, financial condition and results of operations.

The online game market in China is increasingly competitive. Our results of operations to date may be a result, in part, of a first-mover advantage which may not continue to be available to us. A significant number of competitors have entered the online game business in China. We expect more companies to enter the market and we expect a wider range of online games to be introduced to the China market. Competition from other online game operators, both based in China as well as overseas, is likely to increase in the future. Other online game operators or developers, such as China-based Netease and The9, as well as overseas-based Electronic Arts and NCsoft, are current, or potential future, competitors. As the online game industry in China is relatively new and constantly evolving, our current or future competitors may compete more successfully as the industry matures. In particular, any of these competitors may offer products and services that provide significant performance, price, creativity or other advantages over those offered by us. These products and services may weaken the market strength of our brand name and achieve greater market acceptance than ours. Furthermore, any of our current or future competitors may be acquired by, receive investments from or enter into other commercial relationships with, larger, well-established and well-financed companies and therefore obtain significantly greater financial, marketing and game licensing and development resources than we have. In addition, increased competition in the online game industry in China could make it difficult for us to retain existing users and attract new users. Moreover, game consoles that have achieved significant successes in markets other than China have not yet formally entered the market in China due to regulatory and other concerns. If these game consoles, many of which are strengthening their online game features, formally enter the market in China, we would face additional competition. We also compete with other forms of entertainment, such as television and movies. If we are unable to compete effectively in China s online game market as well as China s entertainment market, our business, financial condition and results of operations could be materially and adversely affected.

We may not be able to successfully implement our growth strategies, including our EZ initiative, which may materially and adversely affect our business, financial condition and results of operations.

In 2005, as part of our transition from a pure online game operator to an interactive entertainment media company, we introduced the EZ initiative as an integral part of our home strategy. The EZ initiative involves broadening our interactive entertainment services and content offerings as well as introducing new media platforms over which to deliver our expanded service and content offerings to end users. Our EZ initiative includes introducing new products and services for which there are no established markets. Our ability to successfully implement our EZ initiative will depend upon our success in educating consumers on the value of these new products and services. Many consumers in China may, nonetheless, regard some of the new products as too expensive. In addition, we lack experience and expertise with respect to some of the EZ series products and services. For example, we do not have experience or expertise in distribution, marketing, inventory management or warranty support for consumer electronic products. Although in executing the EZ initiative we will cooperate with consumer electronics manufactures that do have such experience and expertise, our lack of such knowledge internally may prove to be a material disadvantage. We cannot assure you that we will be able to deliver the new EZ series products and services on a commercially viable basis or in a timely manner, or at all. Moreover, execution of the EZ initiative requires a significant amount of managerial time and energy. Pursuit of the EZ initiative, and other growth strategies, may divert senior management s focus away from our core online game business to the detriment of such business. If we are unable to successfully implement our growth strategies, our revenue and profitability will not grow as we expect, which may have a material and adverse effect on our business, financial condition and results of operations.

The recent change to the revenue model for our leading MMORPGs may reduce the amount of revenue that otherwise would have been generated by these games, thereby negatively affecting our financial condition and results of operations.

In late November 2005, we replaced the pay-to-play revenue model with a free-to-play and pay-for in-game value-added services revenue model for three of our leading MMORPGs: Mir II, Woool and Magical Land. Going forward, we will consider adopting this new revenue model for our other existing MMORPGs, depending on the game type and lifecycle. We have also adopted this revenue model for our casual games. Under the new model, end users are able to play the basic functions of these MMORPGs for free and may choose to purchase in-game value-added services, including certain in-game items and premium features, which enhance the game experience. Unaudited revenue generated by these three MMORPGs declined from RMB 320.2 million in the third quarter of 2005, to RMB 220.9 million in the fourth quarter of 2005, to RMB 216.8 million in the first quarter of 2006. Unaudited deferred revenues, which represents cash received from the purchase of pre-paid cards that have not yet been used to play our games or purchase in-game items and value-added services, declined from RMB 267.2 million in the third quarter of 2005, to RMB 172.5 million in the fourth quarter of 2005 and increased to RMB 206.0 million in the first quarter of 2006. Although we believe that adopting this new revenue model will benefit our company in the long run, we cannot assure that the new revenue model will be successful, or that it will not have a negative impact on our financial condition and results of operations. Any material reduction in revenue would have a material and adverse affect on our financial condition and results of operations.

There are risks associated with our pursuit of growth through acquisitions and strategic investments.

In recent years we have pursued, and in the future we may continue to pursue, growth through acquisitions and strategic investments. We acquired or invested in eight businesses in 2004 and 2005 with a total value of US$421.0 million. In May 2005, we completed the second step of a two-step acquisition of Shanghai Haofang Online Information Technology Co., Ltd., or Haofang, at a total purchase price of US$56.0 million. In February 2005, we completed our purchase of an approximately 19.5% stake in Sina Corp, or Sina, at a total purchase price of US$227.6 million. In February 2005, we also completed the purchase of a 29% stake in Actoz, increasing our total stake to approximately 38.1%, at a total purchase price at US$106.1 million. In July 2004, we acquired Hangzhou Bianfeng Software Co., Ltd., or Bianfeng, at a total purchase price of US$20.0 million. For more information on our acquisitions, see Recent Acqusitions in Item 5 Operating and Financial Review and Prospects and History and Development of the Company in Item 4 Information on the Company . These acquired or invested companies operate businesses that complement our core online game business or represent related but new lines of business. We may, however, fail to realize the synergies contemplated at the time of executing these transactions, which could negatively impact our financial condition and results of operations. For example, we completed the purchase of our controlling stake in Actoz, the co-owner of Mir II, in February 2005, for a total consideration of RMB878.0 million (US$106.1 million), which represented an 81% premium over the open market price at the time that we entered into the purchase agreement in October 2004. In the fourth quarter of 2005, however, we recorded a non-cash impairment charge of RMB521.5 million (US$64.6 million) to reflect the fair value of our 38.1% stake in Actoz. We recognized the impairment charge primarily as a result of the continued decline in royalties payable to Actoz from our operation of Mir II in China. The decision to recognize impairment was also influenced by the decline in market price for shares of Actoz, which in the fourth quarter of 2005 was determined to be other than temporary, mainly due to the continued decline in Mir II royalties. Additional risks associated with acquisitions and strategic investments include the following:

It may be difficult to assimilate the operations and personnel of an acquired business into our own business;

Management information and accounting systems of an acquired business must be integrated into our current systems;

Our management must devote its attention to assimilating the acquired business, which diverts attention from other business concerns; and

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We may be unable to complete transactions that we initiate.

We cannot assure you that we will have the ability to effectively integrate the operation of the acquired companies into our own and achieve the synergies contemplated at the time of entering into these transactions. If we are unable to achieve the synergies contemplated at the time of acquiring these businesses, the carrying value of the acquired companies may not be recoverable. We are required by U.S. GAAP to review the impairment at least on an annual basis. If an impairment is determined and charged to the earnings in our financial statements, our financial condition and results of operations may be materially and adversely affected.

There have been historical deficiencies with our internal controls, including material weaknesses, and our internal controls require significant improvement. If we fail to maintain an effective system of internal controls, we may be unable to accurately report our financial results or prevent fraud or restatement of previously reported financial results, and investor confidence and the market price of our ADSs may be adversely impacted.

In the course of their audit of our 2005 operating results, our auditors identified a number of control deficiencies. The substantial majority of these control deficiencies constituted material weaknesses and significant deficiencies in the design or operation of our internal controls that, in our management and independent auditors judgment, could adversely affect our ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. For a description of these deficiencies and material weaknesses, see Item 15 Controls and Procedures .

We must continue to improve our internal controls. If we fail to timely implement solutions to these control deficiencies and other weaknesses in our internal controls or fail to maintain an effective system of internal controls in the future, we may be unable to accurately report our financial results or prevent fraud or prevent potential restatements of or adjustments to previously reported or announced operating results and investor confidence and the market price of our ADSs may be adversely impacted.

In addition, at the end of 2006, we will become subject to Section 404 of the Sarbanes-Oxley Act of 2002 with respect to the evaluation of the effectiveness of our internal control over financial reporting. We cannot be certain as to the timing of completion of our evaluation, testing and any remedial actions with respect to our internal control over financial reporting or the impact of the same on our operations. If we fail to implement the requirements of Section 404 in a timely manner or with adequate compliance, our independent auditors may be unable to provide a written attestation as to the effectiveness of our internal controls over financial reporting and we may be subject to sanctions or investigation by regulatory authorities, such as the Securities and Exchange Commission. As a result, there could be a negative reaction in the financial markets due to a loss of confidence in the reliability of our financial statements. In addition, we may be required to incur significant costs in improving our internal control system and the hiring of additional personnel. Any such action could increase our costs relative to our revenues, thereby reducing our operating margins and could negatively affect the market price of our ADSs.

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Operation of pirate game servers and the expenses incurred in protecting our intellectual property rights, may adversely affect our business.

We continue to face challenges from pirate game servers, which are game servers that operate unauthorized copies of our online games and permit users to play those games without purchasing pre-paid game cards from us. We have detected the operation by pirate servers of unauthorized copies of various of our leading games. In September 2002, for example, we discovered that the server-end software of Mir II was unlawfully released into the China market. This software leak enabled unauthorized third parties to set up local server networks to operate Mir II, which we believe continue to divert a significant number of users of one of our most popular online games away from us. Although we have made efforts to shutdown pirate servers across China, the intellectual property enforcement regime in China is not as robust as that of the United States, and we continue to face considerable challenges when attempting to enforce our intellectual property rights. Enforcement actions generally require cooperation from local authorities, which are not always willing to use their limited resources to enforce the intellectual property rights of national corporations against individuals or companies in their districts. In addition, detailed comparisons of software codes and litigation proceedings are often necessary to enforce our intellectual property rights, which sometimes result in substantial costs. Despite our efforts to shutdown pirate servers, we believe that a significant number of pirate game servers continue to operate unauthorized copies of our online games. The continued operation of our leading games by pirate game servers, or the operation of any new games that we may introduce by pirate servers, may materially and adversely affect our business, financial condition and results of operations.

Undetected programming errors or defects in our games and the proliferation of cheating programs could materially and adversely affect our business, financial condition and results of operations.

Our games may contain undetected programming errors or other defects. In addition, parties unrelated to us may develop Internet cheating programs that enable our users to acquire superior features for their game characters that they would not have otherwise. Furthermore, certain cheating programs could cause the loss of a character s superior features acquired by a user. The occurrence of undetected errors or defects in our games, and our failure to discover and disable cheating programs affecting the fairness of our game environment, could disrupt our operations, damage our reputation and detract from the game experience of our users. As a result, such errors, defects and cheating programs could materially and adversely affect our business, financial condition and results of operations.

Unexpected network interruptions, security breaches or computer virus attacks could have a material adverse effect on our business, financial condition and results of operations.

Any failure to maintain the satisfactory performance, reliability, security and availability of our network infrastructure may cause significant harm to our reputation and our ability to attract and maintain users. We maintain a distributed server network architecture with third party service providers hosting servers in more than one hundred cities throughout China. Most of the servers handling log in, and all servers handling billing and data backup matters for us, are hosted and maintained by third party service providers in Shanghai. We do not maintain full backup for our server network hardware. Major risks involved in such network infrastructure include:

- any break-downs or system failures resulting in a sustained shutdown of all or a material portion of our servers, including failures which may be attributable to sustained power shutdowns, or efforts to gain unauthorized access to our systems causing loss or corruption of data or malfunctions of software or hardware; and

- any disruption or failure in the national backbone network, which would prevent our users outside Shanghai from logging on to any of our games or other content, or playing the games, for which the servers are all located in Shanghai.

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In the past, our server network has experienced unexpected outages for several hours and occasional slower performance in a number of locations in China as a result of failures by third party service providers. Our network systems are also vulnerable to damage from fire, flood, power loss, telecommunications failures, computer virus, hackings and similar events. Any network interruption or inadequacy that causes interruptions in the availability of our games or deterioration in the quality of access to our games could reduce our users satisfaction. In addition, any security breach caused by hacking, which involve efforts to gain unauthorized access to information or systems, or to cause intentional malfunctions or loss or corruption of data, software, hardware or other computer equipment, and the inadvertent transmission of computer viruses could have a material adverse effect on our business, financial condition and results of operations. We do not maintain insurance policies covering losses relating to our systems and we do not have business interruption insurance.

Any failure to maintain a stable and efficient distribution and payment network could have a material and adverse impact on our business, financial condition and results of operations.

Online payment systems in China are in a developmental stage and are not as widely available or acceptable to consumers in China as in the United States. As a result, we rely heavily on a multi-layer distribution and payment network composed of third party distributors for our sales to, and collection of payment from, our users. As we do not enter into long-term agreements with any of our distributors, we cannot assure you that we will continue to maintain favorable relationships with them. If we fail to maintain a stable and efficient distribution and payment network, our business, financial condition and results of operations could be materially and adversely affected.

The limited use of personal computers in China and the relatively high cost of Internet access with respect to per capita gross domestic product may limit the development of the Internet in China and impede our growth.

Although the use of personal computers in China has increased in recent years, the penetration rate for personal computers in China is much lower than in the United States. In addition, despite a decrease in the cost of Internet access in China due to a decrease in the cost of personal computers and the introduction and expansion of broadband access, the cost of personal Internet access, in contrast with Internet access through Internet cafes, remains relatively high in comparison to the average per capita income in China. The limited use of personal computers in China and the relatively high cost of personal Internet access may limit the growth of our business. Furthermore, any Internet access or telecommunications fee increase could reduce the number of users that play our online games.

Our business could suffer if we do not successfully manage our growth.

Our recent growth has placed significant strain on our management, operational, financial and other resources. For example, the total number of our employees increased from 562 as of December 31, 2003 to 1429 as of December 31, 2004, and to 2392 as of December 31, 2005. In addition, certain of our directors, officers and key employees that have recently joined our company will need time to learn our business and successfully integrate themselves into our company. In addition, as a result of our growth we need to continue to develop and expand our financial and management controls and our reporting systems and procedures. We cannot assure you that we will be able to efficiently or effectively manage the growth of our operations, and any failure to do so may limit our future growth and materially and adversely affect our business, financial condition and results of operations.

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We depend on our key personnel, and our business and growth prospects may be severely disrupted if we lose their services.

Our future success is heavily dependent upon the continued service of our key executives and other key employees. In particular, we rely on the expertise, experience and leadership ability of Tianqiao Chen, our founder, controlling shareholder and chief executive officer, in our business operations, and rely on his personal relationships with our employees, the relevant regulatory authorities, our game and service suppliers and Shanda Networking. We also rely on a number of key technology officers and staff for the development and operation of our online games. In addition, as we expect to focus increasingly on the development of our own online games, we will need to continue attracting and retaining skilled and experienced online game developers to maintain our competitiveness.

If one or more of our key personnel are unable or unwilling to continue in their present positions, we may not be able to easily replace them and may incur additional expenses to recruit and train new personnel, our business could be severely disrupted, and our financial condition and results of operations could be materially and adversely affected. Furthermore, since our industry is characterized by high demand and intense competition for talent, we may need to offer higher compensation and other benefits in order to attract and retain key personnel in the future. We cannot assure you that we will be able to attract or retain the key personnel that we will need to achieve our business objectives. Furthermore, we do not maintain key-man life insurance for any of our key personnel.

The discontinuation of any of the preferential tax treatments or the government financial incentives currently available to us in the PRC could materially and adversely affect our business, financial condition and results of operations.

Certain of our PRC companies, including Shengqu, Shanda Networking, Hangzhou Bianfeng and Nanjing Shanda, enjoy preferential tax treatments, in the form of reduced tax rates or tax holidays, provided by the PRC government or its local agencies or bureaus. These four subsidiaries, Shengqu, Shanda Networking, Hangzhou Bianfeng and Nanjing Shanda benefit from a 15% preferential income tax rate. In addition, Shengqu was granted an income tax exemption for 2003 and 2004, followed by a three year tax holiday during which it is subject to a 7.5% preferential income tax rate; Hangzhou Bianfeng was granted an income tax exemption in the second quarter of 2006 for 2005; and Nanjing Shanda was granted an income tax exemption in the third quarter of 2005 for 2005 and 2006. After receiving approval for tax exemption treatment, income tax already paid in 2005 by Hangzhou Bianfeng and Nanjing Shanda prior to receipt of approval has been refunded in the second quarter of 2006 and in the third quarter of 2005, respectively. As a result of these preferential tax treatments, our effective income tax rate for 2005 was 12.1%. Nanjing Shanda must continue to meet a number of financial and non-financial criteria to qualify as a new high technology company for its current and future tax holidays.

In 2004 and 2005 we also received aggregate government financial incentives of RMB88.1 million and RMB137.3 million (US$17.0 million), respectively, which were calculated with reference to taxable revenue and taxable income. For Shengqu and Shanda Networking, these incentives have a term of 3 years with respect to incentives granted with reference to taxable revenue on which we pay business tax and 8 years for incentives granted with reference to taxable income on which we pay income tax. Eligibility for the government financial incentives we receive requires that we continue to meet a number of financial and non-financial criteria and our continued qualification is further subject to the discretion of the municipal government. Moreover, the central government or municipal government could determine at any time to immediately eliminate or reduce these government financial incentives, generally with prospective effect. If we had not received these government financial incentives in 2004, our income before income tax expenses, equity in loss of affiliated companies, and minority interests would have been RMB566.2 million, a decrease of 13.5% from the reported amount. If we had not received these government financial incentives in 2005, our income before income tax expenses, equity in loss of affiliated companies, and minority interests would have been RMB664.1 million (US$82.3 million), a decrease of 17.1% from the reported amount. As the receipt of these government financial incentives are subject to periodic time lags and inconsistent municipal government practice on payment times, for so long as we continue to receive these government financial incentives, our net income in a particular quarter may be higher or lower relative to other quarters based on the potentially uneven receipt by us of these government financial incentives in addition to any business or operating related factors we may otherwise experience.

We cannot assure you that we will continue to enjoy these preferential tax treatments or government financial incentives in the future. The discontinuation of these preferential tax treatments or government financial incentives could materially and adversely affect our business, financial condition and results of operations. Please see Item 5 for a discussion of the duration of these preferential tax treatments or government financial incentives.

The PRC government is now reviewing China s tax policies and it is possible that in the near future, the different income tax rates imposed on enterprises of different ownership natures (i.e. state owned, collectively owned, privately owned and foreign-invested) may be unified, which reform may result in higher income tax rates applicable to our PRC companies and therefore could materially and adversely affect our business, financial condition and results of operations.

We may become a passive foreign-investment company, or PFIC, which could result in adverse U.S. tax consequences to U.S. investors.

Depending upon the value of our ordinary shares and ADSs and the nature of our assets and income over time, we could be classified as a passive foreign-investment company, or PFIC, by the United States Internal Revenue Service, or IRS, for U.S. federal income tax purposes. If we are classified as a PFIC in any taxable year in which you hold our ADSs and you are a U.S. investor, you would generally be taxed at higher ordinary income, rather than lower capital gain rates, if you dispose of ADSs at a gain in a later year, even if we are not a PFIC in that year. In addition, a portion of the tax imposed on your gain would be increased by an interest charge. Moreover, if we were classified as a PFIC in any taxable year, you would not be able to benefit from any preferential tax rate with respect to any dividend distribution that you may receive from us in that year or in the following year. Finally, you would also be subject to special U.S. tax reporting requirements.

We believe that we were not a PFIC for the taxable year 2005. Although in the past we have operated our business, and in the future we intend to operate our business, so as to minimize the risk of being classified as a PFIC, there can be no assurance that we will not be a PFIC for the taxable year 2006 and/or later taxable years, as PFIC status is re-tested each year and depends on our assets and income in such year. For example, we would be a PFIC for the taxable year 2006 if the sum of our average market capitalization, which is our share price multiplied by the total amount of our outstanding shares, and our liabilities over that taxable year is not more than twice the value of our cash, cash equivalents, and other assets that are readily converted into cash. We could also be a PFIC for any taxable year if the gross income that we and our subsidiaries earn from investing the portion of the cash raised in our initial public offering and debt offerings that exceed the immediate capital needs of our active online business is substantial in comparison with the gross income from our business operations.

We cannot assure you that we will not be a PFIC for 2006 or any future taxable year. For more information on the U.S. tax consequences to you that would result from our classification as a PFIC, please, see the subsection Taxation included in Item 10 Additional Information .

We may be required to take significant actions that are contrary to our business objectives to avoid being deemed an investment company as defined under the Investment Company Act.

Generally, the Investment Company Act provides that a company is not an investment company and is not required to register under the Investment Company Act as an investment company if:

the company is primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than those of investing, reinvesting, owning, holding or trading in securities; and

40% or less of the fair market value of the company s assets is represented by investment securities.

We believe that we are engaged primarily in the businesses of, among other things, developing and operating online games. In addition, less than 40% of the fair market value of our assets is represented by investment securities. As a result, we believe, that we are not an investment company as that term is defined under the Investment Company Act. We may, however, be required to take significant actions that are contrary to our business objectives to avoid being deemed an investment company in the future. We may, for example, need to hold a significant portion of our assets and invest portions of our cash flows in low-yielding investments or we may need to acquire additional income or loss generating assets that we might not otherwise have acquired. In addition, we may need to sell all or a portion of our minority investments in Actoz or Sina, or forego opportunities to acquire minority interests in other companies that could be important to our strategy.

The Investment Company Act also contains substantive regulations with respect to investment companies including restrictions on their capital structure, operations, transactions with affiliates and other matters which would be incompatible with our operations. If we were to be deemed an investment company in the future, we would, among other things, effectively be precluded from making public offerings in the United States. We could also be subject to other adverse consequences.

Changes to existing accounting pronouncements, including SFAS 123R, or practices may adversely affect our reported results of operations or how we conduct our business.

A change in accounting pronouncements or practices can have a significant effect on our reported results and may even affect our reporting of transactions completed before the change is effective. Pursuant to SEC rules, we are required to implement the Statement of Financial Accounting Standards No. 123 (revised 2004), Accounting for Share Based Compensation (SFAS 123R) starting in the first quarter of 2006. SFAS 123R requires us to measure compensation costs for all share-based compensation at fair value and take compensation charges equal to that value. The requirement to measure compensation costs for all share-based compensation under SFAS 123R could negatively affect our profitability and the trading price of our ADSs. SFAS 123R and the impact of expensing on our reported results could also limit our ability to continue to use stock options as an incentive and retention tool, which could, in turn, hurt our ability to recruit employees and retain existing employees. Other new accounting pronouncements and varying interpretations of accounting pronouncements have occurred and may occur in the future. This change to existing rules, future changes, if any, or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business.

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We have limited business insurance coverage in China.

The insurance industry in China is still at an early stage of development. In particular, PRC insurance companies do not offer extensive business insurance products. As a result, we do not have any business liability or disruption insurance coverage for our operations in China. Any business disruption, litigation or natural disaster might result in our incurring substantial costs and the diversion of resources.

Risks Relating to Regulation of the Internet and to Our Structure

If the PRC government finds that the agreements that establish the structure for operating our China business do not comply with PRC government restrictions on foreign investment in the online game industry, we could be subject to severe penalties.

PRC regulations currently limit foreign ownership of companies that provide Internet content services, which includes operating online games, to 50%. In addition, foreign and foreign-invested enterprises are currently not able to apply for the licenses required to operate online games in China or to provide Internet information content, such as online advertising. We are a Cayman Islands exempted company and we conduct our operations in China primarily through Shengqu, our indirectly wholly owned subsidiary. We and Shengqu are foreign or foreign-invested enterprises under PRC law and accordingly are ineligible to apply for a license to operate online games or to sell online advertising. In order to comply with foreign ownership restrictions, we operate our online game business in China through Shanda Networking, which is wholly owned by Tianqiao Chen, our chairman and chief executive officer, and Danian Chen, our executive senior vice president, both of whom are PRC citizens, and through Nanjing Shanda and Hangzhou Bianfeng, which are subsidiaries of Shanda Networking. Shanda Networking, Nanjing Shanda, Hangzhou Bianfeng, or our PRC operating companies, and other subsidiaries of Shanda Networking hold the licenses and approvals that are required to operate our online game business and to sell online advertising on our web pages and Shengqu owns the substantial majority of physical assets. Shengqu has entered into a series of contractual arrangements with Shanda Networking and its shareholders. As a result of these contractual arrangements, we are considered the primary beneficiary of Shanda Networking and accordingly we consolidate the results of operations of Shanda Networking and its subsidiaries in our financial statements. For a description of these contractual arrangements, see Organizational Structure in Item 4, Information on the Company and Item 7 Major Shareholders and Related Party Transactions .

We believe that (1) the ownership structures of our company, Shengqu, and our PRC operating companies are in compliance with existing PRC laws and regulations; (2) our contractual arrangements with Shanda Networking and its shareholders are valid, binding and enforceable, and will not result in any violation of PRC laws or regulations currently in effect; and (3) the business operations of our company, Shengqu, and our PRC operating companies, as described in this annual report, are in compliance with existing PRC laws and regulations in all material aspects. There are, however, substantial uncertainties regarding the interpretation and application of current or future PRC laws and regulations. Accordingly, we cannot assure you that the PRC regulatory authorities will not ultimately take a view that is contrary to our view. If we, Shengqu, or any of our PRC operating companies are found to be in violation of any existing or future PRC laws or regulations, the relevant regulatory authorities would have broad discretion in dealing with such violations, including:

revoking Shengqu s or any of our PRC operating companies business and operating licenses;

discontinuing or restricting our, Shengqu s or our PRC operating companies operations;

imposing conditions or requirements with which we, Shengqu or our PRC operating companies may not be able to comply;

requiring us, Shengqu or our PRC operating companies to restructure the relevant ownership structure or operations; or

taking other regulatory or enforcement actions, including levying fines, that could be harmful to our business.

Any of these actions could cause our business, financial condition and results of operations to suffer and the price of our ADSs to decline.

The contractual arrangements related to critical aspects of our operations with Shanda Networking and its shareholders, Tianqiao Chen and Danian Chen, may not be as effective in providing operational control as direct ownership.

We rely on contractual arrangements with Shanda Networking and its shareholders, Tianqiao Chen and Danian Chen, to operate our business. These contractual arrangements may not be as effective as direct ownership in providing us control over PRC operating companies. Direct ownership would allow us, for example, to directly exercise our rights as a shareholder to effect changes in the board of Shanda Networking, which, in turn, could effect changes, subject to any applicable fiduciary obligations, at the management level. However, under the current contractual arrangements, as a legal matter, if Shanda Networking or Tianqiao Chen or Danian Chen fails to perform its, his or her respective obligations under these contractual arrangements, we may have to incur substantial costs and expend significant resources to enforce those arrangements and rely on legal remedies under PRC law. These remedies may include seeking specific performance or injunctive relief, and claiming damages, any of which may not be effective.

All of these contractual arrangements are governed by PRC laws and provide for the resolution of disputes through either arbitration or litigation in the PRC. Accordingly, these contracts would be interpreted in accordance with PRC laws and any disputes would be resolved in accordance with PRC legal procedures. The legal environment in the PRC is not as developed as in other jurisdictions, such as the United States. As a result, uncertainties in the PRC legal system could limit our ability to enforce these contractual arrangements. In the event we are unable to enforce these contractual arrangements, we may be unable to exert effective control over our PRC operating companies, and our ability to conduct our business may be negatively affected.

The entire share capital of Shanda Networking is held by our controlling shareholders, who may cause the agreements between our company and Shanda Networking to be amended in a manner that is adverse to us.

We conduct substantially all of our operations, and generate substantially all of our revenues, through our PRC operating companies. Our control over these entities is based upon contractual arrangements with Shanda Networking and its shareholders that provide us with the substantial ability to control Shanda Networking. The two shareholders of Shanda Networking, Tianqiao Chen and Danian Chen, are also our controlling shareholders. As a result, Tianqiao Chen and Danian Chen may be able to cause these agreements to be amended in a manner that will be adverse to our company, or may be able to prevent these agreements from being renewed, even if their renewal would be beneficial for us. Although we have entered into an agreement that prevents the amendment of these agreements without the approval of our audit committee, which is comprised of independent directors, we can provide no assurances that these agreements will not be amended in the future to contain terms that may be adverse to our interests.

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Our arrangements with our PRC operating companies may be subject to scrutiny by the PRC tax authorities for transfer pricing adjustments.

We also could face material and adverse tax consequences if the PRC tax authorities determine that our contracts with our PRC operating companies were not entered into based on arm s length negotiations. Although we based our contractual arrangements on those of similar businesses, if the PRC tax authorities determine that these contracts were not entered into on an arm s length basis, they may adjust our income and expenses for PRC tax purposes in the form of a transfer pricing adjustment. A transfer pricing adjustment could result in a reduction, for PRC tax purposes, of deductions recorded by our PRC operating companies, which could adversely affect us by:

increasing our PRC operating companies tax liability without reducing Shengqu s tax liability, which could further result in late payment fees and other penalties to our PRC operating companies for under-paid taxes; or

limiting Shengqu s ability to maintain preferential tax treatments and government financial incentives, which if the transfer pricing adjustment is significant, could result in Shengqu failing to qualify for those preferential tax treatments and government financial incentives.

As a result, any transfer pricing adjustment could have a material and adverse impact upon our financial condition.

Our corporate structure may restrict our ability to receive dividends from, and transfer funds to, our PRC subsidiary and our PRC operating companies, which could restrict our ability to act in response to changing market conditions and reallocate funds from one Chinese affiliated entity to another in a timely manner.

We are a Cayman Islands holding company and substantially all of our operations are conducted through our subsidiary, Shengqu, and our PRC operating companies. We rely principally on dividends and other distributions on equity paid by Shengqu for our cash requirements, including the funds necessary to allow us to pay dividends on the shares underlying our ADSs and the funds necessary to service any debt we may incur, or financing we may need for operations other than through Shengqu. If Shengqu incurs debt on its own behalf in the future, the instruments governing the debt may restrict Shengqu s ability to pay dividends or make other distributions to the intermediate holding company and thus to us. We generate substantially all of our revenues through contractual arrangements with our PRC operating companies. However, PRC governmental authorities may require us to amend these contractual arrangements in a manner that would materially and adversely affect Shengqu s ability to pay dividends and other distributions to us. Furthermore, PRC legal restrictions permit payments of dividends by Shengqu only out of its retained earnings, if any, determined in accordance with PRC accounting standards and regulations. Under PRC law, Shengqu is also required to set aside a portion of its net income each year to fund certain reserve funds. These reserves are not distributable as cash dividends. As a result of these and other restrictions under PRC laws and regulations, our PRC subsidiary and our affiliated PRC entities are restricted in their ability to transfer a portion of their net assets to us in the form of dividends, loans or advances, which restricted portion amounted to approximately RMB1,081.6 million (US$134.0 million), or 66.0%, of our total consolidated net assets as of December 31, 2005. Any limitation on the ability of our PRC subsidiary and our affiliated PRC entities to transfer funds to

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us in the form of dividends, loans or advances could materially and adversely limit our ability to grow, make investments or acquisitions that could be beneficial to our businesses, pay debt or dividends, and otherwise fund and conduct our business.

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

Recent PRC regulations relating to offshore investment activities by PRC residents may increase the administrative burden we face and create regulatory uncertainties that could restrict our overseas and cross border investment activity, and a failure by our shareholders who are PRC residents to make any required applications and filings pursuant to such regulations may prevent us from being able to distribute profits and could expose us and our PRC resident shareholders to liability under PRC law.

Regulations were recently promulgated by the State Administration of Foreign Exchange, or SAFE, that require registration with local SAFE offices in connection with direct or indirect offshore investment by PRC residents, including PRC individual residents and PRC corporate entities. These regulations apply to our shareholders who are PRC residents and also apply to our prior and future offshore acquisitions. In particular, the SAFE regulations require PRC Residents to file with competent SAFE offices information about offshore companies in which they have directly or indirectly invested and to make follow-up filings in connection with certain material transactions involving such offshore companies, such as increases or decreases in investment amount, transfers or exchanges of shares, mergers or divisions, long-term equity or debt investments, or external guarantees, or other material events that do not involve return investment.

The SAFE regulations retroactively require registration by March 31, 2006 of direct or indirect investments previously made by PRC residents in offshore companies. If a PRC resident with a direct or indirect stake in an offshore parent company fails to make the required SAFE registration, the PRC subsidiaries of such offshore parent company may be prohibited from making distributions of profit to the offshore parent and from paying the offshore parent proceeds from any reduction in capital, share transfer or liquidation in respect of the PRC subsidiaries. Further, failure to comply with various SAFE registration requirements described above could result in liability under PRC law for foreign exchange evasion.

Our major shareholders who are PRC residents, or whose shares are beneficially owned by PRC residents, have completed foreign exchange registration with the local Shanghai Foreign Exchange Bureau according to these SAFE regulations. As a result of the newness of the regulations and uncertainty concerning the reconciliation of the new regulations with other approval requirements, it remains unclear how the regulations, and any future legislation concerning offshore or cross-border transactions, will be interpreted, amended and implemented by the relevant government authorities. We are committed to complying and to ensuring that our shareholders who are subject to the regulations comply with the relevant rules. However, we cannot assure you that all of our shareholders who are PRC residents will comply with our request to make or obtain any applicable registrations or approvals required by the regulations or other related legislation. The failure or inability of our PRC resident shareholders to receive any required approvals or make any required registrations may subject us to fines and legal sanctions, restrict our overseas or cross border investment activities, limit our

PRC subsidiary, Shengqu, to make distributions or pay dividends or affect our ownership structure, as a result of which our acquisition strategy and business operations and our ability to distribute dividend to you could be materially and adversely affected.

The laws and regulations governing the online game industry and related businesses in China are developing and subject to future changes. If we or any of our PRC operating companies fail to obtain or maintain all applicable permits and approvals, our business and operations would be materially and adversely affected.

The Internet industry, including the operation of online games, in China is highly regulated by the PRC government. Various regulatory authorities of the central PRC government, such as the State Council, the Ministry of Information Industry, the State Administration of Industry and Commerce, the Ministry of Culture, the State Press and Publication Administration, the State Administration of Radio, Film and Television, and the Ministry of Public Security, are empowered to issue and implement regulations governing various aspects of the Internet and online game industries.

Our PRC operating companies are required to obtain applicable permits or approvals from different regulatory authorities in order to provide their services. For example, an Internet content provider, or ICP, must obtain an ICP license from the Ministry of Information Industry in order to engage in any commercial ICP operations within China. An online game operator must also obtain a license from the Ministry of Culture and a license from the State Press and Publication Administration in order to distribute games through the Internet. In addition, in connection with our launch of certain EZ series products, which offer video and audio content, such as music and movies, our PRC operating companies may need to obtain a license from the State Administration of Radio, Film and Television. We understand, however, that companies that are not state-owned may not be able to obtain such license. If any of our PRC operating companies fails to obtain or maintain any of the required permits or approvals, they may be subject to various penalties, including fines and the discontinuation or restriction of their operations. Any such disruption in business operations would materially and adversely affect our financial condition and results of operations.

We currently operate a large number of websites, the domain names of which are registered under the names of Shengqu and our other PRC-incorporated affiliates. In order to streamline and optimize our Internet publication businesses, we have started to put all of our Internet publication businesses, including our editing, content supervision, publication, and other related businesses, under Shanda Networking. We have reported to the Ministry of Information Industry of the change and Shanda Networking has applied to the State Press and Publications Administration for expanding its Internet publication license from the publication of online games to encompass books, newspapers, periodicals, music and video products, works in the fields of literature, art, natural science, social science, engineering, and other electronic publications. We believe that Shanda Networking has satisfied all qualifications required to obtain the permission for license expansion and we do not believe that, while its application is pending, the regulatory authorities will take any action against it. However, we cannot assure you that it will obtain this approval or that the regulatory authority will not take any action against it.

As the online game industry is at an early stage of development in China, new laws and regulations may be adopted in the future to address new issues that arise from time to time, such as online advertising. Also, different regulatory authorities may have different opinions with regard to the licensing requirements imposed on online game operators. As a result, substantial uncertainties exist regarding the interpretation and implementation of current and any future PRC laws and regulations applicable to the online game industry and related businesses. While we believe that we are in compliance in all material respects with all applicable PRC laws and regulations currently in effect, we cannot assure you that we will not be found in violation of any current or future PRC laws and regulations.

The PRC government may prevent us from distributing, and we may be subject to liability for, content that it believes is inappropriate.

China has enacted laws and regulations governing Internet access and the distribution of news, information or other content, as well as products and services, through the Internet. In the past, the PRC government has stopped the distribution of information through the Internet that it believes violates PRC law. The Ministry of Information Industry, the State Press and Publication Administration and the Ministry of Culture have promulgated regulations that prohibit games from being distributed through the Internet if the games contain content that is found to, among other things, propagate obscenity, gambling or violence, instigate crimes, undermine public morality or the cultural traditions of the PRC, or compromise State security or secrets. In addition, certain PRC social organizations have recently discussed the possibility of implementing a rating system for online games. The effect that such a system could have on our business is unclear.

If any games we offer were deemed to violate any such content restrictions, we would not be able to continue such offerings and could be subject to penalties, including confiscation of income, fines, suspension of business and revocation of our license for operating online games, which would materially and adversely affect our business, financial condition and results of operations.

We may also be subject to potential liability for unlawful actions of our users or for content we distribute that is deemed inappropriate. Furthermore, we may be required to delete content that violates the laws of the PRC and report content that we suspect may violate PRC law. It may be difficult to determine the type of content that may result in liability for us, and if we are wrong, we may be prevented from operating our games or other services in China.

The PRC government has announced its intention, and has begun, to intensify its regulation of Internet cafes, which are currently the primary venue for our users to play online games. Intensified government regulation of Internet cafes could restrict our ability to maintain or increase our revenues and expand our customer base.

In April 2001, the PRC government began tightening its regulation and supervision of Internet cafes. In particular, a large number of unlicensed Internet cafes have been closed. The PRC government has also imposed higher capital and facility requirements for the establishment of Internet cafes. Furthermore, the PRC government s policy, which encourages the development of a limited number of national and regional Internet cafe chains and discourages the establishment of independent Internet cafes, may slow down the growth of Internet cafes. Moreover, the State Administration of Industry and Commerce, one of the government agencies in charge of Internet cafe licensing, and other government agencies jointly issued a notice in February 2004 suspending the issuance of new Internet cafe licenses for a period of six months. Although the six-month period is over, in practice, to obtain a license for setting up a new Internet café remains very difficult. It is unclear when this suspension will be lifted, if at all. So long as Internet cafes are the primary venue for our users to play online games, any reduction in the number, or slowdown in the growth, of Internet cafes in China, or any new regulatory restrictions on their operations, could limit our ability to maintain or increase our revenues and expand our customer base, thereby reducing our profitability and growth prospects.

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Currently there are no laws or regulations in the PRC specifically governing virtual asset property rights and therefore, it is not clear what liabilities, if any, online game operators may have for virtual assets.

In the course of playing online games, some virtual assets, such as special equipment, player experience grades and other features of our users game characters, are acquired and accumulated. Such virtual assets can be important to online game players and in some cases are exchanged between players for monetary value. In practice, virtual assets can be lost for various reasons, often through unauthorized use of the game account of one user by other users and occasionally through data loss caused by a delay of network service or by a network crash. Currently there are no PRC laws and regulations specifically governing virtual asset property rights. As a result, it is unclear who is the legal owner of virtual assets and whether and how the ownership of virtual assets is protected by law. In case of a loss of virtual assets, we may be sued by online game players and may be held liable for damages, which may negatively affect our business, financial condition and results of operations.

Risks Relating to the People s Republic of China

Substantially all of our assets are located in China and substantially all of our revenues are derived from our operations in China. Accordingly, our business, financial condition, results of operations and prospects are subject, to a significant extent, to economic, political and legal developments in China.

The PRC s economic, political and social conditions, as well as government policies, could affect our business.

The PRC economy differs from the economies of most developed countries in many respects, including in the amount of government involvement, level of development, growth rate, control of foreign exchange and allocation of resources. While the PRC economy has experienced significant growth over the past twenty-five years, growth has been uneven, both geographically and among various sectors of the economy. The PRC government has implemented numerous measures to encourage economic growth and to guide the allocation of resources. Some of these measures may benefit the overall PRC economy, but also have a negative effect on us. For example, our financial condition and results of operations may be adversely affected by government control over capital investments or changes in tax regulations that are applicable to us.

The PRC economy has been transitioning from a planned economy to a more market-oriented economy. Although the PRC government has implemented measures since the late 1970s emphasizing the utilization of market forces for economic reform, the reduction of state ownership of productive assets and the establishment of sound corporate governance in business enterprises, a substantial portion of productive assets in China is still owned by the PRC government. In addition, the PRC government continues to play a significant role in regulating industry development by imposing industrial policies. The PRC government also exercises significant control over China s economic growth through the allocation of resources, controlling payment of foreign currency denominated obligations, setting monetary policy and providing preferential treatment to particular industries or companies. These actions, as well as future actions and policies of the PRC government, could materially affect general economic conditions in China and could have a material adverse effect on our business and results of operations.

The PRC legal system embodies uncertainties which could limit the legal protections available to you and us.

The PRC legal system is a civil law system based on written statutes. Unlike common law systems, it is a system in which decided legal cases have little precedential value. In 1979, the PRC government began to promulgate a comprehensive system of laws and regulations governing general economic and business matters. The overall effect of legislation over the past 26 years has been a significant enhancement of the protections afforded to various forms of foreign-invested enterprises in mainland China. Our PRC operating subsidiary, Shengqu, is a wholly foreign owned enterprise, or WFOE, which is an enterprise incorporated in mainland China and wholly-owned by foreign investors. Shengqu is subject to laws and regulations applicable to foreign investment in mainland China in general and laws and regulations applicable to WFOEs in particular. However, these laws, regulations and legal requirements are constantly changing, and their interpretation and enforcement involve uncertainties. These uncertainties could limit the legal protections available to us and other foreign investors, including you. In addition, we cannot predict the effect of future developments in the PRC legal system, particularly with regard to the Internet, including the promulgation of new laws, changes to existing laws or the interpretation or enforcement thereof, or the preemption of local regulations by national laws.

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

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

Currently, Shengqu may purchase foreign exchange for settlement of current account transactions , including payment of dividends to us and payment of license fees to foreign game licensors, and our PRC operating companies may purchase foreign exchange for payment of license fees to foreign game licensors without the approval of the State Administration for Foreign Exchange. Shengqu may also retain foreign exchange in its current account, subject to a ceiling approved by the State Administration for Foreign Exchange, to satisfy foreign exchange liabilities or to pay dividends. However, we cannot assure you that the relevant PRC governmental authorities will not limit or eliminate our ability to purchase and retain foreign currencies in the future.

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

Foreign exchange transactions under the capital account are subject to limitations and require registration with or approval by the relevant PRC governmental authorities. In particular, if we finance Shengqu by means of foreign currency loans, those loans cannot exceed certain statutory limits and must be registered with the State Administration for Foreign Exchange, and if we finance Shengqu by means of capital contributions, those capital contributions must be approved by the Ministry of Commerce. Our ability to use the U.S. dollar proceeds of the sale of our equity or debt to finance our business activities conducted through Shengqu will depend on our ability to obtain these governmental registrations or approvals. In addition, because of the regulatory issues related to foreign currency loans to, and foreign investment in, domestic PRC enterprises, we may not be able to finance Shanda Networking or its subsidiaries operations by loans or capital contributions. We cannot assure you that we can obtain these governmental registrations or approvals on a timely basis, if at all.

Fluctuations in exchange rates could result in foreign currency exchange losses.

Substantially all of our revenues are denominated in Renminbi, while a portion of our expenditures are denominated in foreign currencies, primarily the U.S. dollar. Fluctuations in exchange rates, particularly those involving the U.S. dollar, may affect our costs and operating margins. In addition, these fluctuations could result in exchange losses and increased costs in Renminbi terms. Where our operations conducted in Renminbi are reported in dollars, such fluctuations could result in changes in reported results which do not reflect changes in the underlying operations. Since January 1, 1994, the PRC government has used a unitary managed floating rate system. Under that system, the People s Bank of China, or PBOC, publishes a daily base exchange rate with reference primarily to the supply and demand of Renminbi against U.S. dollar and other foreign currencies in the market during the previous day. Authorized banks and financial institutions are allowed to quote buy and sell rates for Renminbi within a specified bank around the central bank s daily exchange rate. On July 21, 2005, PBOC announced an adjustment of the exchange rate of the U.S. dollar to Renminbi from 1:8.27 to 1:8.11 and modified the system by which the exchange rates are determined. This adjustment has resulted in an approximate 3.0% appreciation of the Renminbi against the U.S. dollar as of March 21, 2006 when compared with the exchange rate in effect in March, 2005. While the international reaction to the Renminbi revaluation has generally been positive, there remains significant international pressure on the PRC government to adopt an even more flexible currency policy, which could result in a further reevaluation and a significant fluctuation of the exchange rate of the Renminbi against the U.S. dollar, including possible devaluations. As substantially all of our revenues are denominated in Renminbi, such a potential future devaluation of Renminbi against the U.S. dollars could negatively impact our results of operations. Moreover, we do have material monetary assets and liabilities denominated in U.S. dollars, which mainly consists of the investments in marketable securities, affiliated companies and the convertible notes payable. The fluctuation of foreign exchange rate affects the value of these monetary assets and liabilities denominated in U.S. dollars. Generally, appreciation of Renminbi against U.S. dollars results in a foreign exchange loss for monetary assets denominated in U.S. dollars, and a foreign exchange gain for monetary liabilities denominated in U.S. dollars. On the contrary, devaluation of Renminbi against U.S. dollars results in a foreign exchange gain for monetary assets denominated in U.S. dollars, and a foreign exchange loss for monetary liabilities denominated in U.S. dollars.

Very limited hedging transactions are available in China to reduce our exposure to exchange rate fluctuations. To date, we have not entered into any hedging transactions in an effort to reduce our exposure to foreign currency exchange risk. While we may decide to enter into hedging transactions in the future, the availability and effectiveness of these hedges may be limited and we may not be able to successfully hedge our exposure at all.

In addition, our currency exchange losses may be magnified by PRC exchange control regulations that restrict our ability to convert Renminbi into U.S. dollars. Conversely, an increase in the value of the Renminbi could increase our reported earnings in U.S. dollar terms without a fundamental change in our business or operating performance.

Since our revenues are primarily denominated in Renminbi, our valuation could be materially and adversely affected by the devaluation of the Renminbi if U.S. investors analyze our value based on the U.S. dollar equivalent of our financial condition and results of operations. In addition, certain of our acquisitions may expose us to additional currency fluctuations that would affect our reported valuation of those holdings. Actoz, which we will account for under the equity method, is a South Korean company; changes in its valuation as a consequence of fluctuations in the Korean Won would be reflected in our valuation.

Inflation in China could negatively affect our profitability and growth.

While the PRC economy has experienced rapid growth, such growth has been uneven among various sectors of the economy and in different geographical areas of the country. Rapid economic growth can lead to growth in the money supply and rising inflation. If prices for our products and services rise at a rate that is insufficient to compensate for the rise in our costs, our business may be materially and adversely affected. In order to control inflation in the past, the PRC government has imposed controls on bank credits, limits on loans for fixed assets, and restrictions on state bank lending. Such austerity measures can lead to a slowing of economic growth. A slow down in the PRC economy could also materially and adversely affect our business and prospects.

You may experience difficulties in effecting service of process, enforcing foreign judgments or bringing original actions in China based on United States or other foreign laws against us, our management or the experts named in the prospectus.

We conduct substantially all of our operations in China and substantially all of our assets are located in China. In addition, most of our directors and executive officers reside within China. As a result, it may not be possible to effect service of process within the United States or elsewhere outside China upon some of our directors and senior executive officers, including with respect to matters arising under U.S. federal securities laws or applicable state securities laws. Moreover, the PRC does not have treaties with the United States or many other countries providing for the reciprocal recognition and enforcement of judgment of courts.

Any future outbreak of avian flu or severe acute respiratory syndrome in China or similar adverse public health developments may severely disrupt our business and operations.

Adverse public health epidemics or pandemics could disrupt businesses and national economies in China. For example, from December 2002 to June 2003, China and certain other countries experienced an outbreak of a new and highly contagious form of atypical pneumonia now known as severe acute respiratory syndrome, or SARS. During May and June of 2003, many businesses in China were closed by the PRC government to prevent transmission of SARS. The World Health Organization has announced that there is a high likelihood of an outbreak of avian flu, with the potential to be as disruptive if not more disruptive than SARS. Any recurrence of the SARS outbreak, an avian flu outbreak, or development of a similar health hazard in China, may have disruptive effects on consumer spending. In addition, health or other government regulation may require temporary closure of our offices and operations. Such outbreak may also cause the sickness or death of our key management and employees. Any of such occurrences would adversely affect our business and results of operations.

Risks Relating to our ADSs

One shareholder has significant control over the outcome of our shareholder votes.

As of March 31, 2006, Skyline Media beneficially owned approximately 57% of our outstanding equity interests. Accordingly, Skyline Media has and is expected to maintain significant control over the outcome of any corporate transaction or other matter submitted to our shareholders for approval, including mergers, consolidations and the sale of all or substantially all of our assets.

If our controlling shareholder, Skyline Media ,which holds approximately 57% of our ordinary shares, chose to dispose of a material portion of the ordinary shares that it holds, the prevailing market price for our securities may decline.

As of March 31, 2006, Skyline Media beneficially owned 81,070,090 of our ordinary shares, representing approximately 57% of our outstanding ordinary shares. The beneficial owners of Skyline Media are Tianqiao Chen, our chairman and chief executive officer, Danian Chen, our executive senior vice president and the brother of Tianqiao Chen, and Qianqian Luo, our director and the wife of Tianqiao Chen. Tianqiao Chen and Qianqian Luo beneficially own an additional 1,866,338 of our ordinary shares through DBS Trustees Ltd as trustee for the Jade Trust and Danian Chen beneficially owns an additional 951,170 of our ordinary shares through DBS Trustees Ltd as trustee for the Chifeng Trust.

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In June 2005, Jade Trust adopted pre-arranged stock trading plans in accordance with Rule10b5-1 under the U.S. Securities Exchange Act of 1934, as amended, and the Company s trading policy with respect to sales of the Company s securities by insiders. As of March 31, 2006, 322,000 ordinary shares had been sold pursuant to the 10b5-1 plan, which will expire on August 15, 2006 if it is not renewed. If Skyline Media chooses to sell a material portion of the ordinary shares that it holds, or indicate its intention to do so, the prevailing market price for our securities may decline.

The price of our ADSs has been volatile historically and may continue to be volatile, which may make it difficult for holders to resell the ADSs when desired or at attractive prices.

The trading price of our ADSs has been and may continue to be subject to wide fluctuations. Since we completed our initial public offering in May 2004, the sale prices of our ADSs on the Nasdaq National Market ranged from US$10.58 to US$45.40 per ADS and the last reported sale price on June 26, 2006 was US$13.71. Our ADS price may fluctuate in response to a number of events and factors. In addition, the financial markets in general, and the market prices for Internet-related companies in particular, have experienced extreme volatility that often has been unrelated to the operating performance of such companies. These broad market and industry fluctuations may adversely affect the price of our ADSs, regardless of our operating performance. In addition, the existence of our Zero Coupon Senior Convertible Notes due 2014 that we issued in October 2004, or the convertible notes, may encourage short selling in our ADSs by market participants because the conversion of the convertible notes could depress the price of our ADSs.

You may face difficulties in protecting your interests, and our ability to protect our rights through the U.S. federal courts may be limited, because we are incorporated under Cayman Islands law.

Our corporate affairs are governed by our memorandum and articles of association and by the Companies Law (2004 Revision) and common law of the Cayman Islands. The rights of our shareholders and the fiduciary responsibilities of our directors under Cayman Islands law are not as clearly established as they would be under statutes or judicial precedents in the United States. In particular, the Cayman Islands has a less developed body of company law as compared to the U.S., and provides significantly less protection to investors. Therefore, our shareholders may have more difficulties in protecting their interests in the face of actions by our management, directors or controlling shareholders than would shareholders of a corporation incorporated in a jurisdiction in the United States. In addition, Cayman Islands companies may not have standing to sue before the federal courts of the United States. As a result, our ability to protect our interests if we are harmed in a manner that would otherwise enable us to sue in a United States federal court may be limited.

Anti-takeover provisions in our organizational documents may discourage our acquisition by a third party, which could limit your opportunity to sell your shares at a premium.

Our amended and restated memorandum and articles of association include provisions that could limit the ability of others to acquire control of us, modify our structure or cause us to engage in change of control transactions, including, among other things, the following:

- provisions that restrict the ability of our shareholders to call meetings and to propose special matters for consideration at shareholder meetings; and provisions that authorize our board of directors, without action by our shareholders, to issue preferred shares and to issue additional ordinary shares, including ordinary shares represented by ADSs.

These provisions could have the effect of depriving you of an opportunity to sell your ADSs at a premium over prevailing market prices by discouraging third parties from seeking to acquire control of us in a tender offer or similar transactions.

The voting rights of holders of ADSs are limited by the terms of the deposit agreement.

A holder of our ADSs may only exercise the voting rights with respect to the underlying ordinary shares in accordance with the provisions of the deposit agreement. Upon receipt of voting instructions of a holder of ADSs in the manner set forth in the deposit agreement, the depositary will endeavor to vote the underlying ordinary shares in accordance with these instructions. Under our amended and restated memorandum and articles of association and Cayman Islands law, the minimum notice period required for convening a general meeting is ten days. When a general meeting is convened, you may not receive sufficient notice of a shareholders meeting to permit you to withdraw your ordinary shares to allow you to cast your vote with respect to any specific matter. In addition, the depositary and its agents may not be able to send voting instructions to you or carry out your voting instructions in a timely manner. We will make all reasonable efforts to cause the depositary to extend voting rights to you in a timely manner, but we cannot assure you that you will receive the voting materials in time to ensure that you can instruct the depositary to vote your shares. Furthermore, the depositary and its agents will not be responsible for any failure to carry out any instructions to vote, for the manner in which any vote is cast, or for the effect of any such vote. As a result, you may not be able to exercise your right to vote and you may lack recourse if your ordinary shares are not voted as you requested.

You may be subject to limitations on transfer of your ADSs

Your ADSs represented by American Depositary Receipts are transferable on the books of the depositary. However, the depositary may close its books at any time or from time to time when it deems expedient in connection with the performance of its duties. The depositary may close its books for a number of reasons, including in connection with corporate events such as a rights offering, during which time the depositary needs to maintain an exact number of ADS holders on its books for a specified period. The depositary may also close its books in emergencies, and on weekends and public holidays. The depositary may refuse to deliver, transfer, or register transfers of our ADSs generally when our books or the books of the depositary are closed, or at any time if we or the depositary thinks it is advisable to do so because of any requirement of law or any government or governmental body, or under any provision of the deposit agreement, or for any other reason.

Your right as a holder of ADSs to participate in any future rights offerings may be limited, which may cause dilution to your holdings.

We may from time to time distribute rights to our shareholders, including rights to acquire our securities. However, we cannot make rights available to our ADS holders in the United States unless we register the rights and the securities to which the rights relate under the Securities Act or an exemption from the registration requirements is available. In addition, the deposit agreement provides that the depositary bank will not make rights available to you unless the distribution to ADS holders of both the rights and any related securities are either registered under the Securities Act or exempted from registration under the Securities Act. We are under no obligation to file a registration statement with respect to any such rights or securities or to endeavor to cause such a registration statement to be declared effective. Moreover, we may not be

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able to establish an exemption from registration under the Securities Act. Accordingly, ADS holders may be unable to participate in our rights offerings and may experience dilution in their holdings. In addition, if the depositary is unable to sell rights that are not exercised or not distributed or if the sale is not lawful or reasonably practicable, it will allow the rights to lapse, in which case you will receive no value for these rights.

Risks Relating to our Zero Coupon Senior Convertible Notes

We may not have the ability to repurchase our Zero Coupon Senior Convertible Notes in cash if holders exercise their repurchase rights on October 15, 2007.

In October 2004, we issued US$275 million Zero Coupon Senior Convertible Notes, or the convertible notes. The holders of the notes have the right to require us to repurchase all or a portion of their notes on October 15, 2007 at a repurchase price equal to 100% of the principal amount of notes to be repurchased, plus accrued and unpaid interest and liquidated damages, if any. As of March 31, 2006, we had RMB817.3 million (US$101.3 million) in cash and cash equivalents, RMB68.1 million (US$8.4 million) in short-term investment and RMB2,211.8 million (US$274.1 million)in marketable securities, which includes our minority investments in Sina Corporation, or Sina. The trading prices for the securities have been and may continue to be subject to wide fluctuations. Financial markets in general, and the market price for Internet-related companies in particular, have experienced extreme volatility that is often unrelated to the operating performance of such companies. In addition, the relatively large size of our investments in Sina may inhibit our ability to sell as many of these securities as we might want to sell at an acceptable price or at all. If our resources are insufficient to satisfy our cash requirements for repurchase of the notes, we may seek to sell additional equity or debt securities or obtain a credit facility. The sale of additional equity securities could result in additional dilution to our shareholders. The incurrence of indebtedness would result in increased interest rate risk and debt service obligations and could result in operating and financing covenants that would restrict our operations. We cannot assure you, however, that future financing will be available in amounts or on terms acceptable to us, if at all. As a result, we may not have sufficient funds to make the required repurchase in cash. Our failure to repurchase tendered notes would constitute an event of default under the Indenture for the notes, which might constitute a default under any other obligations we may have at that time.

Item 4. Information on the Company

A. HISTORY AND DEVELOPMENT OF THE COMPANY

Our business was founded in December 1999 when Tianqiao Chen and Danian Chen established Shanda Networking, initially focusing on investments relating to the development and operation of a Chinese language online virtual community. In November 2004, we incorporated Shanda Interactive Entertainment Limited in the Cayman Islands.

Our principal executive offices are located at No. 1 Office Building, No. 690 Bibo Road, Pudong New Area, Shanghai 201203, China. Our telephone number is (86-21) 5050 4740. Our agent for service of process in the United States is CT Corporation System, located at 111 Eighth Avenue, New York, Now York 10011.

In November 2001, we commercially launched Mir II, our first massively multiplayer online role-playing game, or MMORPG. In March 2003, we commercially launched Fortress II, our first casual game, and in October 2003, we launched Woool, our first in-house developed online game. As of December 31, 2005, Shanda commercially operates twelve online

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games, including seven MMORPGs and five casual games. In 2005, total peak concurrent users for all Shanda games in commercial service reached 2.68 million.

In addition to our comprehensive online game portfolio, in 2005 Shanda introduced the EZ Center platform, a unified software solution on top of our service platform that integrates entertainment and informational content from the Internet and provide users with access to such content through a user-friendly interface. For more information on the EZ initiative, see also Business Overview in Item 4 Information on the Company, Item 5 Operating and Financial Review and Prospects, and Item 3 Risk Factors .

In the fourth quarter of 2005, we adopted a free-to-play and pay-for in-game value-added services revenue model for three of our MMORPGs: Mir II, Magical Land and Woool. Going forward, we will consider adopting this new revenue model for our other existing MMORPGs, depending on the game type and lifecycle. For more information on the new revenue model, see also Business Overview in Item 4 Information on the Company , Item 5 Operating and Financial Review and Prospects, and Item 3 Risk Factors .

As part of our efforts to further broaden our content offerings and expedite our growth, we have developed our business through a number of strategic acquisitions and investments, including the following:

In November 2005, we acquired Wenzhou Chuangjia Technology Co., Ltd., or Gametea, which develops chess and board games and operates Gametea, a casual game platform in China;

In May 2005, we completed the second step of a two-step acquisition of Shanghai Haofang Online Information Technology Co. Ltd., or Haofang, the operator of the largest network PC game platform in China;

In February 2005, we completed our purchase of an approximately 19.5% stake in Sina Corp, or Sina, an online media company and value-added service provider in China;

In February 2005, we also completed the purchase of a 29% stake in Actoz, a Korean developer, operator and publisher of online games, increasing our total stake to approximately 38.1%;

In October 2004, we completed the second step of a two-step acquisition of Beijing Digital Red Software Application Technology Co., Ltd., or Digital Red, a developer of mobile phone games;

In September 2004, we acquired Shanghai Xuanting Entertainment Information Technology Co., Ltd., which operates Qidian, an online literature forum; and

In July 2004, we acquired Hangzhou Bianfeng Software Co. Ltd., or Bianfeng, a developer and operator of online chess and board games in China.

B. BUSINESS OVERVIEW

Shanda Interactive Entertainment Limited is an interactive entertainment company and one of the largest operators of online games in China. In addition to our portfolio of online games that users play over the Internet, we provide users with access to additional content and services through our EZ Center platform, including literature, music, movies, radio, finance, e-commerce, travel, news and educational programs.

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Our core online game business includes the operation of online games that are either licensed from third-parties or developed in-house. In 2005, our commercially launched games had approximately 2.68 million peak concurrent users and 1.38 million average concurrent users. In 2005, we commercially launched three new MMORPGs, Magical Land, D.O. and R.O and two new casual games, Three Kingdoms and Shanda Richman. In 2005, we also acquired Wenzhou Chuangjia Technology Co., Ltd., or Gametea, a casual game platform offering more than 90 online games, including poker games, board games, mahjong and other contest games. Gametea, together with Bianfeng, a developer and operator of online chess and board games that we acquired in July 2004, had approximately 500,000 peak concurrent users in 2005.

In late November 2005, we introduced a free-to-play and pay-for in-game value-added services revenue model for three of our leading MMORPGs, Mir II, Woool, and Magical Land. Under the new revenue model, users are able to play the basic functions of an MMORPG for free and may choose to purchase in-game value-added services, including certain in-game items and premium features, which enhance the game experience.

In 2005, in connection with our transition from a pure online game operator to an interactive entertainment company, we introduced EZ Center platform as the unified software solution on top of our service platform. It integrates entertainment and informational content from the Internet and provide users with access to such content through a user-friendly interface that has simple intuitive menus, large text and clear graphics. The EZ Pod, which is the first product launched off our EZ Center platform, enables PC users to navigate and access the aggregated Internet content over our EZ Center platfrom using a remote control. As of March 31, 2006, EZ Center platform is still at the trial run stage and we have not yet charged users subscription fees.

Our operating platform includes our technology infrastructure, distribution and payment system, customer service center, game content management and marketing platform. Our technology infrastructure consists of a nation-wide server network with the capacity to accommodate approximately 6.6 million concurrent online users. Our nation-wide distribution and payment network includes approximately 310,000 distribution points for our pre-paid cards. Our customer service system includes a 24-hour call center and a walk-in customer service center. In addition, for each of our online games we have a separate game content management team which manages the operation of the game and the online community for the game.

Our Content

Our content offerings primarily consist of online games, including MMORPGs and casual games, as well as online chess and board games, a network PC game platform and wireless games. In addition, through our EZ Center platform we provide users with access to additional content and services including movies, music, literature works, finance and investment information, travel information, news and educational programs. As of March 31, 2006, we have not yet started to charge users for access to content or services over the EZ Center platform.

MMORPGs

Our MMORPGs are action-adventure based, and draw upon martial arts and combat themes. Each MMORPG creates a virtual world within which players interact with one another inside the game. Typical features of our MMORPGs include the following:

- players may assume the ongoing role, or alter-ego, of a particular game character, each with different strengths and weaknesses;

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each game character may gain experience and collect certain game features and items, such as weapons and points, which increases the status and power of the game character and, in the process, builds a strong game identity; the variety of features that are available means that a player is unlikely to meet anyone in the virtual world exactly like his or her game character;

although each game character may be unique, groups of players may, and often must, form teams or alliances to fulfill certain game objectives, such as quests and missions;

game features and items may be traded or sold within the game, and game characters may take on life-like social experiences such as getting married and forming master/disciple relationships with other players. In addition, players may communicate with each other through our instant messaging service or our chat room during the game on our operation platform which supports all of our online games;

special events are held from time to time to stimulate group interest, such as fortress raids where players are encouraged to form groups and attack a particular fortress at a specified time; and

the game is ultimately never won or lost, but instead continues through a game story that is interactively written by the game developer and players and does not have a natural ending.

We use two different revenue models to charge users of our MMORPGs. The first revenue model is the traditional subscription-based pay-to-play revenue model, where users purchase pre-paid cards to play for a fixed number of hours or for an unlimited amount of time within a specified number of days. In the fourth quarter of 2005, we adopted a free-to-play and pay-for in-game value-added services revenue model for three of our MMORPGs: Mir II, Woool and Magical Land. Under the new revenue model, users are able to play the basic functions of a MMORPG for free and may choose to purchase in-game value-added services, as well as certain in-game items and premium features, which enhance the game experience. Same as our traditional subscription-based pay-to-play revenue model, payment is collected upon the sale of our pre-paid cards under the new revenue model. However, game points are consumed as users purchase value-added services and in-game items, instead of as users play the games.

In preparation for the commercial launch of a new game, we conduct closed beta testing of the game in an effort to eliminate technical problems. This closed beta testing is followed by open beta testing in which we allow our registered users to play without charge in open market conditions to ensure performance consistency and stability of operation systems.

As of December 31, 2005, the following table summarizes the MMORPGs or other massively multiplayer online games that we offer.

Game	Description	Game Source	Date of Commercial Launch
Mir II	Martial arts adventure	Licensed	November 2001
Woool	Martial arts adventure	In-house developed	October 2003
The Sign	3D martial arts adventure	In-house developed	May 2004
The Age	Society simulation	In-house developed	June 2004
Magical Land	Fantasy role-playing	In-house developed	July 2005
D.O.	3D martial arts adventure	Licensed	August 2005
R.O.	Fantasy role-playing	Licensed	September 2005

In addition to the MMORPGs listed above, we have entered into license agreements to operate two other MMORPGs in China. In April 2005, we entered into a license agreement for the China operation of Dungeons & Dragons Online, a 3-D fantasy role-playing game based on the Hasbro and Wizards of the Coast Dungeons and Dragons franchise, and Archlord, a 3-D martial arts adventure game. We began open beta testing of ArchLord on June 18, 2006, and started closed beta testing of Dungeons & Dragons Online on June 28, 2006.

In 2005, our MMORPGs in commercial service had approximately 1.03 million peak concurrent users and 672,000 average concurrent users.

Our Casual Games

Casual games are easier to play than MMORPGs. Casual games are typically session based, meaning that a game can be played to a conclusion within a short period of time. Generally, fewer than ten players may interact with each other in an online casual game. Casual games are an important component of our overall home strategy because casual games attract a broader range of users than MMORPGs, as well as more home users. We believe that casual games provide us with certain benefits and opportunities not typically available through MMORPGs, including:

casual games, due to their lower level of complexity and typically shorter duration, provide less-experienced online game players with a means to become familiar with both online game playing and the online game culture without making substantial commitments of time and resources; and

casual games are well-suited to use at home, due to their shorter duration and reduced demand for a player s full attention for prolonged periods, as compared to MMORPGs; as a result, we believe that casual games may contribute to the expansion of the online game culture beyond the Internet cafes and into the homes of users.

We use the free-to-play and pay-for in-game value-added services revenue model to charge users of our casual games. As a result, users are able to play the basic functions of our casual games for free and may choose to purchase in-game items and premium features, which enhance the game experience.

As of December 31, 2005, the following table summarizes the casual games that we offer.

Game	Description	Game Source	Date of Commercial Launch
BNB	Battle	Licensed	August 2003
GetAmped	3D fighting game	Licensed	May 2004
Maple Story	Side-scrolling combat game	Licensed	August 2004
Three Kingdoms	Strategy combat	In-house developed	September 2005
Shanda Richman	3D Strategy Operation	In-house developed	December 2005

In addition to the casual games listed above, we have entered into license agreements to operate DJ Max and Kong Kong, two South Korean casual games. In February 2006, we also entered into an agreement with Walt Disney Internet Group pursuant to which we have agreed to develop, distribute and operate in China a online casual game based on the magical worlds of Disney and featuring some of Disney s most popular animated characters. In March 2006, we commercially launched our in-house developed car racing game, Crazy Kart. In addition to these games, we also have a number of casual games under in-house development, which we hope to introduce during 2006.

In 2005, our commercially launched casual games, excluding the casual games operated by or played on the platforms provided by Bianfeng, Haofang and Gametea, had approximately 825,000 peak concurrent users.

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Our Online Chess and Board Games

Our casual games also include online chess and board games offered through Bianfeng, which we acquired in 2004, and Gametea, which we acquired in 2005. Through Bianfeng and Gametea, we offer a variety of casual games, including card games, board games, mahjong and simple arcade games. In 2005, the casual games operated by Bianfeng and Gametea had approximately 500,000 peak concurrent users.

Network PC Games Platform

Through Haofang, which we completed the two-step acquisition of in May 2005, we provide a personal computer game network to our end users. Through this platform, users of PC games are able to find and connect through the Internet with other players of the same PC games. This enables users to form a large network through which to interact with others virtually, using software that has network capability. Without such an Internet based network, users of PC games would generally be limited to playing with other users that are either at the same PC or connected through a local area network. Unlike with our MMORPGs and casual games, we do not own or license the content that PC game players use over the Haofang network. Nonetheless, we believe that the Haofang PC game network enhances our overall online game platform. In 2005, the Haofang PC game network had approximately 535,000 peak concurrent users.

Wireless Games

Through Digital Red, which we completed the two-step acquisition of in October 2004, we develop and offer wireless games to end users of mobile phones. Digital Red has developed approximately 600 wireless games, approximately 400 of which were in distribution as of December 31, 2005. Digital Red primarily distributes its wireless games by pre-loading the games on handsets produced by mobile phone manufacturers and by downloading the games from game portal of the mobile phone service providers.

EZ Content

In addition to our core online game content, we offer additional content through our EZ Center platform. Through cooperation with more than 100 Internet content and service providers, we provide users with access to an array of content and services that can be grouped into three broad categories:

Entertainment, including radio, movies, music, karaoke and literature;

Life, including finance, e-commerce, travel and communication programs; and

Info-learning, including news and educational programs.

Sources of Content

Game Licensing

We license games from developers in various countries where online game use is relatively established. We monitor each of the South Korean, Japanese, United States and European markets to identify and source new online games. Prior to negotiating a license agreement with an overseas game developer, we evaluate games in our game testing center.

The cost of licensing games from developers generally consists of an upfront licensing fee, which we normally pay in several installments, and ongoing licensing fees, which are equal to a percentage of revenues generated from operation of the game. The ongoing licensing fee payments for games which have been commercially launched range from 20% to 30% of revenues for MMORPGs, and 17% to 40% of revenues for casual games**.** Each of our licenses provides us with the

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exclusive right to operate the game in China. Most developers agree to timely provide us, without any additional charge, with updates, enhancements and improvements developed for the games licensed to us. The majority of our game licenses require the licensors to provide us with technical support. As of December 31, 2005, six of the twelve online games that we commercially operate are licensed from overseas developers.

We have also obtained rights or control to certain licenses through the acquisition of, or investment in, other businesses. Please see the section Recent Acquisitions in Item 5 Operating and Financial Review and Prospects .

Game Development

We both develop online games at our in-house game development studios and fund the development of games at independent game development studios. Our initial in-house game development efforts focused upon MMORPGs. In 2005, as part of our home strategy and EZ initiative, we have shifted the focus of our in-house game development efforts away from MMORPGs and toward casual games. In addition to the development of traditional online games, through Bianfeng and Gametea we develop online chess and board games, and through Digital Red we develop wireless games for mobile phone users. As of December 31, 2005, approximately 580 employees were engaged in our in-house game development efforts. In addition, as of December 31, 2005, six of the twelve online games that we commercially operate were in-house developed, including two casual games.

Other Content

We offer other content to users both through our Internet platform and through our EZ Center platform. This additional content is generally provided in partnership with third party service and content providers. We have entered into strategic partnerships with Universal Music and EMI, for example, to provide their music content to end users through our EZ Center platform as well as our online interactive entertainment portal. In addition, through Qidian, a Chinese language original literature portal that we acquired in 2004, we publish works of independent writers, including magic fantasy works, science fiction works and works based upon the story lines of online games. As of December 31, 2005, we have entered into agreements with over 100 content and service providers to offer non-game content over our EZ Center platform.

Our Operating Platform

We believe that our operating platform contributes to the experience of our users and enhances user loyalty. Our operating platform encompasses a variety of elements, including our product management system, distribution and payment network, unified billing platform, marketing, customer service and technological infrastructure.

Game Product Management

We have a separate product management team for each of our MMORPGs and casual games. Each product team acts as a product specialist in interaction with our functional departments, such as research and development, marketing, sales and distribution, technology support and customer services. Our product teams:

- conduct the cost/return analysis and form operational plans before the launch of each game;
- coordinate internal resources and interact with the other departments to secure the smooth operation of the game on a day-to-day basis;
- control the timing of the release of new game versions and enhancements; and

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manage the online game s virtual community on an hour-by-hour basis including, for example, by organizing in-game events.

As of December 31, 2005, our product management teams consisted of 254 employees.

Pricing, Distribution and Payment

In order to play our games or in order to purchase in-game value-added services, users must purchase pre-paid cards, which are sold in both virtual and physical form. Each pre-paid card contains a unique access code and password that enables users to add value to their account for one of our online games. Currently, each pre-paid card may only be used to play one of our online games, although a user may choose which game account, among all accounts held by the user, to apply the pre-paid card s value to. Charges based on the number of hours of playtime, unlimited playtime for a specified number of days or the value and amount of in-game value-added services purchased are deducted against the value provided in the pre-paid cards.

We generally develop a pricing curve to set the retail prices for the games we offer. Pricing curves are developed primarily based on the game cost, user game playing and payment patterns and the pricing of competing games in the market. Since the launch of our first online game in 2001, we have tracked and accumulated user data generated from our user base, which provides us with an extensive database to analyze user patterns and establish pricing curves for particular types of games. Once a game s pricing is set, it is difficult to increase prices during the game s commercial lifecycle. We have generally maintained stable pricing curves for our games.

We distribute our pre-paid cards through three principal channels:

our e-sales system for virtual pre-paid cards;

our offline distribution system for physical pre-paid cards; and

direct online sales.

Other than direct online sales, we generally operate by selling pre-paid cards to a group of regional distributors from whom we generally collect payment on a prepaid basis. These distributors resell the cards to sub-distributors who, in turn, distribute the cards directly to Internet cafes and other retail points of sale. We estimate, based on a survey we conducted among our regional distributors in December 2005 and sales records in our e-sales system, that our e-sales and offline distribution networks include approximately 134,000 and 174,000 points of sale in China, respectively. Our data center and servers maintain user information, including user registration information and data relating to usage patterns, and we do not rely on distributors for such information.

The following table sets forth the percentage of pre-paid card sales from each of these distribution channels in 2005:

	Prepaid Card Sales in	
Distribution Channel	**2004**	**2005**
E-sales	44.7%	48.6%
Offline Distribution	44.1%	36.9%
Direct Online Sales	5.7%	13.8%
Other	5.4%	0.7%
Total	100%	100%

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In 2005, we offered average sales discounts of approximately 23.8% and 16.7% to our e-sales distributors and offline distributors, respectively. The sales discount represents the difference between the price at which we sell pre-paid cards to distributors and the face value of the pre-paid cards. We generally offer a larger discount to our e-sales distributors than our offline physical card distributors because we intend to facilitate the expansion of our e-sales system, which provides us with control over the distribution process. In addition, the cost of distributing virtual pre-paid cards through our e-sales system is lower than the costs involved in offline distribution of physical pre-paid cards. In addition, we are actively promoting direct online sales of our pre-paid cards through credit and debit card payments. For more information on our sales discount policy, please also see subsection A. Operating Results-Net Revenue in Item 5 Operating and Financial Review and Prospects

Our Unified User Platform

Through our unified user and billing verification system, users can access our various online games and other interactive entertainment content through a single Shanda account. We believe that our unified user platform helps us to leverage the value of our user base within any given application, to build user loyalty and to have an efficient means to manage our billing and user data as well as to organize promotional events for new products and services.

Marketing

Due to the group interaction appeal of online games, word-of-mouth is a major medium for promoting our games. Our marketing strategy includes utilizing our large user base and nationwide distribution network to retain our existing users and attract new users. We employ a variety of traditional and online marketing programs and promotional activities, including in-game events, in-game marketing, open beta testing and offline efforts.

We frequently organize in-game events for our users, which we believe encourages the development of virtual communities among our users and increases user interest in our games. Examples of in-game events include special challenges or features, such as fortress raids, introduced to the game environments for a scheduled period. In addition, we use in-game events to introduce users to new features of our games. Moreover, we frequently post announcements in the game environment of our MMORPGs to promote new features, other improvements to the games, and in-game events. We generally use these announcements to promote the game in which they are displayed.

Our open beta testing system both tests the operation of new games under open market conditions and introduces new games to users. During open beta testing, we do not charge users to play the new game. Open beta testing provides an initial user base and creates initial excitement and word-of-mouth publicity to support the commercial launch of the game.

We also market new games through offline efforts. We promote new games by placing game posters in Internet cafes. In addition, we place advertisements in traditional print media as well as on billboards and city buses. In connection with the commercial launch of Magical Land, for example, we placed advertisements in over 100 newspapers and magazines, over 600 billboards in nine major cities and on over 200 websites. We also cooperated with other businesses, such as soft drink manufacturers in co-marketing projects. In addition, we organize promotional events at Internet cafes, distribution points, school campuses and other locations frequented by game players. We also sponsor select media events to promote our brand name and our games.

Customer Service

We regard customer service as one of our key marketing tools and we are committed to providing superior customer service to our users. We provide service to our customers through three principal channels:

- our call center, which serves our customers 24 hours per day, seven days per week;

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our walk-in customer service center, located in Shanghai; and

e-mail and facsimile letters.

In addition, we offer bulletin board services that allow users to post questions to, and receive responses from, other users.

Technology Infrastructure

We have developed an extensive technology infrastructure to support the operation of our games, including a nation-wide server network. Due to the real-time interaction among thousands of users, the stable operation of our MMORPGs requires a large number of servers and a significant amount of connectivity bandwidth. Due to China s large geographical area and limitations on bandwidth, we have located game servers for our MMORPGs in a number of regions throughout China. As a result, our MMORPG users can play our games using servers located in their region and without exchanging data across the national network, thereby increasing the speed at which our games operate and enhancing the user experience.

As of December 31, 2005, our server network for our game operations consisted of approximately 13,400 servers and 2,500 server annex equipment units with the capacity to accommodate up to 6.6 million concurrent online users. As of December 31, 2005, we owned approximately 57.7% of the servers in our network, and we leased the remainder from telecommunications operators. All of the servers in our server network are located on the premises of our hosting telecommunications operators.

Our EZ Initiative

In 2005 we introduced our EZ Center platform as an integral part of our home strategy, which aims to provide home users with a broad range of interactive entertainment content from the Internet and display them in a user-friendly interface that has simple intuitive menus, large text and clear graphics. Through cooperation with a variety of Internet content and service providers, we offer an array of content and services to users over our EZ Center platform, including literature, music, movies, radio, finance, e-commerce, travel, news and education programs.

The EZ Center platform is supported by our integrated operating platform, including our unified user account authorization system, payment system and customer service center. Users that purchase an EZ series product and access the EZ Center platform will, after a free or reduced rate introductory period, be able to purchase EZ content and services on an a-la-carte basis or on a monthly subscription basis. As of March 31, 2006, we have not yet started to charge users for access to content or services over the EZ Center platform.

The debut of the EZ Pod was our first step to bring the interactive entertainment content offerings on the EZ Center platform to home users in China. The EZ Pod includes a remote control, an inferred dongle and the EZ Center software. The EZ Center software solution transforms an average PC into an entertainment PC, thus changes the way users navigate the online media content from an information-based Internet portal model to an application-based new entertainment portal model.

The EZ Pod is a Shanda in-house developed product and we are actively managing its marketing and distribution. We commercially launched the EZ Pod on December 1, 2005 and are distributing the EZ Pod primarily through two channels. The first is our own distribution channel, including the distribution channel for our pre-paid cards, which will target existing personal computer owners encouraging them to transform their computers into an entertainment PC by purchasing and installing an EZ Pod. The second channel is through partnerships with PC manufactures, targeting new PC purchasers by bundling and pre-installing EZ Center software on new computers. In addition, we are actively exploring other opportunities in partnerships, such as collaboration with telecom operators.

As part of our EZ initiative, we are also exploring additional products that would allow users to access the EZ Center platform through various delivery channels. If we introduce additional products, we do not intend to be responsible for hardware manufacturing, inventory, sales and distribution of those products. Instead, we intend to license the hardware and software solutions to consumer electronic manufactures. We will focus not upon the hardware component of the EZ initiative, but upon providing content and services to users over the EZ Center platform.

Competition

We compete primarily with other online game operators based in China. We believe that domestic operators, including us, are likely to have a competitive advantage over international service providers who enter the China market, as these international service providers are likely to lack operational infrastructure in China and content localization experience for the China market. We cannot assure you, however, that this competitive advantage will continue to exist, particularly if international operators establish joint ventures or form alliances with, or acquire, domestic operators. In addition, we compete for users against various offline games, such as console games, arcade games and handheld games, as well as various other forms of traditional or other online entertainment.

Intellectual Property and Proprietary Rights

We rely on copyright, trademark, patent, trade secret and other intellectual property law, as well as non-competition, confidentiality and license agreements with our employees, suppliers, business partners and others to protect our intellectual property rights. Our employees are generally required to sign agreements acknowledging that all inventions, trade secrets, works of authorship, developments and other processes generated by them on our behalf are our property, and assigning to us any ownership rights that they may claim in those works. Despite our precautions, it may be possible for third parties to obtain and use intellectual property that we own or license without our consent. Unauthorized use of our intellectual property by third parties, and the expenses incurred in protecting our intellectual property rights, may adversely affect our business.

As of December 31, 2005, we own 35 software copyrights, each of which we have registered with the State Copyright Bureau of the PRC.

As of December 31, 2005, we own 28 trademarks, each in various classes, each of which we have registered with the China Trademark Office, and had 70 trademark applications, each in various classes, pending with the China Trademark Office. We have also filed applications to register certain trademarks in a number of other jurisdictions, including Taiwan, Hong Kong, South Korea, the United States, India, Japan, Canada, Singapore and New Zealand.

As of December 31, 2005, we hold six patents granted by the State Intellectual Property Office of the PRC and we have eleven patent applications pending with the State Intellectual Property Office. In addition, we hold two patents that have been granted by select jurisdictions outside of China, including the European Union, South Korea and Singapore.

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Regulatory Matters

The online game industry in China operates under a legal regime that consists of the State Council, which is the highest authority of the executive branch of the PRC central government, and the various ministries and agencies under its leadership. These ministries and agencies mainly include:

- the Ministry of Information Industry;
- the Ministry of Culture;
- the State Press and Publications Administration;
- the State Copyright Bureau;
- the State Administration for Industry and Commerce;
- the Ministry of Public Security; and
- the Bureau of State Secrecy.

The State Council and these ministries and agencies have issued a series of rules that regulate a number of different substantive areas of our business, which are discussed below.

Foreign Ownership Restrictions

PRC regulations currently limit foreign ownership of companies that provide Internet content services, which includes operating online games, to 50%. In addition, foreign and foreign-invested enterprises are currently not able to apply for the required licenses for operating online games in China. In order to comply with foreign ownership restrictions, we operate our online game business in China through Shanda Networking, which is wholly owned by Tianqiao Chen, our chairman and chief executive officer, and Danian Chen, our executive senior vice president, both of whom are PRC citizens, and through Nanjing Shanda and Hangzhou Bianfeng, which are subsidiaries of Shanda Networking. Under PRC law, we cannot hold the licenses and approvals necessary to operate our online games because those licenses and approvals can only be held by domestic PRC persons and we are not considered to be a domestic PRC person for this purpose. We believe that (1) the ownership structures of our company, Shengqu and our PRC operating companies are in compliance with existing PRC laws and regulations, (2) our contractual arrangements with Shanda Networking and its shareholders are valid and binding, and will not result in any violation of PRC laws or regulations currently in effect; and (3) the business operations of our company, Shengqu and our PRC operating companies, as described in this annual report, are in compliance with existing PRC laws and regulations in all material aspects. There are, however, substantial uncertainties regarding the interpretation and application of current or future PRC laws and regulations. Accordingly, we cannot assure you that the PRC regulatory authorities will not ultimately take a view that is contrary to our view. If the PRC government finds that the agreements that establish the structure for operating our China business do not comply with PRC government restrictions on foreign investment in the online game industry, we could be subject to severe penalties.

Licenses

There are a number of aspects of our business which require us to obtain licenses from a variety of PRC regulatory authorities.

As ICP service providers, our PRC operating companies are required to either hold value-added telecommunications business operation licenses, or ICP licenses, issued by the Ministry of Information Industry or its local offices or be sublicensed by qualified ICP license holders. Moreover, ICP operators providing ICP services in multiple provinces, autonomous regions and centrally administered municipalities may be required to obtain an Inter-regional ICP license. Shanda Networking and Shanghai Shulong Technology Development Co., Ltd. have already obtained inter-regional ICP licenses, which both cover SMS service. Shanda Networking s license also covers online bulletin board service. Nanjing Shanda and Hangzhou Bianfeng currently conduct ICP businesses by having sublicensing arrangements with Shanda Networking.

Each ICP license holder that engages in the supply and servicing of Internet cultural products, which include online games, must obtain an additional Internet culture business operations license from the Ministry of Culture. Shanda Networking holds an Internet culture business operations license issued by the Ministry of Culture. In connection with our launch of certain EZ series products, which offer video and audio content, such as music and movies, we may need to obtain a license from the State Administration of Radio, Film and Television. We understand that non-State-owned companies may not be able to obtain such a license and, accordingly, if it is determined that such a license is required our E2 initiative may be materially and adversely affected.

The State Press and Publications Administration and the Ministry of Information Industry jointly impose a license requirement for any company that intends to engage in online publishing, defined as any act by an Internet information service provider to select, edit and process content or programs and to make such content or programs publicly available on the Internet. Shanda Networking holds an online publishing license issued by the State Press and Publications Administration. In addition, the Ministry of Culture requires us to submit for its content review and approval any online games we would like to import. If we import games without that approval, the Ministry of Culture may impose penalties on us, including revoking our Internet culture business operations license required for the operation of online games in China.

The Ministry of Public Security imposes a license requirement for any company that intends to engage in the development and sales of computer and information system safety guard products. Shanda Networking holds a computer and information system safety guard products sales license issued by the Ministry of Public Security.

ICP License Sublicensing

According to rules promulgated by the Ministry of Information Industry, an ICP service provider that has obtained an inter-regional ICP license shall conduct its business operations in provinces, autonomous regions and centrally administered municipalities as covered by its license within one year after acquiring the license. An inter-regional ICP service provider may authorize its subsidiaries or its branches to conduct an ICP business in licensed regions. If it authorizes its subsidiaries, the ICP service provider s shareholding in such subsidiaries must be greater than 51%. Moreover, an ICP service provider shall not authorize two or more subsidiaries or branches to conduct the same ICP business in the same region. Shanda Networking has authorized Nanjing Shanda and Hangzhou Bianfeng to conduct ICP business in several regions. Nanjing Shanda is responsible for the east and central-south of China. Hangzhou Bianfeng is responsible for north-east China.

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Shanda Networking will continue to conduct online game business in residual regions, with its Xian branch, Beijing branch and its subsidiary Chengdu Jisheng Technology Co., Ltd. being respectively responsible for north-west China, north China and south-west China. Shanghai Shulong Technology Development Co., Ltd has set up five branches and authorized them to conduct ICP business in five regions of north China, north-east China, central-south China, south-west China and north-west China. Shanghai Shulong Technology Development Co., Ltd. is responsible for east China.

Regulation of Internet Content

The PRC government has promulgated measures relating to Internet content through a number of ministries and agencies, including the Ministry of Information Industry, the Ministry of Culture and the State Press and Publications Administration. These measures specifically prohibit Internet activities, which includes the operation of online games that result in the publication of any content which is found to, among other things, propagate obscenity, gambling or violence, instigate crimes, undermine public morality or the cultural traditions of the PRC, or compromise State security or secrets. If an ICP license holder violates these measures, the PRC government may revoke its ICP license and shut down its websites.

Regulation of Information Security

Internet content in China is also regulated and restricted from a State security standpoint. The Standing Committee of the National People s Congress, China s national legislative body, issued a decision in December 2000, according to which following conducts in China may be subject to criminal punishment in China any effort to: (1) gain improper entry into a computer or system of strategic importance; (2) disseminate politically disruptive information; (3) leak state secrets; (4) spread false commercial information; or (5) infringe intellectual property rights.

The Ministry of Public Security has promulgated measures that prohibit use of the Internet in ways which, among other things, result in a leakage of state secrets or a spread of socially destabilizing content. The Ministry of Public Security has supervision and inspection rights in this regard, and we may be subject to the jurisdiction of the local security bureaus. If an ICP license holder violates these measures, the PRC government may revoke its ICP license and shut down its websites.

Import Regulation

Our ability to license online games from abroad and import them into China is regulated in several ways. We are required to register with the Ministry of Commerce any license agreement with a foreign licensor that involves an import of technologies, including online game software into China. Without that registration, we cannot remit licensing fees out of China to any foreign game licensor. Furthermore, the State Copyright Bureau requires us to register copyright license agreements relating to imported software. Without the State Copyright Bureau registration, we cannot remit licensing fees out of China to any foreign game licensor and are not allowed to publish or reproduce the imported game software in China. In addition, imported online game software is also required to pass a content examination by the Ministry of Culture. Any imported online game software, which has not been examined and approved by the Ministry of Culture or is not registered with the Ministry of Information Industry, is not allowed to be put into operation in China.

Publishing Regulation

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Our publishing activities include both online publishing and offline publishing. In order to engage in the online publishing business, we have obtained licenses from both the State Press and Publications Administration and the Ministry of Culture. We do not hold the required license to engage in offline publishing, so in order to conduct our game related content publishing business, we cooperate with companies that are licensed to conduct such businesses.

Advertising Regulation

According to PRC laws and regulations, in order to conduct advertising and related business, a company must have an approved business scope that covers such businesses. Currently, we conduct our advertising and related businesses primarily through our subsidiary, Shanghai Shengyue Advertisement Co., Ltd., which is licensed to conduct these businesses.

Intellectual Property Rights

The State Council and the State Copyright Bureau have promulgated various regulations and rules relating to protection of software in China. Under these regulations and rules, software owners, licensees and transferees may register their rights in software with the State Copyright Bureau or its local branches and obtain software copyright registration certificates. Although such registration is not mandatory under PRC law, software owners, licensees and transferees are encouraged to go through the registration process and registered software rights may be entitled to better protections. We have registered all of our commercially launched in-house developed online games with the State Copyright Bureau.

Internet Cafe Regulation

Internet cafes are required to obtain a license from the Ministry of Culture and the State Administration of Industry and Commerce, and are subject to requirements and regulations with respect to location, size, number of computers, age limit of customers and business hours. Although we do not own or operate any Internet cafes, many Internet cafes distribute our virtual pre-paid cards. The PRC government has announced its intention, and has begun, to intensify its regulation of Internet cafes, which are currently the primary venue for our users to play online games. In February 2004, the State Administration of Industry and Commerce and other related government agencies issued a notice to suspend issuance of new Internet cafe licenses for a six month period. While the specified suspension period is nominally over, in practice, to obtain a license for setting up a new Internet café remains very difficult. Intensified government regulation of Internet cafes could restrict our ability to maintain or increase our revenues and expand our customer base.

Privacy Protection

PRC law does not prohibit Internet content providers from collecting and analyzing personal information from their users. We require our users to accept a user agreement whereby they agree to provide certain personal information to us. PRC law prohibits Internet content providers from disclosing to any third parties any information transmitted by users through their networks unless otherwise permitted by law. If an Internet content provider violates these regulations, the Ministry of Information Industry or its local bureaus may impose penalties and the Internet content provider may be liable for damages caused to its users.

C. ORGANIZATIONAL STRUCTURE

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We are a holding company with no operations of our own. We are a Cayman Islands exempted company and we conduct our operations in China primarily through Shengqu, our indirectly wholly owned subsidiary. We and Shengqu are foreign or foreign-invested enterprises under PRC law and accordingly are ineligible to apply for a license to operate online games. In order to comply with foreign ownership restrictions, we operate our online game business in China through Shanda Networking, which is wholly owned by Tianqiao Chen, our chairman and chief executive officer, and Danian Chen, our executive senior vice president, both of whom are PRC citizens, and through Nanjing Shanda and Hangzhou Bianfeng, which are subsidiaries of Shanda Networking. Shanda Networking, Nanjing Shanda, Hangzhou Bianfeng, collectively referred to as our PRC operating companies, and other subsidiaries of Shanda Networking hold the licenses and approvals that are required to operate our online game business and to sell online advertising on our web pages, and Shengqu owns the substantial majority of physical assets. Shengqu has entered into a series of contractual arrangements with Shanda Networking and its shareholders. As a result of these contractual arrangements, we are considered the primary beneficiary of Shanda Networking and its subsidiaries (including the other PRC operating companies) and accordingly we consolidate the results of operations of Shanda Networking and its subsidiaries in our financial statements. However, neither we nor Shengqu owns the equity of the PRC operating companies, and, although we consolidate the results of the PRC operating companies in our consolidated financial statements and we can utilize their cash and cash equivalents in our operations through our contractual arrangements with Shanda Networking, we do not have direct access to the cash and cash equivalents or future earnings of the PRC operating companies. As of March 31, 2006, we had approximately RMB817.3 million (US$101.3 million)in cash and cash equivalents, of which RMB442.0 million (US$54.8 million)was held by Shanda Networking and its subsidiaries.

Pursuant to our contractual arrangements with Shanda Networking and the other PRC operating companies, we provide services, software licenses and equipment to the PRC operating companies in exchange for fees. The principal service, software license and equipment lease agreements that we have entered into are:

equipment leasing agreements, pursuant to which Shanda Networking, Nanjing Shanda and Hangzhou Bianfeng lease a substantial majority of their operating assets from Shengqu;

a technical support agreement, pursuant to which Shengqu provides technical support for Shanda Networking s operations;

technology licensing agreements, pursuant to which Shengqu licenses certain billing technology to Shanda Networking, Nanjing Shanda and Hangzhou Bianfeng;

software license agreements, pursuant to which Shengqu licenses certain software to Shanda Networking, Nanjing Shanda and Hangzhou Bianfeng;

a strategic consulting agreement, pursuant to which Shengqu provides strategic consulting services to Shanda Networking; and

online game distribution and service agreements, pursuant to which Shanda Networking, Nanjing Shanda and Hangzhou Bianfeng distributes and services certain online games that are licensed or owned by Shengqu.

In addition, we have entered into agreements with Shanda Networking and its shareholders that provide us with the substantial ability to control Shanda Networking. Pursuant to these contractual arrangements:

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the shareholders of Shanda Networking have granted an irrevocable proxy to individuals designated by Shengqu to exercise the right to appoint directors, the general manager and other senior management of Shanda Networking;

Shanda Networking will not enter into any transaction that may materially affect its assets, liabilities, equity or operations without our prior written consent;

Shanda Networking will not distribute any dividend;

Shengqu may purchase the entire equity interest in, or all the assets of, Shanda Networking for a purchase price of the lower of RMB10 million or the lowest price permitted under PRC law when and if such purchase is permitted by PRC law or when the current shareholders of Shanda Networking cease to be directors or employees of Shanda Networking;

the shareholders of Shanda Networking have pledged their equity interest in Shanda Networking to Shengqu to secure the payment obligations of Shanda Networking under all of the agreements between Shanda Networking and Shengqu; and

the shareholders of Shanda Networking will not transfer, sell, pledge, dispose of or create any encumbrance on their equity interest in Shanda Networking without the prior written consent of Shengqu.

Each of Shengqu s contractual arrangements with Shanda Networking and its shareholders may only be amended with the approval of our audit committee or another independent body of our board of directors.

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The following diagram illustrates our corporate and share ownership structure as of March 31, 2006:

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[1] Skyline Media Limited is 100% owned by Skyline Capital International Limited, which is in turn 40% owned by Tianqiao Chen through Shanda Media Limited, a company wholly owned by him, 30% owned by Danian Chen through Shanda Investment International Limited, a company wholly owned by him, and 30% owned by Qianqian Luo through Fortune Capital Holdings Enterprise Limited, a company wholly owned by her.

[2] Shanda Interactive Entertainment Limited holds a beneficial ownership interest in a number of subsidiaries and investee companies, a list of which is set forth below.

[3] Shanda Networking

holds a beneficial ownership interests in a number of subsidiary and investee companies established in the PRC. Although we consolidate our results of operations with those of Shanda Networking and its majority beneficially owned subsidiaries, we do not own these entities. Shanda Networking s beneficial ownership interests in its subsidiaries and investee companies are listed in the table set forth below.

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Subsidiaries and Investee Companies

The following table sets forth the direct and indirect subsidiaries and investee companies of Shanda Interactive Entertainment Limited.

	Shanda Interactive Entertainment s Beneficial Ownership Percentage[1]	**Jurisdiction of Incorporation**	**Business**
Shengqu Information Technology (Shanghai) Co., Ltd.	100%	PRC	Provider of information technology-related services and developer of software
Shanda Computer (Shanghai) Co., Ltd.	100%	PRC	Developer of software, hardware and composite systems for end-users
Grandpro Technology Ltd.	100%	BVI	Network PC game platform operator
Shanda Zona LLC	100%	Delaware	Developer and provider of server infrastructure
Shanda Zona Limited	100%	BVI	Developer and provider of server infrastructure
Actoz Soft Co., Ltd.	38.1%	Korea	Developer, operator and publisher of online games
Sina Corporation	18.4%[3]	Cayman Islands	Online media company and value-added information service provider for China and Chinese communities worldwide
Grandpro Technology (Shanghai) Co., Ltd.	100%	PRC	Network PC game platform operator

The following table sets forth the direct and indirect subsidiaries and investee companies of Shanda Networking. Although we consolidate our results of operations with those of Shanda Networking and its majority beneficially owned subsidiaries, we do not own Shanda Networking or such subsidiaries.

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	Shanda Networking s Beneficial Ownership Percentage[1]	Jurisdiction of Incorporation	Business
Nanjing Shanda Networking Co., Ltd.	100%	PRC	Operation of online games
Hangzhou Bianfeng Networking Co., Ltd.	100%	PRC	Operation of online games
Shanghai Shengjin Software Development Co., Ltd.	51.0%	PRC	Development of online games
Shanghai Shengpin Network Technology Development Co., Ltd.	62.5%	PRC	Development of online games
Shanghai Shanda Xinhua Network Development Co., Ltd.	56.0%	PRC	Development and distribution of game publications and Products
Shanghai Orient Youth Culture Development Co., Ltd.	16.8%[2]	PRC	Expo services, consulting services related to international cultural activities, and advertising business
Chengdu Jisheng Technology Co., Ltd.	100.0%	PRC	Development and distribution of management software for Internet cafes
Shanghai Shulong Technology Development Co., Ltd.	100.0%	PRC	Short messaging services
Shanghai Haofang Online Information Technology Co., Ltd.	100%	PRC	Operation of network PC game platform
Hangzhou Bianfeng Software Co., Ltd.	100%	PRC	Development and operation of online chess and board games
Beijing Manyou Tiandi Networking Service Co., Ltd.	100%	PRC	Development of virtual community website
Shanghai Xuanting Entertainment Information Technology Co., Ltd.	100%	PRC	Publication of original literature online
Beijing Digital Red Software Technology Co., Ltd.	100%	PRC	Development of mobile phone-based wireless games
Shanghai Shengyue Advertisement Co., Ltd.	100%	PRC	Provider of online advertising services
Beijing Shengkai Interactive Entertainment Technology Co., Ltd.	75%	PRC	Development of video games.
Shanghai Qipai Computer Technology Co., Ltd.	100%	PRC	Development and operation of online chess and board games.
Shanghai Shanda Family Culture Communication Co., Ltd.	49%	PRC	Distributer of magazines

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	Shanda Networking s Beneficial Ownership Percentage[1]	Jurisdiction of Incorporation	Business
Shanghai Shengci Network Technology Co., Ltd.	75%	PRC	Developer of instant message software
Wenzhou Chuangjia Technology Co., Ltd.	100%	PRC	Development and operation of online chess and board games.

[1] For purposes of reporting beneficial ownership, we include interests held by controlled subsidiaries and nominee shareholders. Due to certain restrictions under PRC Company Law and practices, most PRC limited liability companies, including Shanda Networking, were required to have two or more shareholders. A common practice in cases where a subsidiary would otherwise be wholly-owned is to realize ownership and control via connected companies or organize a second,

nominee shareholder through whom control and beneficial ownership are maintained by contractual arrangements. PRC Company Law was amened on October 27, 2005, which came into effect on January 1, 2006. According to the amended Company Law, limited liability companies are no longer required to have two or more shareholders. We may change our current shareholding structure accordingly.

2 The figure 16.8% is derived from the fact that Shanda Networking owns 56% of Shanghai Xinhua Networking Development Co., Ltd., which in turn owns 30% of Shanghai Orient Youth Culture Development Co., Ltd.

3

We currently hold 9,821,765 ordinary shares of Sina Corporation, or Sina. The figure 18.4% is based on the 53,289,232 ordinary shares outstanding as of March 10, 2006, as reported by Sina Corporation on its 10-K annual report, filed with the Securities and Exchange Commission on March 15, 2006. The figure 19.5% we disclosed in February 2005 is based on the 50,477,694 ordinary shares outstanding as of October 30, 2004, as reported by Sina Corporation on its 10-Q quarterly report, filed with the Securities and Exchange Commission on November 11, 2004.

D. PROPERTY, PLANTS AND EQUIPMENT

Our principal executive offices are located in approximately 14,500 square meters of office space in the No. 1 Office Building in Shanghai under a lease that expires in December 2008. In the fourth quarter of 2005, we acquired a property located at Guoshoujing Road 356, Shanghai, with approximately 10,197.70 square meters of office spaces in Shanghai for office use. We occupy approximately 2,000 square meters of additional leased office space and warehouse space in a number of locations in Shanghai and approximately 6,500 square meters of additional leased office space in Beijing, Shenzhen, Chengdu, Hangzhou, Guangzhou and Wuhan, China; Tokyo, Japan; and Santa Clara, California. We believe that our existing facilities are adequate for our current requirements and that additional space can be obtained on commercially reasonable terms to meet our future requirements.

Item 4A. Unresolved Staff Comments

Not applicable

Item 5. Operating and Financial Review and Prospects

The following discussion of our financial condition and results of operations is based upon and should be read in conjunction with our consolidated financial statements and their related notes included in this annual report 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 and Exchange Act of 1934, or the Exchange Act, including, without limitation, statements regarding *our expectations, beliefs, intentions or future strategies that are signified by the words expect , anticipate , intend , believe , or similar language. All forward-looking statements included in this annual report are based on information available to us on the date hereof, and we assume no obligations 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.*

Our consolidated financial statements and the financial data included in this annual report reflect our reorganization and have been prepared as if our current corporate structure had been in existence throughout the relevant periods. See note 1 to our audited consolidated financial statements.

Overview

We are an interactive entertainment company and one of the largest operators of online games in China. In 2005, our commercially launched games had approximately 2.68 million peak concurrent users and 1.38 million average concurrent users, which refer to the highest number and average number, respectively, of users playing our games at the same time during that period. Immediately below is a summary of our net revenue and net income over the past two years:

In 2005, our net revenues increased by 46.0% to RMB1,896.6 million (US$235.0 million) from RMB1,298.7 million in 2004; but our net income decreased by 72.9% to RMB165.3 million (US$20.5 million) in 2005 from RMB609.5 million in 2004. The decrease in net income is primarily due to a provision of RMB521.5 million (US$64.6 million) for impairment of the investment in Actoz Soft Co., Ltd., or Actoz, an associated company in which we own its 38.1% equity interest; and

Our net revenues increased by 116.5% to RMB1,298.7 million in 2004 from RMB600.0 million in 2003; our net income increased by 123.4% to RMB609.5 million in 2004 from RMB272.9 million in 2003.

Significant factors affecting our financial condition and results of operations include:

The commercial lifespan of the online games and other content that we offer, and our ability to replace such content with new popular online games during that lifespan;

The arrival of additional competition into our markets and its erosion of any first-mover advantage that we might have benefited from by having been one of the first entrants into the online game market in China, and any effect on market prices and the costs of our services and operations;

Our ability to successfully grow through the identification and acquisition of complementary businesses and our ability to successfully integrate acquired companies and realize synergies envisioned at the time of acquisition;

Our ability to successfully develop the EZ initiative and transition from a pure online game company to an interactive entertainment media platform, content and service provider.

The cost of researching, developing and marketing new products, including the EZ initiative.

Our traditional subscription based pay-to-play revenue model;

The willingness of users to purchase in-game value-added services following the introduction of a new free-to-play and pay-for-in-game-value-added services revenue model for our leading MMORPGs.

The costs of licensing and in-house development of new games;

The future availability of preferential tax treatments and government financial incentives in China;

The effect of PRC regulations on the conduct of our operations; and

The growth of Internet and personal computer use and the popularity of these media as a source of entertainment.

In late November 2005, we adopted a free-to-play and pay-for in-game value-added services revenue model for three of our MMORPGs: Mir II, Magical Land and Woool. Going forward, we will consider adopting this new revenue model for our other existing MMORPGs, depending on the game type and lifecycle. Under this new revenue model, which is also used for our casual games, playing the basic features of the game is free and users are able to purchase in-game value-added services, including in-game items and premium features, that enhance the game experience. This new revenue model was introduced primarily in response to the changes in consumption patterns of online game players, as well as market conditions of online game industry in China since we first standardized the pay-to-play revenue model for MMORPGs more than four years ago.

In 2005, as part of our transition from a pure online game operator to an interactive entertainment media company, we introduced the EZ initiative as an integral part of our home strategy. This initiative aims to provide home users with a broad range of entertainment content and services in a convenient and easy-to-use format. We intend to generate revenues from the EZ initiative from the sale of content and services over the EZ Center platform as well as from the sale or licensing of EZ Series products, and we continue efforts in building better partnerships and developing the distribution models for our EZ Pod products.

Recent Acquisitions

In 2004 as well as 2005, we developed and expanded our business through strategic acquisitions and investments. Since the completion of our initial public offering and listing on Nasdaq in May 2004, we have completed acquisitions and investments in businesses that specialize in, among other things, online chess and board games, infrastructure platforms for online and network PC games, mobile phone games, online games and online media, wireless value-added services and Internet portal services. These investments helped us to expand our product offerings and to grow our user base.

Our recent purchases and acquisitions have included the following:

In July 2004, we completed the acquisition of Hangzhou Bianfeng Software Co. Ltd., or Bianfeng, a developer and operator of online chess and board games in China. The total purchase price for the entire equity interest in Bianfeng and an affiliated company was US$20.0 million in cash.

In September 2004, we completed the acquisition of Shanghai Xuanting Entertainment Information Technology Co., Ltd., which operates Qidian, an online forum where independent writers publish their original literature online. The total purchase price for the entire equity interest in Qidian was RMB16.5 million (US$2.0 million).

In October 2004, we completed the second step of a two-step acquisition of Beijing Digital Red Software Application Technology Co., Ltd., or Digital Red, a developer of mobile phone games. The total purchase price for the entire equity interest in Digital Red was RMB19.2 million (US$2.4 million).

In February 2005, we completed our purchase of an approximately 29% stake in Actoz Soft Co., Ltd., or Actoz, a Korean developer, operator and publisher of online games from certain shareholders of Actoz for approximately US$91.7 million in cash. Prior to the shares transfer, we had purchased approximately 9% of Actoz s issued and outstanding shares from KOSDAQ market at an aggregate cost of approximately US$14.4 million. As a result, our ownership in equity interest of Actoz raised to 38.1%. Actoz owns 50% of the copyright for Mir II, the operation of which has generated a significant portion of our revenue.

In February 2005, we completed the purchase of an approximately 19.5% stake in Sina, an online media company, wireless value-added services provider and Internet portal in China, the shares of which are publicly traded on Nasdaq, at a purchase price of US$227.6 million.

In May 2005, we completed the second step of a two-step acquisition of Shanghai Haofang Online Information Technology Co. Ltd., or Haofang, the operator of the largest network PC game platform in China. The total purchase price for the entire equity interest in Haofang and two affiliated companies, including earn-out payments, which was made in February 2006 based on the audited earnings of 2005, was US$56.0 million.

In November 2005, we completed the acquisition of Wenzhou Chuangjia Technology Co., Ltd., or Gametea, a developer and operator of online chess and board games in China. The total purchase price for the entire equity interest in Gametea and an affiliated company was US$4.9 million in cash, of which approximately US$ 3.6 million was paid up, and the remaining consideration shall be paid by two installments in the next two years.

From time to time, we may engage in discussions with third parties with respect to additional acquisitions or investments. Our reported financial results may be affected by any such acquisitions and/or investments, including any acquisitions or dispositions undertaken by us in anticipation of or in connection with any such acquisitions and/or investments. See Risk Factors in Item 3 Key Information .

Related Party Arrangements

In order to comply with current foreign ownership restrictions, we operate our online game business in China through Shanda Networking, a company wholly owned by Tianqiao Chen, our chairman and chief executive officer, and Danian Chen, our executive senior vice president, both of whom are PRC citizens, and through Nanjing Shanda and Hangzhou

Bianfeng, which are subsidiaries of Shanda Networking. Tianqiao Chen and Danian Chen, together with Qianqian Luo, also own all of the shares of Skyline Media Limited, our controlling shareholder. We have entered into a series of contractual arrangements with Shanda Networking, Nanjing Shanda, Hangzhou Bianfeng and the shareholders of Shanda Networking. Pursuant to these contractual arrangements, we provide services, software licenses and equipment to the PRC operating companies in exchange for fees, and we have undertaken to provide financial support to the PRC operating companies to the extent necessary for their operations. As a result of these contractual arrangements, we are considered the primary beneficiary of the PRC operating companies and accordingly we consolidate the results of operations of the PRC operating companies in our financial statements. For a description of our contractual arrangements with Shanda Networking and its shareholders and with Nanjing Shanda and Hangzhou Bianfeng, see Organizational Structure in Item 4 and Major Shareholders and Related Party Transactions in Item 7.

A. OPERATING RESULTS

Net Revenues

In 2005, we had net revenues of RMB1,896.6 million (US$235.0 million), of which net revenues from our online games were RMB1,658.3 million (US$205.5 million), accounting for approximately 87.4% of total net revenues, and net revenues from other sources were RMB238.3 million (US$29.5 million), accounting for approximately 12.6% of total net revenues. Our online game revenues are net of a sales discount, which in 2005 averaged approximately 23.8% and 16.7% of the face value of our pre-paid cards that we sell to our e-sales distributors and offline distributors, respectively. The sales discounts represent the difference between the price at which we sell pre-paid cards to distributors and the face value of the pre-paid cards. In April 2006, we adopted a new discount policy, which cuts the sales discount rates, while alternatively gives distributors more rebate and incentive, based on how much they sell and what kinds of pre-paid game card they sell. Under the new policy, we are able to encourage our distributors to promote games and thus have more control over the distributors.

Our net revenues reflect a deduction from our revenues for business taxes and related surcharges incurred in connection with our China operations. Since Shanda Networking and its subsidiaries operate in China, their revenues are subject to a business tax, at an effective rate of 4.3%, on revenues earned from services provided in the PRC. We deduct these amounts from our revenues to arrive at our net revenues. Due to the preferential treatments for qualified high technology companies in China and the incentive from local government to encourage regional business development, a portion of our revenues for which we previously paid business taxes in connection with our operations in China are currently refunded to us in the form of government financial incentives, but the amount of the financial incentives and the timing to grant them are subject to determination of the government authorities. Upon receipt, these government financial incentives are recognized as other income in our statements of operations and comprehensive income. Please see Taxation in Item 10 Additional Information and note 7 to our consolidated financial statements.

Sources of Revenues

Online game revenues. We derive our online game revenues, which constitute substantially all of our revenues, from online game usage fees paid by users of our MMORPGs and casual games. Mir II and Woool are our two most popular MMORPGs and together have historically accounted for most of our revenues. In the second half of 2005, revenues from Mir II and Woool declined as each game entered the later stages of its lifecycle. We expect Mir II and Woool still to be significant contributors to our revenues during the remainder of their respective lifecycles, and we have taken various

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measures to stabilize the revenue from these two games under the free-to-play and pay-for in-game value-added services revenue model, including upgrade of game version and provision of various customized virtual items and value-added services to game players. Revenues from casual games are primarily derived from BNB and Maple Story. In 2005, the revenue contribution from casual games increased to 21.2% of total net revenue from 16.5% of total net revenue in 2004. The revenue contributed from BNB did, however, begin to decline during 2005 and we expect this downward trend to continue in 2006. As a general matter, online games have a relatively short commercial lifecycle, typically four to five years for successful games. According to our game pipeline, we plan to commercially launch two licensed MMORPGs, Dungeons & Dragons Online and ArchLord, in the second half of 2006. Dungeons & Dragons Online is licensed from a US game developer. We will operate Dungeons & Dragons Online using the pay-to-play revenue model. ArchLord is a 3D MMORPG developed by a leading South Korean game developer and will be operated under the free-to-play and pay-for in-game value-added services model. Within casual games, following the successful commercial launch of our in-house developed car racing game Crazy Kart in March 2006, we plan to commercialize two new casual games, including one South Korean music game DJ Max and one in-house developed casual game in the second half of 2006. We expect that these new games will start to contribute revenue beginning in the third or fourth quarter of 2006.

Other net revenues. Our other net revenues primarily consist of net revenues from online advertising, sales of our user password protection product, sales of EZ Pod, short messaging services, or SMS, technical service and cooperation on our network PC game platform and our online literature portal. In 2005, the contribution from other revenues increased to 12.6% of total net revenue from 6.9% of total net revenue in 2004. In the last quarter of 2005, we commenced the sale of EZ-Pod products, which is a software-based upgrade that allows users to access our interactive entertainment content. For the year ended December 31, 2005, the revenue from sale of EZ Pod amounted to RMB22.5 million (US$2.8 million). As of March 31, 2006, Shanda s EZ platform is still at the trial run stage and we have not yet charged users subscription fee.

Significant Factors

Pay-to-play revenue model. Prior to late November 2005, our MMORPG online game revenues were primarily derived from the purchase and utilization of playing time by our users. Accordingly, the two significant factors that affect our MMORPG online game revenues have been:

- the number of hours that users play our games, or total user-hours; and

- our average revenue per user-hour.

We calculate our total user-hours based on our average concurrent users, which is a commonly used industry statistic. In a given period, the number of total user-hours equals the average concurrent users for that period multiplied by the number of hours in that period. In measuring average concurrent users, we determine the number of users logged on to each of our commercially launched games at one minute intervals, then average that data over the course of a day to derive daily averages. Average daily information is further averaged over a particular period to determine average concurrent users for that period. For a discussion of factors that might affect total user-hours, see Risk Factors in Item 3, Key Information .

Our effective revenue per user-hour is derived by taking the revenues from our online games for a period and dividing this number by total user-hours in that period. This provides us with a measure of the average revenue per user-hour that we receive from users that play our games.

Free-to-play and pay-for in-game value-added services revenue model. In late November 2005, we adopted a free-to-play and pay-for in-game value-added services revenue model for three of our MMORPGs: Mir II, Magical Land and Woool.

The free-to-play and pay-for in-game value-added services revenue model is also used for our casual games. Under this model, users acquire in-game items by converting game points from pre-paid cards. Because playing the basic features of the game is free and the purchase of in-game items is optional, average concurrent users is not a significant revenue factor under this model. The most significant factors that affect MMORPG and casual game revenue under the free-to-play and pay-for in-game value-added services revenue model are:

- the number of active paying accounts; and

- our average revenue per active paying account.

The number of active paying accounts for any given period is equal to the number of accounts from which game points are utilized during such period. Our average revenue per paying account is equal to our revenue for the given period divided by our active paying accounts in that period. For a discussion of factors that might affect the number of active paying casual game account and the average revenue per active paying account, see Risk Factors in Item 3, Key Information

Revenue Collection

Our online game revenues are collected through the sale of pre-paid cards, which we sell in both virtual and physical form, to third party distributors and retailers, including Internet cafes, as well as through our direct online payment systems. In most cases, we receive cash payments from these parties in exchange for delivery of the pre-paid cards. We do not provide refunds to these distributors or retailers with respect to unsold inventories of pre-paid cards. We also collect online game revenues through certain telecommunications service operators that bundle broadband access services for home users with our online games.

Our other revenues are collected through mobile telecommunications service operators, in the case of certain of our SMS services, and through traditional sales channels in the case of our game-related publications, derivative products, online advertising sales, sales of our user password protection product and sales of EZ Pod.

In 2005, we recorded doubtful debts in the amount of RMB55.7 million (US$6.9 million), which was mainly due to overdue receivables from online advertising and sales of our user password protection product. As of December 31, 2005, we had net accounts receivable of RMB81.1 million (US$10.1 million), which were also mainly due from purchasers of online advertising and sales of our user password protection product.

Revenue Recognition and Deferred Revenue

In the case of pay-to-play games, we recognize revenues based on the time units actually consumed by our users, and, in the case of pay-for-items games, we recognize revenues over the life of the in-game premium features users purchase or as the premium features are consumed. We also recognize revenues when our users who had previously purchased playing time and/or points are no longer entitled to access the online games in accordance with our published expiration policy. We account for the amounts received upon the sale of pre-paid cards, but prior to usage or expiration of the value sold, as deferred revenue in our consolidated balance sheets. Deferred revenue is reduced as revenues are recognized. As our online game business has grown, our deferred revenue balances have increased from RMB197.5 million as of December 31, 2003, to RMB247.3 million as of December 31, 2004. In 2005, however, our deferred revenue balance decreased to RMB172.5 million (US$21.4 million) as of December 31, 2005.

Sales Tax

Our PRC affiliates are subject to PRC business tax. We primarily pay business tax on gross revenues generated from online game operations, rentals, service fees and license fees. Shanda Networking, Nanjing Shanda and Hangzhou Bianfeng pay business tax on their gross revenues derived from online game operations at a rate ranging from 3% to 5%, and this business tax is deducted from total revenues. In addition, Shengqu pays a 5% business tax on the gross revenues derived from its contractual arrangements with Shanda Networking, Nanjing Shanda and Hangzhou Bianfeng, and these taxes are primarily recorded in operating expenses in accordance with our accounting policy.

Cost of Revenue

Our cost of revenue primarily consists of ongoing licensing fees for online games, amortization of upfront licensing fees, server leasing and maintenance fees, salary and benefits, depreciation of property, equipment and software, and manufacturing costs of pre-paid cards, our user password protection product and EZ Pod.

Upfront and ongoing licensing fees. The cost of licensing games from developers consists of upfront licensing fees, which are generally paid in several installments, and ongoing licensing fees, which are equal to a percentage of our revenues from the relevant licensed game. The ongoing licensing fee payments range from 20% to 30% of revenues for our commercially launched MMORPGs, and from 17% to 40% of our revenues for our commercially launched casual games. The cost of licensing games was equal to 21.3% of our net revenues in 2004 and 17.7% of our net revenues in 2005, and constituted the largest component of our cost of revenue in each such period. Six of the twelve online games we offer commercially are licensed from third parties. The decrease of the percentage of cost of licensing games in our net revenue is primarily due to the increase of percentage of net revenue generated by Woool, an in-house developed game in total net revenue and the increase in our non-game revenue.

Server leasing and maintenance fees. Server leasing and maintenance fees was equal to 6.2% of our net revenues in 2004 and 4.7% of our net revenues in 2005. As of December 31, 2005, we leased approximately 42.3% of our servers, primarily from telecommunications companies. These companies host our server network, and receive maintenance fees from us in addition to the lease payments. The majority of our server leases have variable payment obligations based on the number of our users logging on to each relevant server. We expect our costs for servers to increase in the future, due to the purchase of additional servers in connection with our introduction of new games and due to our recent change in revenue model, which resulted in an increase in the average number of users playing our games. For a discussion of our change in revenue model, see Item 5 Operating and Financial Review and Prospects A. Operating Results Net Revenues Significant Factors.

Depreciation of property, equipment and software. Depreciation of property, equipment and software, which consisted primarily of servers and other computer equipment, was equal to 2.2% of our net revenues in 2004 and 2.3% of our net revenues in 2005. We include depreciation expenses within our cost of revenue when the relevant assets are directly

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related to the operations of our online game network and provision of online game services. Depreciation expenses are characterized as operating expenses in all other cases. In 2005, the increase in our depreciation expense was primarily due to the acquisition of additional servers. As we expect to continue to purchase additional servers in connection with the introduction of new games, we believe that our depreciate costs will continue to increase in 2006.

Salary and benefits. Salary and benefits expense was equal to 1.8% of our net revenues in 2004 and 2.2 % of our net revenues in 2005. Salary and benefits expense includes employee wages and welfare benefits, such as medical insurance, housing subsidies, unemployment insurance and pension benefits. Salary and benefits expense included in our cost of revenue primarily relates to employees involved in the operation of our online games, including network maintenance, billing systems and our call center. In 2004 and 2005, approximately 18.2% and 18.6%, respectively, of our salary and benefits expense was included in our cost of revenue, with the remainder constituting operating expenses. We do not expect an increase in the number of employees involved in the operation of our games in 2006. In the second quarter of 2006, we adopted a new compensation structure for employees that operate our games, pursuant to which an employee s bonus is tied to the financial performance of the game that his group operates. As this compensation structure is untested, we are unsure what impact the new system will have on cost of revenue salary and benefits expense.

Gross profit/margin. Gross profit represented 63.7% of our net revenues in 2004 and 67.6% of our net revenues in 2005.

Operating Expenses

Our operating expenses consist of product development expenses, sales and marketing expenses, general and administrative expenses.

Product development expenses. Product development expenses were equal to 5.5% of our net revenues in 2004 and 8.7% of our net revenues in 2005. Our product development expenses primarily consist of salary and benefits expenses of personnel engaged in the research and development of our products, amortization of software used by our research and development center, rental and management fees for office space used by our research and development center, share-based compensation, and depreciation of equipment used in research and development activities. We expect our product development expenses to continue to increase in the future, as we continue research and development projects related to our EZ initiative and our in-house casual games.

Sales and marketing expenses. Sales and marketing expenses were equal to 7.0% of our net revenues in 2004 and 12.4% of our net revenues in 2005. Our sales and marketing expenses primarily consist of promotion, advertising and sponsorship of media events, share-based compensation, and salary and benefits of our sales and marketing department. We have taken various measures to improve the budget control procedure. Going forward, we will focus on the effective usage of the budget, with emphasis on promoting new games launched as well as our EZ initiative. We expect that sales and marketing expenses will decline in 2006.

General and administrative expenses. General and administrative expenses were equal to 11.8% of our net revenues in 2004 and 13.7% of our net revenues in 2005. General and administrative expenses primarily consist of salary and benefits for general management, finance and administrative personnel, professional service fees, business tax expense, share-based compensation, and provision for doubtful debts. Our business tax expense primarily relates to services and licensing fees paid by our PRC operating companies to Shengqu. Provisions of RMB 55.7 million (US$ 6.9 million) for doubtful debts were made in 2005 for the overdue receivables from online advertising and sales of our user password protection product. As a result of tightening of credit controls and other cost control procedures, we expect general and administrative expenses to decline in 2006. See the sections entitled Our Corporate Structure and Related Party Transactions in Item 7 Major Shareholders and Related Party Transactions for additional description of the relationship between Shengqu and our PRC operating companies.

Income from operations/margin. In 2004, our income from operations accounted for 39.3% of our net revenues. In 2005, our income from operations accounted for 32.8% of our net revenues.

Other Income

Our other income consists primarily of government financial incentives that certain of our PRC incorporated affiliates receive from municipal governments and that are calculated with reference to taxable income and revenues, as the case may be. In 2004 and 2005, we received aggregate government financial incentives of RMB88.1 million and RMB137.3 million (US$17.0 million), respectively, from municipal governments. We expect to continue receiving government financial incentives relating to our 2005 taxable income and revenues in 2006, until those 2005 financial incentives are completed. Going forward, eligibility for the government financial incentives we are to receive requires that we continue to meet a number of government financial and non-financial criteria to continue to qualify for these government financial incentives. Generally, which include:

- at least a minimum level of revenues must be generated from high-tech related sales or services, determined as a percentage of total revenues;
- at least a minimum number of employees must be engaged in research and development; and
- at least a minimum amount must be expended on research and development, determined as a percentage of total revenues.

The continued qualification is further subject to the discretion of the municipal government. Moreover, the central government or municipal government could determine at any time to immediately eliminate or reduce these financial incentives. Upon expiration of these government financial incentives, we will consider available options, in accordance with applicable law, that would enable us to qualify for further government financial incentives to the extent they are then available to us.

In 2005, other income also includes a foreign exchange gain of RMB48.9 million (US$6.1 million) arising from a revaluation of monetary assets and liabilities denominated in US dollar following the appreciation of the RMB against the U.S. dollar in 2005.

Income Tax Expense

Under the current laws of the Cayman Islands and the British Virgin Islands, neither Shanda Interactive Entertainment Limited nor Shanda Holdings Limited, our wholly owned subsidiary incorporated in the British Virgin Islands, is subject to tax on its income or capital gains. In addition, payment of dividends by either company is not subject to withholding tax in those jurisdictions.

PRC enterprise income tax. Our PRC incorporated affiliates, including Shengqu, Shanda Networking, Nanjing Shanda, Hangzhou Bianfeng and Shanda Computer, are subject to PRC enterprise income tax on the taxable income as reported in their respective statutory financial statements, adjusted in accordance with the Enterprise Income Tax Law and the Income Tax Law of the People s Republic of China concerning Foreign Investment Enterprise and Foreign Enterprises (collectively the PRC Income Tax Laws), respectively. Pursuant to the PRC Income Tax Laws, our PRC incorporated affiliates are generally subject to PRC enterprise income tax at a statutory rate of 33%, among which Shengqu, Shanda Networking and Shanda Computer, because of incorporation in the Pudong New District of Shanghai, are however, subject to a 15% preferential income tax rate pursuant to the local tax preferential treatment. Shengqu, as a software development enterprise, has been granted a two year income tax exemption to be followed by a three year 50% income tax reduction on its taxable income, commencing the year ended December 31, 2003 (tax holiday). Nanjing Shanda, as a result of receiving government s recognition as a technologically advanced enterprise in the third quarter of 2005, has been entitled to a full income tax exemption for two years effective from January 1, 2005 and will be subject to a preferential tax rate of 15% after January 1, 2007 due to its residence in a national high-tech development zone. As a result of this recognition, Nanjing Shanda received the refund for the income tax it previously paid in 2005. Hangzhou Bianfeng was in the process of apply for recognition as a technologically advanced enterprise in 2005 and was then subject to income tax at the statutory rate of 33%. In the second quarter of 2006**,** Hangzhou Bianfeng received an approval from local tax authorities in respect of the preferencial treatment as a technologically advanced enterprise and is thus entitled to a reduced income tax rate of 15% effective from January 1, 2006. Moreover, the income tax previously paid by Hangzhou Bianfeng for the year ended December 31, 2005 will be refunded to it in 2006. The qualifications of Shengqu, Shanda Networking, Nanjing Shanda and Hangzhou Bianfeng as a software development enterprise or a technologically advanced enterprise are required to be reassessed on an annual basis. Shanda Computer was still in a loss-making position as of December 31, 2005, and thus no PRC enterprise income tax was due for the year then ended.

Critical Accounting Policies

We prepare our financial statements in conformity with US GAAP, which requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities on the date of the financial statements and the reported amounts of revenues and expenses during the financial reporting period. We continually evaluate these estimates and assumptions based on the most recently available information, our own historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Since the use of estimates is an integral component of the financial reporting process, actual results could differ from those estimates. Some of our accounting policies require higher degrees of judgment than others in their application. We consider the policies discussed below to be critical to an understanding of our financial statements as their application places the most significant demands in our management s judgment.

Revenue Recognition

Substantially all of our revenues are collected through the sales of pre-paid cards, which we sell in both virtual and physical form, to third party distributors and retailers. Prior to late November 2005, we operated all MMORPGs under a pay-to-play model. Under this model, the subscription fees from distributors or retailers are deferred when received and revenue is recognized based upon the actual usage of time units by the end users. In late November 2005, we changed the revenue model of certain MMORPGs from the pay-to-play model to a free-to-play and pay-for in-game value-added services revenue model. Under the new model, players can access the game free of charge but may pay for in-game premium features. Under the new model, subscription fee is deferred when received and revenue is recognized over the life of the premium features users purchase or as the premium features are consumed. For casual games, which can also be accessed for free and in-game premium features are provided users purchase with charges, we deferred the subscription fee received and recognize it as revenue over the life of the premium features or as they are consumed.

Revenue is recognized when our users who had previously purchased playing time and/or points are no longer entitled to use that playing time and/or points in accordance with our published expiration policy. Our users must activate their pre-paid cards by using access codes and pass