

GIGAMEDIA LTD  
Form 20-F  
June 30, 2010

**Table of Contents**

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

**FORM 20-F**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2009  
Commission File Number: 000-30540**

**GIGAMEDIA LIMITED**  
(Exact name of registrant as specified in its charter)  
**REPUBLIC OF SINGAPORE**  
(Jurisdiction of incorporation or organization)  
**8<sup>TH</sup> FLOOR, 207 TIDING BOULEVARD, SECTION 2, TAIPEI 114, TAIWAN, R.O.C.**  
(Address of principal executive offices)  
**Arthur M. Wang, Chief Executive Officer**  
**8<sup>TH</sup> FLOOR, 207 TIDING BOULEVARD, SECTION 2, TAIPEI 114, TAIWAN, R.O.C.**  
**Tel: 886-2-2656-8000; Fax: 886-2-2656-8003**

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

<b>Title of Each Class</b>	<b>Name of Each Exchange on Which Registered</b>
----------------------------	--

<b>Ordinary Shares</b>	<b>The NASDAQ Stock Market LLC</b>
------------------------	------------------------------------

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

**None**

**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:

**54,994,800 ordinary shares**

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

Yes  No

If this annual report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes  No

note Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

U.S. GAAP

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

Other

If  Other has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow. Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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

---

**TABLE OF CONTENTS**

	Page
<b><u>PART I</u></b>	2
<u>ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS</u>	2
<u>ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE</u>	2
<u>ITEM 3. KEY INFORMATION</u>	2
<u>ITEM 4. INFORMATION ON THE COMPANY</u>	20
<u>ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS</u>	47
<u>ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES</u>	73
<u>ITEM 7. MAJOR SHAREHOLDERS AND RELATED-PARTY TRANSACTIONS</u>	82
<u>ITEM 8. FINANCIAL INFORMATION</u>	83
<u>ITEM 9. THE OFFER AND LISTING</u>	87
<u>ITEM 10. ADDITIONAL INFORMATION</u>	88
<u>ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	97
<u>ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES</u>	98
<b><u>PART II</u></b>	98
<u>ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES</u>	98
<u>ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS</u>	99
<u>ITEM 15. CONTROLS AND PROCEDURES</u>	99
<u>ITEM 16. Reserved</u>	100
<u>ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT</u>	100
<u>ITEM 16B. CODE OF ETHICS</u>	100
<u>ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES</u>	101
<u>ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES</u>	102
	102

ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

ITEM 16F. CHANGES IN REGISTRANT S CERTIFYING ACCOUNTANTS 102

ITEM 16G. CORPORATE GOVERNANCE 102

**PART III** 102

ITEM 17. FINANCIAL STATEMENTS 102

ITEM 18. FINANCIAL STATEMENTS 103

ITEM 19. EXHIBITS 103

Exhibit 4.34

Exhibit 4.35

Exhibit 4.36

Exhibit 4.37

Exhibit 4.38

Exhibit 4.39

Exhibit 4.40

Exhibit 4.41

Exhibit 4.42

Exhibit 4.43

Exhibit 4.44

Exhibit 8.1

Exhibit 12.1

Exhibit 12.2

Exhibit 13.1

Exhibit 13.2

Exhibit 15.1

**Table of Contents****CERTAIN TERMS AND CONVENTIONS**

In this annual report, all references to (i) we, us, our, our Company or GigaMedia are to GigaMedia Limited and unless the context requires otherwise, its subsidiaries, or where the context refers to any time prior to the incorporation of any of its subsidiaries, the business which predecessors of the present subsidiaries were engaged in and which were subsequently assumed by such subsidiaries; (ii) Shares are to ordinary shares of our Company; (iii) CESL are to Cambridge Entertainment Software Limited (formerly known as Grand Virtual International Limited), a company incorporated under the laws of The British Virgin Islands; (iv) Hoshin GigaMedia are to Hoshin GigaMedia Center Inc., a company incorporated under the laws of Taiwan, Republic of China, ( Taiwan or R.O.C. ); (v) FunTown are to our online games business operated through our two operating subsidiaries, Hoshin GigaMedia and FunTown World Limited, a company incorporated under the laws of The British Virgin Islands; (vi) T2CN are to T2CN Holding Limited, a company incorporated under the laws of The British Virgin Islands, and its subsidiaries; (vii) Internet access and service business are to an Internet access and service business that we historically operated through Koos Broadband Telecom Co., Ltd. ( KBT ) and completely disposed of in September 2008; and (viii) UIM are to Ultra Internet Media S.A., a company incorporated under the laws of Nevis; and (ix) Mangas Everest are to Mangas Everest, a société par actions simplifiée registered with the Trade and Companies Registry of Paris and organized under the laws of France.

For the purpose of this annual report only, geographical references to China and the PRC are to the People's Republic of China and do not include Taiwan, the Hong Kong Special Administrative Region ( Hong Kong ) and the Macau Special Administrative Region ( Macau ). Except the context otherwise requires and for the purposes of this annual report only, references to Greater China include the PRC, Taiwan, Hong Kong and Macau. References to South Korea are to the Republic of Korea.

All references in this annual report to U.S. dollar, \$ and US\$ are to the legal currency of the United States; all references to NT dollar or New Taiwan dollar are to the legal currency of Taiwan; all references to RMB, Rmb or Renminbi are to the legal currency of the PRC; and all references to Hong Kong dollar are to the legal currency of Hong Kong.

We have approximated certain numbers in this annual report to their closest round numbers or a given number of decimal places. Due to rounding, figures shown as totals in tables may not be arithmetic aggregations of the figures preceding them.

**DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS**

This annual report includes forward-looking statements within the meaning of, and intended to qualify for the safe harbor from liability established by, the United States Private Securities Litigation Reform Act of 1995. These statements, which are not statements of historical fact, may contain estimates, assumptions, projections and/or expectations regarding future events, which may or may not occur. These statements involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. Some of the risks are listed under Item 3, Key Information D. Risk Factors and elsewhere in this annual report. In some cases, you can identify these forward-looking statements by words such as anticipate, believe, could, estimate, expect, intend, may, plan, potential, should, will, would, or similar expressions, including These forward-looking statements include, without limitation, statements relating to:

- our business plan and strategies;
- our future business development and potential financial condition, results of operations and other projected financial information;
- our ability to manage current and potential future growth;
- expected continued acceptance of our revenue model;
- our plans for strategic partnerships, licenses and alliances;
- our acquisition and strategic investment strategy, and ability to successfully integrate any past, current, or future acquisitions into our operations;
- our ability to protect our intellectual property rights and the security of our customers' information;
- launch of new online games according to our timetable;

expected continued acceptance of our online games, including expected growth of the online games industry, and consumer preferences for our products and services;

**Table of Contents**

the in-house development of new online games and our plans to expand our in-house online game development team;

the performance of Mangas Everest and developments in the online gaming industry;

our plans to license additional games from third parties, and the launch of these new games or gaming software systems, including the timing of any such development, licenses or launches, in various geographic markets;

our ability to maintain and strengthen our position as one of the largest online MahJong operators in Taiwan;

our ability to maintain the well-established online sports game platform in the PRC;

potential entry of new competitors in any of our business lines;

changes in the global regulatory environment relating to the online gaming business;

changes or stability in certain regulatory environments relating to Mangas Everest's operations or gaming licenses;

changes in PRC laws and regulations, and future enforcement of those laws and regulations, including laws and regulations relating to Internet usage, advertising over the Internet, Internet content providers, foreign investment and ownership in online business, distribution of dividends and foreign exchange controls;

the outcome of ongoing, or any future, litigation or arbitration; and

our corporate classification by various governmental entities.

These forward-looking statements are based on our own information and on information from other sources we believe to be reliable. Our actual results may differ materially from those expressed or implied by these forward-looking statements as a result of risk factors and other factors noted throughout this annual report, including those described under Item 3, Key Information D. Risk Factors and those detailed from time to time in other filings with the U.S. Securities and Exchange Commission (the SEC). We do not guarantee that the transactions and events described in this annual report will happen as described or that they will happen at all. We undertake no obligation to update or revise any forward-looking statements to reflect events or circumstances after the date of this annual report or to reflect the occurrence of unanticipated events. Whether actual results will conform to our expectations and predictions is subject to a number of risks and uncertainties, many of which are beyond our control, and reflect future business decisions that are subject to change. Given this level of uncertainty, you are advised not to place undue reliance on such forward-looking statements.

**PART I**

**ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS**

Not applicable, but see Item 6, Directors, Senior Management and Employees A. Directors and Senior Management in this annual report.

**ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable.

**ITEM 3. KEY INFORMATION**

**Exchange Rates**

Our consolidated financial statements were historically reported in New Taiwan dollars. Effective January 1, 2004, we adopted the U.S. dollar as our reporting currency because operations denominated in U.S. dollars represented a significant portion of our business following the acquisition of our gaming software and service business. Assets and liabilities on our balance sheet denominated in non-U.S. dollars are translated into U.S. dollars using year-end exchange rates. Income and expense items in our statement of operations denominated in non-U.S. dollars are translated into U.S. dollars using the weighted-average exchange rates. Certain other operating financial information denominated in non-U.S. dollars, not included in our consolidated financial statements and provided in this annual report, are translated using weighted-average exchange rates. For convenience, transactions in 2010 denominated in non-U.S. dollars have been translated into U.S. dollars using the year-end exchange rate for 2009. We make no representation that the non-U.S. dollars could be converted to U.S. dollars at such rate or any particular rates.





**Table of Contents****A. Selected Financial Data**

The following selected consolidated balance sheet data as of December 31, 2008 and 2009 and the selected consolidated statement of operations data for the years ended December 31, 2007, 2008 and 2009 have been derived from our audited consolidated financial statements included in Item 18 in this annual report. The selected consolidated balance sheet data as of December 31, 2005, 2006 and 2007, and the selected consolidated statement of operations data for the years ended December 31, 2005 and 2006 have been derived from our audited consolidated financial statements for the years ended December 31, 2005, 2006 and 2007, which are not included in this annual report. The consolidated financial statements have been prepared and presented in accordance with generally accepted accounting principles in the United States, or U.S. GAAP. You should read the following selected consolidated financial data in conjunction with Item 5, Operating and Financial Review and Prospects, and the consolidated financial statements and the accompanying notes to those statements included in this annual report. The statements of operations for the years ended December 31, 2005, 2006, 2007 and 2008 have been retroactively restated to reflect (i) the results of our music distribution business, which was sold in September 2005, and (ii) the results of our Internet access and service business, which was sold in September 2008, as discontinued operations. Certain prior-year amounts have been reclassified to conform to the current-year presentation. These reclassifications had no effect on the results of operations or equity as previously reported.

**For the Years Ended December 31,**  
(in thousands except for earnings per share amounts)

	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
	<b>US\$</b>	<b>US\$</b>	<b>US\$</b>	<b>US\$</b>	<b>US\$</b>
<b>STATEMENT OF OPERATIONS DATA:</b>					
<b>OPERATING REVENUES</b>					
Gaming software and service revenues	22,511	55,019	118,950	144,765	112,694
Online game and service revenues	0	18,692	32,764	45,604	46,887
Total operating revenues	22,511	73,711	151,714	190,369	159,581
<b>OPERATING COSTS</b>					
Cost of gaming software and service revenues	(3,327)	(7,824)	(16,201)	(22,770)	(20,102)
Cost of online game and service revenues	0	(3,667)	(9,118)	(12,404)	(16,785)
Total operating costs	(3,327)	(11,491)	(25,319)	(35,174)	(36,887)
<b>GROSS PROFIT</b>	<b>19,184</b>	<b>62,220</b>	<b>126,395</b>	<b>155,195</b>	<b>122,694</b>
<b>OPERATING EXPENSES</b>					
Product development and engineering expenses	(2,524)	(5,244)	(7,338)	(13,455)	(14,195)
Selling and marketing expenses	(8,042)	(27,653)	(60,106)	(74,173)	(79,421)
General and administrative expenses	(6,374)	(11,096)	(20,983)	(25,035)	(29,692)
Bad debt expenses	0	(448)	(548)	(2,905)	(1,092)
Impairment loss on property, plant, and equipment	0	0	0	0	(1,250)

Edgar Filing: GIGAMEDIA LTD - Form 20-F

Impairment loss on goodwill	0	0	0	0	(14,103)
Impairment loss on prepaid licensing fees and intangible assets	0	0	0	(1,524)	(23,002)
Total operating expenses	(16,940)	(44,441)	(88,975)	(117,092)	(162,755)
Income (loss) from operations	2,244	17,779	37,420	38,103	(40,061)
Income (loss) from continuing operations	3,525	18,173	39,083	35,710	(56,102)
Income from discontinued operations	2,961	12,932	1,088	9,435	222
Net income (loss)	6,486	31,105	40,171	45,145	(55,880)
Less: Net (income) loss attributable to the noncontrolling interest	(150)	(321)	(1,281)	(757)	6,795
Net income (loss) attributable to GigaMedia	6,336	30,784	38,890	44,388	(49,085)
Earnings (loss) per share (in dollars):					
Basic:					
Income (loss) from continuing operations	0.07	0.35	0.72	0.65	(0.90)
Income from discontinued operations	0.06	0.25	0.02	0.17	0.00
Net income (loss)	0.13	0.60	0.74	0.82	(0.90)
Diluted:					
Income (loss) from continuing operations	0.06	0.30	0.63	0.58	(0.90)
Income from discontinued operations	0.06	0.21	0.02	0.16	0.00
Net income (loss)	0.12	0.51	0.65	0.74	(0.90)

**Table of Contents**

**As of December 31,**  
(US dollars in thousands except for number of issued shares)

	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
	<b>US\$</b>	<b>US\$</b>	<b>US\$</b>	<b>US\$</b>	<b>US\$</b>
<b>BALANCE SHEET DATA:</b>					
Total current assets	70,204	64,176	115,417	128,799	104,839
Property, plant and equipment-net	10,747	10,098	13,008	13,468	5,989
Goodwill	29,243	55,817	85,149	87,098	44,417
Intangible assets-net	2,704	23,067	26,060	28,930	18,924
Total assets	113,519	182,619	283,865	316,793	260,181
Total GigaMedia shareholders' equity	100,648	134,087	180,665	228,456	184,745
Common shares, no par value, and additional paid-in capital	287,920	289,495	296,793	300,021	304,379
Number of issued shares (in thousands)	50,344	51,495	53,700	54,365	54,995
Dividends declared per share (in dollars)	0	0	0	0	0

Presentation of financial information for the years ended December 31, 2005, 2006, 2007 and 2008 has been reclassified to conform to the presentation for the year ended December 31, 2009 for non-controlling interest.

**B. Capitalization and Indebtedness**

Not applicable.

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

Not applicable.

**D. Risk Factors****Risks Related to Our Business and Industries****The limited operating history of the Mangas Everest business and our online games business may not provide you with an adequate basis upon which to evaluate our business and prospects**

We commenced our gaming software and service business operations in April 2004 and our online games business in January 2006. We sold 60 percent interest in our gaming software business to Mangas Gaming (Mangas), a leading European sports betting and online gaming group, on April 8, 2010. The strategic alliance with Mangas was structured as a stock and asset sale to a newly-formed French entity, Mangas Everest, in which we hold a 40 percent stake.

Mangas Everest's operating history as an online gambling operator and our operating history as an online games operator may be too short to give you a sufficient basis for evaluating our business and financial performance. It is also difficult to evaluate our prospective business, because we may not have sufficient experience to address the risks frequently encountered by companies entering new and rapidly evolving markets such as the online gaming and online games market. These risks include our potential failure to:

- respond to technological changes or resolve unexpected service interruptions in a timely manner;
- adapt to regulatory changes;
- retain existing customers or attract new customers;

## **Table of Contents**

license, develop, or acquire additional online games that are appealing to consumers;  
anticipate and adapt to changing consumer preferences;  
adapt to competitive market conditions;  
adequately and efficiently operate, upgrade and develop our transaction and service platforms; and  
maintain adequate control of our expenses.

If we are unsuccessful in addressing any of these risks, our business and financial condition will be adversely affected. In addition, certain management members have worked at our Company for a relatively short period. We may not be able to achieve similar results or growth in future periods. Accordingly, you should not rely on our results of operations for any prior periods as an indication of our future performance.

### **In operating our online games business, we may fail to launch new games according to our timetable, and our new games may not be commercially successful**

In order for our online games business strategy to succeed over time, we will need to license, acquire or develop new online games that can generate additional revenue and further diversify our revenue sources. A number of factors, including technical difficulties, government approvals and game licenses required for launching new games, lack of sufficient game development personnel and other resources, and adverse developments in our relationship with the licensors of our new licensed games could result in delay in launching our new games. Therefore, we cannot assure you that we will be able to meet our timetable for new game launches.

In January 2009, we introduced Holic Online, an adventure-themed massively multi-player online role playing game ( MMORPG ), in Taiwan. On June 25, 2009, we launched Warhammer Online: Age of Reckoning, a war-themed MMORPG, in Taiwan, Hong Kong and Macau. On July 7, 2009, we launched Luna Online, a casual fantasy-themed MMORPG in the PRC. Warhammer Online: Age of Reckoning and Luna Online were not commercially successful in the territories in which they were launched. As a result, we terminated the license agreements for these two games in April 2010 and June 2010, respectively. In addition, we have one MMORPG and two advanced casual games in the pipeline, which we expect to launch in various target markets in Greater China, including the PRC, Taiwan, Hong Kong and Macau. There are many factors that may adversely affect the popularity of our new games. For example, we may fail to anticipate and adapt to future technical trends and new business models, fail to satisfy game player preferences and requirements, fail to effectively plan and organize marketing and promotion activities, fail to effectively detect and prevent programming errors or defects in the games, and fail to operate our new games at acceptable costs. We cannot assure you that our new games will gain market acceptance and become commercially successful. If we are not able to license, develop or acquire additional online games that are commercially successful, our future revenues and profitability may decline.

Due to increased competition among online games operators in the PRC and Taiwan, license fees for online games have increased and most licensors are demanding upfront license fees and guaranteed minimum royalty payments. If any of the new games we license from third parties fails to appeal to players, we may not be able to fully recover upfront and/or minimum royalty licensing costs, which can be significant. As a result, our results of operations and financial condition may be materially and adversely affected.

### **We may not be successful in operating and improving our existing online games to satisfy the changing demands and preferences of players**

The level of demand and market acceptance of our existing online games is subject to a high degree of uncertainty. Our future operating results will depend on numerous factors, many of which are beyond our control. These factors include:

the popularity of existing and new online games operated by us;  
the introduction of new online games by us or third parties, competing with or replacing our existing online games;  
general economic conditions, particularly economic conditions adversely affecting discretionary consumer spending;  
changes in our customer demands and preferences;  
the availability of other forms of entertainment; and  
critical reviews and public tastes and preferences, all of which change rapidly and cannot be predicted.



## **Table of Contents**

Our ability to plan for product development and distribution and promotional activities will be significantly affected by how well we anticipate and adapt to relatively rapid changes in consumer tastes and preferences. Currently, a substantial portion of our online games revenue is derived from revenues from Freestyle, an online sports game offered in the PRC, and the online MahJong games offered in Taiwan and Hong Kong. However, there is no assurance that these games will continue to be popular. A decline in the popularity of online games in general or, in particular, Freestyle and online MahJong, is likely to adversely affect our business, financial condition and results of operations. To maintain competitiveness of our games, we are generally required to continuously invest in enhancing, improving, expanding or upgrading our games. If we fail to do so, revenues generated from our existing games may decline. In addition, we expect that as we introduce new online games, a portion of our existing customers will switch to the new games. If this transfer of players from our existing games exceeds our expectations, we may have to adjust our marketing, pricing and other business plans and, as a result, our growth and profitability could be materially and adversely affected.

### **Our results of operations are subject to significant fluctuations**

Our revenues, expenses and results of operations have varied in the past and may fluctuate significantly in the future due to a variety of factors, many of which are beyond our control. The key factors affecting our businesses include:

Gaming software and service business: the regulatory restrictions applicable to the Internet gaming industry; the revenues, expenses and results of operations of Mangas Everest, our joint venture with Mangas; global economic conditions and general economic conditions of the markets where our products target; availability of the Internet infrastructure; and the technological and other competition from existing and new competitors.

Online games business: our ability to retain existing users; attract new users and maintain user satisfaction; the pace of rolling out new games or updating existing games by us or our competitors; the amount and timing of operating costs and capital expenditures relating to our business operations and expansion; seasonal trends in Internet use; price competition in the industry; regulatory and other risks associated from our operations in China and Taiwan.

In addition, our operating expenses are based on our expectations of the future demand for our services and are relatively fixed in the short term. We may be unable to adjust spending quickly enough to offset any unexpected demand shortfall. A decrease in revenues in relation to our expenses could have a material and adverse effect on our business, results of operations and financial condition. You should not place undue reliance on our financial guidance, nor should you rely on year-to-year or quarter-to-quarter comparisons of our results of operations as indicators of our future performance.

### **The online games market is characterized by rapid technological change, and failure to respond quickly and effectively to new Internet technologies or standards may have a material adverse effect on our business**

The online games industry is evolving rapidly. Any new technologies and new standards may require increases in expenditures for online game development and operations. In addition, we use internally developed software systems that support nearly all aspects of our billing and payment transactions in our online games business. All of our businesses may be adversely affected if we are unable to upgrade our systems effectively to accommodate future traffic levels, to avoid obsolescence or to successfully integrate any newly developed or acquired technology with our existing systems. Capacity constraints could cause unanticipated system disruptions and slower responses, which could adversely affect data transmission and game play. These factors could, among other things, cause us to lose existing or potential users and existing or potential game development partners.

### **The current global economic slowdown and other adverse economic conditions may negatively impact our business**

The current global economic slowdown has resulted in an increased level of commercial and consumer delinquencies, lack of consumer confidence and increased market volatility. These unfavorable changes in economic conditions have resulted in decreased spending by our customers. The impact of economic conditions on our licensees and business partners could adversely affect our business and revenues. In addition, the current global financial turmoil and the tightening of credit have resulted in a general credit crunch and have negatively impacted our ability to obtain additional financings. If the current global economic slowdown and global financial turmoil continue on a sustained

basis, they will further negatively impact the demand for our online games and Mangas Everest's gaming software products and services and adversely affect our business, revenues, cash flows, profitability and financial condition.



**Table of Contents****Our business could suffer if we do not successfully manage current growth and potential future growth**

We are pursuing a number of growth strategies. Some of these strategies relate to services, products or markets in which we lack experience and expertise. As part of our growth strategy for the online games operation, in December 2006, we entered into a strategic alliance with Infocomm Asia Holdings Pte Ltd ( Infocomm Asia ), an online gaming operator and distributor operating primarily in the Southeast Asia region, in which we had no business operations at that time. On April 30, 2010, we increased our investment in Infocomm Asia by acquiring additional preferred shares from Infocomm Asia and certain shareholders of Infocomm Asia. The acquisition of Infocomm Asia is expected to close in the third quarter of 2010 and upon closing, we will hold preferred shares convertible into approximately 80 percent of the common shares of Infocomm Asia. Infocomm Asia has entered into certain license agreements with Blizzard Entertainment International, a division of Coöperatie Activision Blizzard International U.A. ( Blizzard ), under which Blizzard agreed to license certain games to Infocomm Asia or its wholly owned subsidiary in Southeastern Asia. We cannot assure you that we will be able to leverage our past experience and successfully manage our expansion into Southeastern Asia and other new markets.

Our growth to date has placed, and our anticipated further expansion of our operations will continue to place, a significant strain on our management, operation systems and resources. In addition to training and managing our workforce, we will need to continue to develop and improve our financial and management controls and our reporting systems and procedures, including those of acquired businesses. We cannot assure you that we will be able to 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.

**Our business strategy, which contemplates growth through acquisitions and strategic investments, exposes us to significant risks**

We have pursued and may continue to pursue growth through acquisitions and strategic investments. Any acquisition or investment is subject to a number of risks. Such risks include the diversion of management time and resources, disruption of our ongoing business, lack of familiarity with new markets, difficulties in supporting the acquired business, and dilution to existing stockholders if our common stock is issued in consideration for an acquisition or investment, incurring or assuming indebtedness or other liabilities in connection with an acquisition.

The total costs incurred in connection with our acquisitions and investments in various businesses in 2009 were approximately US\$9.9 million. For additional information with respect to our acquisitions and investments, see Item 4, Information on The Company A. History and Development of Our Company in this annual report. Our financial results may be affected by such acquisitions or investments. We may incur debts upon an acquisition or suffer losses related to the impairment of goodwill and other intangible assets following the acquisition. These debts or losses could negatively impact our results of operations. We recognized impairment loss on goodwill of approximately US\$14.1 million and impairment loss on marketable securities and investments of approximately US\$15.7 million in 2009. (See note 10 Marketable Securities Current to our consolidated financial statements for additional information). Any impairment on goodwill and marketable securities and investments in the future will have a negative impact on our financial results.

We will continue to examine the merits, risks and feasibility of potential transactions, and expect to explore additional acquisition opportunities in the future. Such examination and exploration efforts, and any related discussions with third parties, may or may not lead to future acquisitions and investments. We may not be able to complete acquiring or investing transactions that we initiate. Our ability to grow through such acquisitions and investments will depend on many factors, including the availability of suitable acquisition candidates at an acceptable cost, our ability to reach agreement with acquisition candidates or investee companies on commercially reasonable terms, the availability of financing to complete the transactions and our ability to obtain any required governmental approvals.

We also face challenges in integrating any acquired business. These challenges include eliminating redundant operations, facilities and systems, coordinating management and personnel, retaining key employees, managing different corporate cultures, maintaining the relationship with the suppliers, vendors and/or distributors of acquired businesses, and achieving cost reductions and cross-selling opportunities. There can be no assurance that we will be able to successfully integrate all aspects of acquired businesses. The process of integrating the acquired business may disrupt our business and divert our resources. In addition, the benefits of an acquisition or investment transaction may

take considerable time to be fully realized and we cannot assure you that any particular acquisition or investment and the subsequent integration will produce the intended benefits.

**Our online games business faces intense competition, which may adversely affect our revenues, profitability and planned business expansion**

The online games market is highly competitive. Our main competitors in the online games business are online game operators in Taiwan and China. Our major competitors in Taiwan include Gamania Digital Entertainment Co., Ltd. ( Gamania ), Soft-World International Corporation ( Soft-World ), International Games System, Co., Ltd. ( IGS ), UserJoy Technology Co., Ltd. ( UserJoy ) and GodGame Inc. ( GodGame ). Our major competitors in the PRC include Shanda Interactive Entertainment Ltd. ( Shanda ), Giant Interactive Group, Inc. ( Giant ), Changyou.com Limited ( Changyou ), The9 Limited, Shanghai Everstar Online Entertainment Co., Ltd. ( Nineyou ), Tencent Holdings Limited ( Tencent ), Beijing Globalink Computer Technology Co., Ltd.( Ourgames.com ) and Chinagames.net.

**Table of Contents**

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 online entertainment.

We expect more online games operating companies to enter in the markets where we operate, including Taiwan, the PRC and Hong Kong, and a wider range of online games to be introduced to these markets, given the relatively low entry barriers to the online games industry. Our competitors vary in size and include private and public companies, many of which have greater financial, marketing and technical resources as well as name recognition. We intend to continue to enhance our market position through providing competitive products and quality services that meet market trends and users' preferences, as well as strengthening sales effectiveness.

As a result of the above, significant competition may reduce the number of our users or the growth rate of our user base, reduce the average number of hours played by our users, or cause us to reduce usage fees. All of these competitive factors could have a material adverse effect on our business, financial condition and results of operations.

**Our online games business depends on the reliability of the network infrastructure and related services provided by ourselves and third parties, which is subject to physical, technological, security and other risks; the Mangas Everest business also faces similar risks**

The development and operation of our online networks and those of Mangas Everest, are subject to physical, technological, security and other risks which may result in interruption in service or reduced capacity. These risks include physical damage, power loss, telecommunications failure, capacity limitation, hardware or software failures or defects and breaches of security by computer viruses, system break-ins or otherwise. An increase in the volume of usage of online services could strain the capacity of the software and hardware employed, which could result in slower response time or system failures. We have a variety of backup servers at our primary site to deal with possible system failures. However, we do not have redundant facilities in the event of an emergency. The occurrence of any of these events could result in interruptions, delays or cessation in service to users of our online services, which could have a material adverse effect on our business and results of operations.

While we and Mangas Everest have implemented industry-standard security measures, our network and those of Mangas Everest may still be vulnerable to unauthorized access, computer viruses, denial of service and other disruptive problems. Our Internet-based services may be interrupted as a result of the accidental or intentional actions of Internet users, our current and former employees or others. A party that is able to circumvent security measures could misappropriate proprietary information, attack our security and network system, and, perhaps, most importantly, cause interruptions in our operations. We and Mangas Everest have experienced, in the past, and may experience, in the future, security breaches and attacks. We may be required to expend significant capital or other resources to protect against the threat of security breaches and attacks or to alleviate problems caused by such actions. There can be no assurance that any measures implemented will not be circumvented in the future.

Our business and that of Mangas Everest are also vulnerable to delays or interruptions due to our reliance on infrastructure and related services provided by third parties. End-users of Mangas Everest's gaming software depend on ISPs and Mangas Everest's system infrastructure for access to the Internet gaming sites operated by UIM and its sub-licensees and currently by Mangas Everest. Many of these services have experienced service outages in the past and could experience service outages, delays and other difficulties due to system failures, stability or interruption. For example, in February 2007, an earthquake off the coast of Taiwan damaged several undersea fiber optic cables linking countries such as Malaysia, Singapore, Australia, Japan, South Korea, China, the United States and Europe, causing disruptions in Internet traffic worldwide. We may lose customers as a result of delays or interruption in service, including delays or interruptions relating to high volumes of traffic or technological problems, which may prevent communication over the Internet and could materially adversely affect our business, revenues, results of operations and financial condition.

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

Our online games business operation relies 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.

## **Table of Contents**

In addition, our ability to process electronic commerce transactions depends on bank processing and credit card systems. In order to prepare for certain types of system problems, we have a formal disaster recovery plan. Nevertheless, any system failure, including network, software or hardware failure, which causes a delay or interruption in our e-commerce services could have a material adverse effect on our business, revenues, results of operations and financial condition.

### **We could be liable for breaches of security on our websites and fraudulent transactions by users of our websites**

A portion of our transactions are conducted through our websites. In such transactions, secured transmission of confidential information (such as customers' credit card numbers and expiration dates, personal information and billing addresses) over public networks is essential to maintain consumer confidence. In addition, we may face internal fraud, including potential unauthorized usage of customer credit card information by our employees. While we have taken steps to prevent this, including the implementation of payment card industry data security standards, our current security measures may not be adequate. Security breaches could expose us to litigation and possible liability for failing to secure confidential customer information and could harm our or our licensees' reputation and ability to attract and retain customers. Mangas Everest may also face similar risks in its online gaming operations.

### **Undetected programming errors or defects in our software, services and games and the proliferation of cheating programs could materially and adversely affect our online games business and the Mangas Everest business, financial condition and results of operations**

Mangas Everest's software, services and games may contain undetected programming errors or other defects. These errors or other defects could result in losses to the licensees of Mangas Everest's gaming software, end-users and us. Claims resulting from losses to end users could damage Mangas Everest's reputation and subject it to liability. As to online games, parties unrelated to us may develop Internet cheating programs that enable 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. If such errors, defects and cheating programs occur in software, services and games Mangas Everest operates, Mangas Everest's business operations and, in turn, our business and financial condition could be materially and adversely affected.

### **Online games and online gaming are relatively new industries and therefore, we do not know if the market will continue to grow**

The online games and online gaming industries are at an early stage of development, and the extent of acceptance of online games and online gaming products and services is uncertain. Market data for the online games and online gaming industries is not as readily available as that on other more established industries where trends can be assessed more reliably from data gathered over a longer period of time. If the market fails to develop, develops more slowly than expected, or becomes saturated with our or Mangas Everest's competitors, or if our or Mangas Everest's products and services do not achieve market acceptance, or if the availability of the Internet commercial transactions fails to develop sufficiently to support the online games and online gaming industries, our and Mangas Everest's business, revenues, results of operations and financial condition could be materially and adversely affected.

### **Operation of pirate game servers and the expenses incurred in protecting our online games operation against unlawful operations through pirate servers 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. The existence of unauthorized servers may attract game players away from our games and may result in decreases in our revenues. We have detected the operation by pirate servers of unauthorized copies of several of our games. In January 2009, for example, we discovered that certain unauthorized third parties had misappropriated the source codes of Luna Online and had set up unauthorized servers to unlawfully operate the game in the PRC. Although we have made efforts to detect and shutdown pirate servers in China, Taiwan and Hong Kong, we cannot assure you that such

efforts will be successful in eliminating these unauthorized servers. In addition, detailed comparisons of software codes and litigation proceedings are often necessary to enforce the intellectual property rights, whether owned by or licensed by us, which sometimes result in substantial costs. The continued illegal operation of any of our existing games by pirate game servers, or the illegal operation of any of our new games by pirate servers, may materially and adversely affect our business, financial condition and results of operations.

**We may be subject to claims of intellectual property right infringement by third parties, which could subject us to significant liabilities and other costs**

Our success depends largely on our ability to use and develop our technology and know-how without infringing upon the intellectual property rights of third parties. We cannot assure you that third parties will not assert intellectual property claims against us. The validity and scope of claims relating to the intellectual property may involve complex scientific, legal and factual questions and analysis, and tend to be uncertain. If third parties assert copyright or patent infringement or violation of other intellectual property rights against us, we have to defend ourselves in legal or administrative proceedings, which can be costly and time consuming and may significantly divert the efforts and resources of our technical and management personnel. An adverse determination in any such proceedings to which we may become a party could subject us to significant liability to third parties, require us to seek licenses from third parties, and prevent us from selling our products and services. The imposition of liabilities that are not covered by insurance, in excess of insurance coverage or for which we are not indemnified by a content provider, could have a material adverse effect on our business, results of operations and financial condition.

**Table of Contents**

**We may need to incur significant expenses to protect our intellectual property rights, and if we are unable to adequately protect our intellectual property rights, our competitive position could be harmed**

We regard our copyrights, service marks, trademarks, trade secrets, patents and other intellectual property as critical to our success. We rely on a combination of copyright and trademark laws, trade secret protection, confidentiality and non-disclosure agreements, and other contractual provisions to protect our proprietary software, trade secrets and similar intellectual property. We have patents, copyrights and trademarks in certain jurisdictions and may apply for further trademark and copyright registrations and additional patents, which may provide such protection in relevant jurisdictions. However, we cannot assure you that our efforts will prove to be sufficient or that third parties will not infringe upon or misappropriate our proprietary rights. Unauthorized use of the intellectual property, whether owned by or licensed to us, could adversely affect our business and reputation.

The validity, enforceability and scope of protection of intellectual property in Internet-related industries are evolving, and therefore, uncertain. In particular, the laws and enforcement procedures of the PRC, Taiwan and Hong Kong are uncertain or do not protect intellectual property rights to the same extent as the laws and enforcement procedures of the United States do. We may have to engage in litigation or other legal proceedings to enforce and protect our intellectual property rights, which could result in substantial costs and diversion of our resources, and have a material adverse effect on our business, financial condition and results of operations.

**Our future results of operations or the growth of our business may suffer if we are unable to maintain satisfactory relationships with the licensors of our online games**

We primarily source MMORPGs and advanced casual games through licensing from developers in various regions where online game development is relatively established. As of the date of this annual report, we have four licensed MMORPGs and six licensed advanced casual games in our online game portfolio, including the games we currently offer and the games in the pipeline. We need to maintain stable and satisfactory working relationships with our licensors in order to ensure the continued operation of our licensed online games and our continued access to new online game licenses. We depend on our licensors to provide the necessary technical support for the operation of the licensed games as well as expansion packs and upgrades that sustain continuing interest in the games. Our ability to maintain satisfactory working relationships with our licensors may also influence our ability to license new online games developed by the same or other licensors. If we are unable to maintain satisfactory relationships with our licensors, our financial condition, results of operations, future profitability and growth prospects may be materially and adversely affected.

**Failure to maintain effective internal controls could have a material adverse effect on our business, results of operations and the trading price of our Shares**

Effective internal controls are necessary for us to provide reasonable assurance with respect to our financial reports and to effectively prevent fraud. If we cannot provide reasonable assurance with respect to our financial reports and effectively prevent fraud, our results of operations could be materially and adversely affected. We are subject to reporting requirements under the U.S. securities laws. The SEC, as required by Section 404 of the Sarbanes-Oxley Act of 2002, has adopted rules requiring public companies to include a report of management on such company's internal control over financial reporting in its annual report, which must contain an assessment by management of the effectiveness of such company's internal control over financial reporting. In addition, an independent registered public accounting firm must express an opinion on the effectiveness of our Company's internal control over financial reporting.

Our management conducted an evaluation of the effectiveness of our internal control over financial reporting and concluded that our internal control over financial reporting was effective as of December 31, 2009. In addition, the report of our independent registered public accounting firm includes an opinion regarding the effectiveness of our internal control over financial reporting. We have successfully completed our Section 404 assessment under the Sarbanes-Oxley Act and received our auditors' attestation as of December 31, 2009. However, internal control over financial reporting may not prevent or detect misstatements because of its inherent limitations, including the possibility of human error, the circumvention or overriding of controls, or fraud. Therefore, even effective internal controls can provide only reasonable assurance with respect to the preparation and fair presentation of financial statements. In addition, projections of any evaluation of effectiveness of internal control over financial reporting to

future periods are subject to the risk that the control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Our failure to maintain effective internal control over financial reporting could result in the loss of investor confidence in the reliability of our financial statements, which in turn could harm our business and negatively impact the trading price of our Shares. Furthermore, we may incur additional costs and use significant management and other resources in an effort to comply with Section 404 and other requirements of the Sarbanes-Oxley Act going forward.



**Table of Contents**

**We may need additional capital in the future, and it may not be available on acceptable terms**

The development of our business may require significant additional capital in the future to:

- fund our operations;
- enhance and expand the range of products and services we offer; and
- respond to competitive pressures and perceived opportunities, such as investment, acquisition and international expansion activities.

We cannot assure you that additional financing will be available on terms favorable to us, if at all. If adequate funds are not available on acceptable terms, we may be forced to curtail or cease our operations. Moreover, even if we are able to continue our operations, any failure to obtain additional financing could have a material and adverse effect on our business, financial condition and results of operations, and we may need to delay the deployment of our services. See Item 5, Operating and Financial Review and Prospects B. Liquidity and Capital Resources.

**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 our chief executive officer, Arthur M. Wang, and our president and chief operating officer, Thomas Hui, in our business operations, and rely on their personal relationships with our employees, the relevant regulatory authorities, and our game and service suppliers. 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 our online games business, we will need to continue attracting and retaining skilled and experienced professionals 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. As a result, 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.

**Our results of operations and financial condition are affected by political stability, as well as the occurrence of natural disasters and epidemics**

We operate our online games business both in Taiwan and the PRC. Political unrest, war, acts of terrorism and other instability, as well as natural disasters such as earthquakes and typhoons which are common in Taiwan and the PRC, can result in disruption to our business or the businesses of our customers.

Our business could be adversely affected by natural disasters and the effects of influenza A (H1N1), avian flu, SARS or other epidemics. Any prolonged recurrence of such adverse public health developments in the regions where we operate may have material adverse effect on our business operations. These could include illness and loss of our management and key employees. Natural disasters or outbreak of epidemics may result in a decrease in economic activities or temporary closure of many businesses and disruption in our operations. In addition, other major natural disasters may also adversely affect our business by, for example, causing disruptions of the Internet network or otherwise affecting access to our games.

**In 2009, we recorded operating and net losses, and we may experience losses in the future**

In 2009, we recorded an operating loss of US\$40.1 million and a net loss of US\$49.1 million. Our future profitability will depend primarily upon the performance of our online games business and the Mangas Everest business. We cannot assure you that we will not experience operating or net losses in future periods.

**Table of Contents****Risks Related to Our Joint Venture with Mangas****We do not control the management of our joint venture with Mangas and have no control over its business decisions and any significant difficulties encountered by the joint venture in its operations may have a material and adverse effect on our business and financial results**

On April 8, 2010, we completed the sale of a 60 percent interest in our online gaming software business to Mangas, a leading European sports betting and online gaming group. The strategic alliance with Mangas was structured as a stock and asset sale to a newly-formed French entity, Mangas Everest, in which we received a 40 percent stake. Concurrent with the transaction, we purchased the shares of UIM, our then-major licensee which provided online gaming services, and sold all of UIM's material assets to Mangas Everest.

We hold the remaining 40 percent of Mangas Everest with a put option to sell all or part of our shares to Mangas. The put option is exercisable in 2013, 2014 and 2015. Mangas holds a call option on any remaining Mangas Everest interests held by us which it may exercise in 2015 and 2016. For both our put option and Mangas' call option, the price paid will be determined based upon the fair market value of Mangas Everest as of December 31 of the prior year, as determined by mutual agreement between the parties or, failing that, an appraisal process.

While Mangas will generally control the day-to-day operations of Mangas Everest, so long as we hold at least 20 percent of Mangas Everest's share capital, we will have approval rights over certain material actions of Mangas Everest, including certain issuances of securities of Mangas Everest, acquisitions and dispositions of certain assets and material changes to the principal business of Mangas Everest. In addition, so long as we hold at least 10 percent of Mangas Everest's share capital, we will have representation on the board of directors of Mangas Everest.

We do not control Mangas Everest's management and hence have no control over its business decisions. Our rights under the earn-out and the put or call option are of uncertain value. We may have disputes with Mangas regarding the operations of Mangas Everest or the calculation of the earn-out or put or call option payments. We cannot assure you that our strategic alliance with Mangas through such joint venture structure will be commercially successful. Any significant difficulties encountered by Mangas Everest in its operations or significant deviation from the terms of the agreement with Mangas, may have a material and adverse effect on our business and financial results.

**The uncertain global legal and regulatory environment could have a negative impact on the Mangas Everest business and prospects**

We historically relied on our gaming software and services business for a substantial majority of our revenues. Our gaming software and services business included software development and the provision of application services for Internet gaming, including online poker rooms, casinos and the related marketing affiliate programs. We historically licensed our gaming software to UIM, which operates various online poker rooms and casinos and also sub-licenses our software products to third parties. Fees earned by us were historically based on UIM's gross receipt from the operation utilizing the licensed software. UIM held a gaming license issued by the Kahnawake Gaming Commission in Canada and two gaming licenses issued by Lotteries and Gaming Authority in Malta. Issues such as determining the physical location of a gaming event and significant differences among the gaming laws and Cyberlaws of various countries make traditional concepts of jurisdiction and conflicts of laws difficult to apply. In addition, the substantial uncertainties in the global regulatory environment relating to online gaming expose us to the risk that regulatory authorities in various jurisdictions may determine that our Company provided online gaming services (rather than only licensing software and providing application services) and thus subject our Company to gaming laws and regulations in such jurisdictions.

On April 8, 2010, we completed the sale of a 60 percent interest in our online gaming software business to Mangas. As part of and as a condition to the completion of the transaction, we purchased the shares of our then-major licensee, UIM, all of the material assets (including the Everest Poker operations) of which were sold to Mangas Everest as part of the transaction. See Item 5, Operating and Financial Review and Prospects A. Operating Results Subsequent Events Transaction with Mangas for additional information. In accordance with the terms of the strategic alliance, Mangas Everest will endeavor to migrate all Mangas poker players to the Everest Poker platform creating one of the largest poker player liquidity platforms in Europe. Everest Poker will also be able to benefit from the sports betting solutions of Mangas. In addition, the combined user base of Everest Poker and BetClic—both leading brands in France strongly positions the alliance to capture potential growth from the soon to be opened and regulated French market,

one of the largest in Europe. Mangas Everest operates under two full remote gaming licenses (a Class 1 and a Class 3) issued by Malta Lotteries and Gaming Authority and a license issued by the Kahnawake Gaming Commission, subject to continuing compliance with applicable licensing requirements. On June 7, 2010, Everest Poker and BetClic Poker operations, owned by Mangas Everest, received online poker licenses as part of the first grant of licenses in France. Everest Poker and BetClic Poker accounted for two of the seven licenses granted in the initial approvals and expect to begin French operations in late June 2010.

**Table of Contents**

Mangas Everest, our joint venture with Mangas, primarily targets non-U.S. markets, predominantly in Continental European markets. Several European countries have adopted a regulated online gaming approach. For example, Italy has introduced a new set of regulations on online gaming. In Italy, there is a general prohibition on casino-type games. As early as October or November of 2010, Italy will also prohibit cash games in online poker offerings, thereby restricting the poker activity to tournaments. The French government has published a gaming bill and has begun issuing licenses that allow an operator to conduct remote sports betting, pari-mutual horserace betting, and poker. No regulations permitting the operation of online casino operations have yet been enacted in France. Spain and Ireland have announced their intentions to introduce a regulatory framework on online gaming. As of yet, no regulations have been issued, however there is speculation that a draft of the Spanish regulations may be issued as soon as the summer of 2010. Other jurisdictions in which Mangas Everest operates may require local licensing in the future. There can be no assurance that Mangas Everest will be successful in its efforts to obtain a gaming license from these jurisdictions, and that Mangas Everest would not face the potential loss of users in these jurisdictions. In addition, many European countries, including The Netherlands, Denmark and Germany, have taken actions or introduced legislation aimed at banning foreign online gaming operators, which could have a material adverse effect on Mangas Everest and consequently on our Company.

The Internet gaming industry is still in an early stage of development and the global legal and regulatory environment in which the Internet gaming businesses operate remains highly uncertain and is subject to change. While many jurisdictions have some form of legal framework applicable to games of chance and land-based casinos, few provide clear guidance on how this framework applies to Internet gaming. In addition, the very nature of Internet gaming creates new and unique forms of entertainment that were neither contemplated nor feasible in the past. There can be no assurance that legislation prohibiting Internet gaming or regulating various aspects of Internet gaming industry will not be proposed and passed in potentially relevant jurisdictions. We cannot assure you that Mangas Everest as an online gaming operator, are in compliance with all laws and regulations of the jurisdictions in which it operates, or that changes in such laws and regulations, or in their interpretation, will not adversely affect our business and results of operations.

For additional information on the regulatory environment relating to online gaming, see Item 4, Information on the Company B. Business Overview Regulation in this annual report.

**The Mangas Everest business faces intense competition, which may adversely affect our financial results**

We are exposed to competition among Mangas Everest and other game operators in the online gaming industry. Mangas Everest faces intense competition in the online gaming industry, which is characterized by low barriers to entry, rapid technological change and ever-changing consumer preferences. New entrants to the online gaming industry, increasingly competitive market consolidations and aggressive marketing and pricing by competitors may lead to a significant decline in the customer base, revenues and margins of Mangas Everest. In addition, the online gaming industry is influenced by various other factors, including changes in policies and regulations and economic conditions in different jurisdictions. For example, as a result of the Unlawful Internet Gambling Enforcement Act of 2006 ( UIGEA ) and the subsequent closing of the online gaming market in the United States, Mangas Everest faces increased competition from entertainment service providers in markets in Continental Europe, which are also increasingly subject to regulation from governmental authorities. Furthermore, some of Mangas Everest's competitors have greater experiences, resources and distribution capabilities. For additional information, see Item 4, Information on the Company B. Business Overview Gaming Software and Service Business Competition in this annual report.

**The Mangas Everest business will be materially and adversely affected if credit card companies and other financial institutions cease to accept online gaming transactions**

A substantial portion of Mangas Everest's proceeds from its online gaming operations is from the deposits or payments made by its customers through credit card transactions. Financial institutions in the United States have ceased to accept online gaming transactions after the enactment of the UIGEA, which prohibits the use of communication facilities and financial transactions in connection with Internet gambling. For additional information, see Item 4, The Information on The Company B. Business Overview Regulation in this annual report. Although Mangas Everest primarily targets non-U.S. markets, predominantly in Continental European markets, there can be no assurance that credit card companies or other financial institutions in the jurisdictions where Mangas Everest operates will continue

to accept and process online gaming transactions. Furthermore, there is a higher incidence of fraud associated with online credit card payments than with other types of payments, which could further discourage issuing banks from processing online gaming transactions. If credit card companies or other financial institutions cease to accept online gaming transactions, either generally or in the jurisdictions where Mangas Everest operates, Mangas Everest's revenues and, in turn, its gaming software and service business could be materially and adversely affected.

**The Mangas Everest business is international and therefore faces associated risks**

There are certain difficulties and inherent risks faced by our Company and Mangas Everest, our joint venture with Mangas, in doing business internationally, including the burden of complying with multiple and conflicting regulatory requirements, foreign exchange controls, potential restrictions or tariffs on gaming activities that may be imposed, potentially adverse tax consequences and tax risks. Changes in the political and economic stability, regulatory and taxation structures, and the interpretation thereof, in jurisdictions in which we or Mangas Everest operate, and in which our or Mangas Everest's customers are located could have a material adverse effect on our business, revenues, results of operations and financial condition. In addition, while the functional currency of the Mangas Everest business is U.S. dollar, the principal geographic markets of Mangas Everest products and services are Continental European markets. The fluctuation of exchange rate between Euro and U.S. dollar may adversely affect spending of players from Continental Europe and the demand for Mangas Everest products and services, and in turn, adversely affect our business and revenues.

**Table of Contents****Risks Related to Doing Business in Greater China****PRC laws and regulations restrict foreign ownership and investment in the online game industry, and substantial uncertainties exist with respect to the application and implementation of PRC laws and regulations**

We are classified as a foreign enterprise under PRC laws and various regulations in the PRC currently restrict foreign or foreign-owned enterprises from holding certain licenses required to provide online games over the Internet in the PRC, including Internet content provision, Internet culture operation and Internet publishing licenses. In order to comply with foreign ownership restrictions, we operate our online games business in the PRC through our three variable interest entities ( VIEs ), including Shanghai T2 Entertainment Co., Ltd. ( T2 Entertainment ), Shanghai T2 Advertisement Co., Ltd. ( T2 Advertisement ) and Shanghai Jinyou Network & Technology Co., Ltd. ( Jinyou ). All the VIEs are effectively controlled by T2CN through contractual arrangements. T2 Entertainment and Jinyou hold the Internet content provision and Internet cultural operation licenses that are required to operate our online games business in the PRC, and T2 Advertisement holds an advertising license that is required to sell advertisements on our websites in the PRC. Beginning in June 2007, the results of T2 Entertainment and T2 Advertisement have been included in our consolidated financial statements. The results of Jinyou have been included in our consolidated financial statements starting from September 2008. For additional information, see Item 4, Information on the Company B. Business Overview Regulation Regulations Relating to Online Games in the PRC Foreign Ownership Restrictions and Item 4, Information on the Company C. Organizational Structure in this annual report. In July 2006, the Ministry of Industry and Information Technology ( MIIT , formerly the Ministry of Information Industry) issued a notice, which prohibits Internet content providers ( ICP licenses ) and holders of value-added telecommunications business operation licenses from leasing, transferring or selling a telecommunications business operating license to any foreign investors in any form, or providing any resource, sites or facilities to any foreign investors for their illegal operation of telecommunications business in the PRC. The notice also requires that ICP license holders and their shareholders directly own the domain names and trademarks used by such ICP license holders in their daily operations. The notice further requires each ICP license holder to have the necessary facilities for its approved business operations and to maintain such facilities in the regions covered by its license. In addition, all value-added telecommunication service providers are required to maintain network and information security in accordance with the standards set forth under relevant PRC regulations. Local authorities in the various regions were required to ensure that existing ICP license holders conducted self-assessments of their compliance with the Notice and submitted their status reports to the MIIT prior to November 1, 2006. T2 Entertainment has conducted its self-assessment and believes that it is in compliance with the requirements of notice. Jinyou obtained the ICP license in September 2008.

On September 28, 2009, the PRC General Administration of Press and Publication ( GAPP ), National Copyright Administration, and National Office of Combating Pornography and Illegal Publications jointly published a notice, which, among others, (i) provides that GAPP is responsible for pre-examination and approval of internet games as authorized by the central government and State Council, and that the provision of Internet games either online or on a downloaded basis constitutes Internet game publishing, which is subject to pre-examination and approval by GAPP; and (ii) prohibits foreign investors from participating in Internet game operating businesses via wholly owned, equity joint venture or cooperative joint venture investments in the PRC, and from controlling and participating in such businesses directly or indirectly through contractual or technical support arrangements. If applied literally and uniformly, such notice would render our ownership structure in the PRC invalid and illegal. To date, however, there are substantial uncertainties regarding the interpretation and application of such notice.

There are substantial uncertainties regarding the interpretation and application of current or future PRC laws and regulations. Accordingly, we cannot assure you that PRC government authorities will ultimately take a view that is consistent with our view. If we or any of our PRC operating companies are found to be in violation of any existing or future PRC laws or regulations, the relevant government authorities would have broad discretion in dealing with such violations and could impose significant penalties and sanctions or other regulatory or enforcement actions, including levying fines, confiscating income, revoking business or operating licenses, requiring us to restructure our ownership structure, and requiring us to discontinue all or any part of our business operations. Any of these actions could have a material adverse effect on our business, financial condition and results of operations.

We could also face material and adverse tax consequences if the PRC tax authorities determine that our contractual arrangements with T2 Entertainment, T2 Advertisement and Jinyou were not made on reasonable commercial terms. In such an event, they could adjust our income and expenses for PRC tax purposes in the form of a transfer pricing adjustment which could result in an increase in our PRC subsidiaries' tax liability or limit our PRC subsidiaries' ability to maintain preferential tax treatments and other financial incentives.

**Table of Contents****The contractual arrangements with T2 Entertainment, T2 Advertisement and Jinyou and their shareholders may not be as effective in providing operational control as direct ownership and the shareholders of T2 Entertainment, T2 Advertisement and Jinyou may have potential conflicts of interest with us**

We operate our online games business through T2 Entertainment, T2 Advertisement and Jinyou, all of which are our VIEs. We have no ownership interest in any of these VIEs and rely on a series of contractual arrangements that are intended to give us effective control over them. However, the contractual arrangements may not be as effective as compared to having direct ownership and control over these companies. Direct ownership would allow us, for example, to directly exercise our rights as a shareholder to effect changes in the board of directors, which, in turn, could affect changes, at the management level. In addition, these VIEs could violate their contractual arrangements with us, go bankrupt, suffer from problems in their businesses or otherwise become unable to perform their contracts with us. As a result, our business could be disrupted and our results of operations may be materially and adversely affected.

Most principal shareholders of T2 Entertainment, T2 Advertisement and Jinyou are executive officers of T2CN and have no substantial shareholdings in our Company. Thus, their interests as shareholders of the VIEs and their duties to our Company may conflict. We cannot assure you that when conflicts of interest arise, these persons will act completely in our interests or that conflicts of interests will be resolved in our favor. Any legal proceeding could result in the disruption of our business, diversion of our resources and the incurring of substantial costs.

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, the underlying 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 VIEs, and our ability to conduct our business may be negatively affected. See Item 4, Information on the Company C. Organizational Structure in this annual report.

**The laws and regulations governing the online games industry in the PRC are evolving and new regulations may adversely affect our business**

Our provision of online games and online game-related content on our websites in China is subject to various PRC laws and regulations relating to the telecommunications industry and Internet and online games, and is regulated by various government and regulatory authorities. The principal PRC regulations governing the provision of Internet content and online gaming services include (among others) the Telecommunications Regulations (2000), the Administrative Rules for Foreign Investments in Telecommunications Enterprises (2001), the Tentative Measures for the Administration of Internet Publications (2002), the Tentative Measures for Administration of Internet Culture (2003), the Opinions on the Development and Management of Online Games (2005), the Anti-Internet Addiction Regulations (2007), the Administrative Measures for Telecommunications Business Operating Licenses (2009), and the Tentative Measures for Cyber Games Administration (2010). We may be affected by these regulations, which seek to regulate the content of online games and the business operation of online game operators and discourage online game players from spending excessive amounts of time playing online games. This may reduce the number of our users, the growth rate of our user base, the general online games market in the PRC or the average number of hours played by online game players, or cause us to reduce usage fees or other charges in connection with our online games business. In addition, compliance with such regulations may require us to incur substantial costs in modifying or adapting our game software to comply with the regulatory requirements. This may adversely affect our business, financial condition and results of operations.

The adoption of new laws or regulations in the PRC relating to the Internet, or particular applications or interpretations of existing laws, could decrease the growth in the use of the Internet, decrease the demand for our products and services, increase the cost of conducting our business or could otherwise have a material adverse effect on our business, revenues, results of operations and financial condition.

New PRC laws and regulations that address issues such as user privacy, pricing, online content, taxation, advertising, intellectual property, information security, and the characteristics and quality of online products and services may be



enacted. For example, in order to counter the Internet addiction, in April 2007, eight PRC government authorities issued regulations to discourage online game-players who are minors from spending excessive amounts of time playing online games. Pursuant to these regulations, Internet game operators have been ordered to install anti-addiction software features on games offered in the PRC, which will, among other features, limit the number of points and other benefits which can be awarded to game players after they have been online in excess of specified periods of time. Internet game operators will also be required to adopt real-name registration, which will require online game players to register their real identity information before they will be allowed to play online games. See Item 4, Information on the Company B. Business Overview Regulation in this annual report.

**Table of Contents****There are currently no clear laws or regulations governing virtual asset property rights, in particular, in Greater China, and therefore, it is not clear what liabilities, if any, online game operators may have in respect of 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. In practice, virtual assets can be lost for various reasons, often through unauthorized use of user identifications by other users and occasionally through data loss caused by delay of network service or by a network crash. Currently there are no clear laws or regulations governing virtual asset property rights, in particular, in Greater China where we operate our online games business. As a result, it is unclear under PRC law whether an operator of online games such as us would have any liability (whether in contract, tort or otherwise) for loss of such virtual assets by game players. Based on several judgments regarding the liabilities of online game operators for loss of virtual assets by game players, the PRC courts have generally required online game operators to provide well-developed security systems to protect such virtual assets owned by game players. In the case of a loss of virtual assets, we may be sued by online game players and could be held liable for damages, which may negatively affect our business, financial condition and results of operations.

**Restrictions on virtual currency may adversely affect our revenues from online game operations in the PRC**

Our online game operations revenues in the PRC are primarily collected through the sale of our prepaid game cards or online sale of game points. On February 15, 2007, 14 PRC government authorities jointly issued Circular for Further Strengthening the Administration of Internet Café and Online Games, which directs the People's Bank of China (PBOC) to strengthen the administration of virtual currency in online games to avoid any adverse impact on the PRC economy and financial system. This circular provides that the total amount of virtual currency issued by online game operators and the amount purchased by individual game players should be strictly limited, with a strict and clear division between virtual transactions and real transactions carried out by way of electronic commerce. This notice also provides that virtual currency should only be used to purchase virtual items. On June 4, 2009, the Ministry of Culture and the Ministry of Commerce jointly issued the Circular on Strengthening the Administration of Virtual Currency in Online Games. According to this circular, any PRC entities engaging in issuance or trade service of virtual currency in online games shall meet the requirements of Commercial Online Cultural Entities as prescribed in the Tentative Measures for Administration of Internet Culture (2003) and are required to apply to the Ministry of Culture for an approval. This circular further provides, among others, that (i) the form, issuance scope and unit purchase price of virtual currency, the refund method in case of termination of online games, the purchase method for the users (including cash, bank card, payment via Internet, etc.), the protection measures for users' rights and interests, and the technology security safeguard measures, shall be filed with the Ministry of Culture for record; (ii) the unit purchase price of virtual currency shall not be changed by online games operators; (iii) the new type of virtual currency shall be filed with the Ministry of Culture for record before issuance by online games operators; and (iv) the virtual currency trade service shall not be open to the minors. These restrictions may result in lower sales of our prepaid game cards or game points, and could have an adverse effect on our game operations revenues.

**Our business may be adversely affected by government policies and regulation of Internet cafés in the PRC**

Internet cafés are one of the primary venues where our online games were distributed and played in the PRC. In April 2001, the PRC government began tightening its regulation and supervision of Internet cafés. In particular, a large number of Internet cafés without requisite government licenses have been closed. In addition, the PRC government has imposed higher capital and facility requirements for the establishment of Internet cafés. The PRC government's policy, which encourages the development of a limited number of national and regional Internet café chains and discourages the establishment of independent Internet cafés, may also slow down the growth in the number of new Internet cafés. In February 2007, 14 PRC government authorities jointly issued a notice, which suspended approval for the establishment of new Internet cafés and called for strengthened regulation of existing Internet cafés. It is unclear when or if this suspension will be lifted. The PRC governmental authorities may from time to time impose stricter requirements, such as the customers' age limit and hours of operation, among others, as a result of the occurrence and perception of, and the media attention on, gang fights, arson and other incidents in or related to Internet cafés. The implementation of these measures, or enactment by the PRC government of any additional laws to

further regulate Internet cafés, may result in fewer customers or less time spent by customers playing our online games, which could restrict our ability to maintain or increase our revenues and expand our customer base. See Item 4, Information on the Company B. Business Overview Regulation Internet Café Regulation in this annual report.

**Fluctuations in the exchange rates between the U.S. dollar and other currencies in which we conduct our business could adversely affect our profitability**

The operations of our online games business are conducted in NT dollars, Hong Kong dollars and Renminbi. Accordingly, fluctuations in the exchange rates could have a positive or negative effect on our reported results. Generally, an appreciation of NT dollars, Hong Kong dollars or 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, a devaluation of NT dollars, Hong Kong dollars or 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. Given the constantly changing currency exposures and the substantial volatility of currency exchange rates, we cannot predict the effect of exchange rate fluctuations upon future operating results. There can be no assurance that we will not experience currency losses in the future, which could have a material adverse effect on our business, revenues, results of operations and financial condition.

**Table of Contents****Changes in foreign exchange and foreign investment regulations and limitations on dividend payment in the PRC may affect our ability to invest in China and the ability of our PRC subsidiaries to pay dividends and service debts**

Renminbi is not a freely convertible currency at present. The PRC government regulates conversion between Renminbi and foreign currencies. Changes in PRC laws and regulations on foreign exchange may result in uncertainties in our financing and operating plans in China. Over the years, China has significantly reduced the government's control over routine foreign exchange transactions under current accounts, including trade and service related foreign exchange transactions, payment of dividends and service of foreign debts. In accordance with the existing foreign exchange regulations in China, our PRC subsidiaries may, within the scope of current account transactions, pay dividends and service debts in foreign currencies without prior approval from the PRC State Administration of Foreign Exchange, or SAFE, by complying with certain procedural requirements. However, there can be no assurance that the current PRC foreign exchange policies with respect to debt service and payment of dividends in foreign currencies will continue in the future. Changes in PRC foreign exchange policies may have a negative impact on our ability to service our foreign currency-denominated indebtedness and to distribute dividends to our shareholders in foreign currencies since our subsidiaries in China need to convert their Renminbi cash flow to service such foreign debt and to make such dividend payments.

Foreign exchange transactions by our PRC subsidiaries under the capital account continue to be subject to significant foreign exchange controls. In particular, foreign exchange transactions involving foreign direct investment, foreign debts and outbound investment in securities and derivatives are subject to limitations and require approvals from the relevant SAFE authorities. We have the choice, as permitted by the PRC foreign investment regulations, to invest in the form of registered capital or a shareholder loan into our PRC subsidiaries to finance our operations in China. Our choice of investment is affected by the different treatments under the relevant PRC regulations with respect to capital-account and current-account foreign exchange transactions in China. For example, our transfer of funds to our subsidiaries in China is subject to approval of PRC governmental authorities in case of an increase in registered capital, or subject to registration with PRC governmental authorities in case of a shareholder loan. These and other limitations on the flow of funds between us and our PRC subsidiaries could restrict our ability to act in response to changing market conditions and limit our flexibility in the management of our cash flow and financings. See Item 10, Additional Information D. Exchange Controls in this annual report.

In addition, recent PRC regulations relating to the establishment of offshore special purpose companies by PRC residents may subject the PRC resident shareholders of our PRC subsidiaries or us to penalties and limit our ability to inject capital into our PRC subsidiaries, limit our subsidiaries' ability to increase their registered capital, distribute profits to us, or otherwise adversely affect us. Moreover, our PRC subsidiaries are required to set aside a certain percentage of their after-tax profit based on PRC accounting standards each year for their reserve fund in accordance with the requirements of relevant PRC laws and the relevant provisions in their respective articles of associations. As a result, our PRC subsidiaries may be restricted in their ability to transfer any portion of their net income to us whether in the form of dividends, loans or advances.

**There are economic risks associated with doing business in Taiwan, particularly due to the tense relationship between Taiwan and the PRC**

Our principal executive offices and a significant portion of our assets are located in Taiwan and a major portion of our revenues of online games business are derived from our operations in Taiwan. Taiwan, as part of the Republic of China, has a unique international political status. The PRC asserts sovereignty over mainland China and Taiwan and does not recognize the legitimacy of the Taiwan government. Relations between Taiwan and the PRC and other factors affecting the political or economic conditions of Taiwan could also affect our online games business.

**Risks Related to Ownership of our Shares****The price of our Shares has been volatile historically and may continue to be volatile, which may make it difficult for holders to resell our Shares when desired or at attractive prices**

The trading price of our Shares has been and may continue to be subject to wide fluctuations. In 2009, the closing prices of our Shares on the NASDAQ Stock Market have ranged from US\$3.04 to US\$7.47 per share, and the closing price on June 25, 2010 was US\$2.03. Our Share 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 Shares, regardless of our operating performance.

**We are controlled by the Koo family, which has significant influence in determining the outcome of any corporate transaction or other matters submitted to our shareholders for approval, and their interests may conflict with your interests**

As of March 31, 2010, members of the Koo family beneficially owned approximately 19.59 percent of our outstanding Shares. Accordingly, the members of the Koo family have significant influence in determining the outcome of any corporate transaction or other matters submitted to our shareholders for approval, including mergers, consolidations, the sale of all or substantially all of our assets and the power to prevent or cause a change in control. The interests of such members of the Koo family may differ from or conflict with your interests.

**Table of Contents****Our transactions with related parties may not benefit us and may harm our Company**

We have entered into several transactions with certain related parties. We believe that we have conducted our related-party transactions on an arm's-length basis and on terms comparable to, or more favorable to us than, similar transactions we would enter into with independent third parties. However, we cannot assure you that all our future transactions with related parties will be beneficial to us. See Item 7, Major Shareholders and Related-Party Transactions in this annual report.

**Our online games business in the PRC relies on payments made by our PRC VIEs to T2CN, our majority-owned subsidiary, pursuant to contractual arrangements to transfer any such revenues to T2CN. Any restriction on such payments and any increase in the amount of PRC taxes applicable to such payments may materially and adversely affect our business and our ability to pay dividends to our shareholders**

T2 Entertainment, T2 Advertisement and Jinyou are not owned by us and they are not able to make dividend payments to us. Instead, T2CN, our majority-owned subsidiary in China, entered into a number of agreements with T2 Entertainment, T2 Advertisement and Jinyou, including certain exclusive technical service and consultancy agreement and exclusive business consultancy service agreements, pursuant to which T2 Entertainment, T2 Advertisement and Jinyou pay T2CN for certain services that T2CN provides to these companies. However, depending on the nature of services provided, certain of these payments are subject to PRC taxes at different rates, including business taxes and VATs, which effectively reduce the amount that T2CN receives from T2 Entertainment, T2 Advertisement and Jinyou. We cannot assure you that the PRC government will not impose restrictions on such payments or change the tax rates applicable to such payments. Any such restrictions on such payment or increases in the applicable tax rates may materially and adversely affect our ability to receive payments from T2 Entertainment, T2 Advertisement and Jinyou or the amount of such payments, and may in turn materially and adversely affect our business, our net income and our ability to pay dividends to our shareholders.

**The ability of our subsidiaries in Taiwan to distribute dividends to us may be subject to restrictions under the laws of Taiwan**

We are a holding company, and some of our assets constitute our ownership interests in our subsidiaries in Taiwan, including Hoshin GigaMedia, which owns the Taiwan-based operations of our online games business. Accordingly, part of our primary internal source of funds to meet our cash needs is our share of the dividends, if any, paid by our subsidiaries, including those in Taiwan. The distribution of dividends to us from these subsidiaries in Taiwan is subject to restrictions imposed by the applicable corporate and tax regulations in these countries, which are more fully described in Item 5, Operating and Financial Review and Prospects B. Liquidity and Capital Resources Dividends from Our Subsidiaries in this annual report. In addition, although there are currently no foreign exchange control regulations which restrict the ability of our subsidiaries in Taiwan to distribute dividends to us, the relevant regulations may be changed and the ability of these subsidiaries to distribute dividends to us may be restricted in the future.

**Anti-takeover provisions under the Singapore Securities and Futures Act (Chapter 289) and the Singapore Code on Take-overs and Mergers may delay, deter or prevent a future takeover or change of control of our Company, which could adversely affect the price of our Shares**

The Singapore Code on Take-overs and Mergers (the Code) issued pursuant to Section 321 of the Singapore Securities and Futures Act (Chapter 289) regulates the acquisition of ordinary shares of, inter alia, listed public companies and contain certain provisions that may delay, deter or prevent a future takeover or change of control of our Company. Any person acquiring an interest, either on his own or together with parties acting in concert with him, in 30 percent or more of the voting shares in our Company must, except with the prior consent of the Singapore Securities Industry Council (the SIC), extend a takeover offer for the remaining voting shares in our Company in accordance with the provisions of the Code. Likewise, any person holding between 30 percent and 50 percent of the voting shares in our Company, either on his own or together with parties acting in concert with him, must, except with the prior consent of the SIC, make a takeover offer in accordance with the provisions of the Code if that person together with parties acting in concert with him acquires additional voting shares in excess of one percent of the total number of voting shares in any six-month period.

Under the Code, an offeror must treat all shareholders of the same class in an offeree company equally. A fundamental requirement is that shareholders in the company subject to the takeover offer must be given sufficient information, advice and time to consider and decide on the offer.

These provisions contained in the Code may discourage or prevent transactions that involve an actual or threatened change of control of our Company. This may harm you because an acquisition bid may allow you to sell your Shares at a price above the prevailing market price.

**Table of Contents****Our shareholders may be subject to Singapore taxes**

Singapore tax law may differ from the tax laws of other jurisdictions, including the United States. Gains from the sale of our Shares by a person not tax resident in Singapore may be taxable in Singapore if such gains are part of the profits of any business carried on in Singapore. For additional information, see Item 10, Additional Information E. Taxation Singapore Tax Consideration in this annual report. You should consult your tax advisors concerning the overall tax consequences of acquiring, owning or selling the Shares.

**We are a Singapore company, and because the rights of shareholders under Singapore law differ from those under U.S. law, you may have difficulty in protecting your shareholder rights or enforcing any judgment obtained in the U.S. against us or our affiliates**

Our corporate affairs are governed by our memorandum and articles of association and by the laws governing corporations incorporated in Singapore. The rights of our shareholders and the responsibilities of members of our board of directors under Singapore law are different from those applicable to a corporation incorporated in the United States and, therefore, our shareholders may have more difficulty protecting their interests in connection with actions by the management, members of our board of directors or our controlling shareholders than they would as shareholders of a corporation incorporated in the United States.

Our Company is incorporated under the laws of the Republic of Singapore. Many of our directors and senior management reside outside the United States. As a result, it may be difficult for investors to effect service of process within the United States upon us or any of these persons or to enforce in the United States any judgment obtained in the U.S. courts against us or any of these persons, including judgments based upon the civil liability provisions of the U.S. federal securities laws or any state or territory of the United States. Judgments of the U.S. courts based upon the civil liability provisions of the U.S. federal securities laws may not be enforceable in Singapore courts, and there is doubt as to whether Singapore courts will enter judgments in original actions brought in Singapore courts based solely upon the civil liability provisions of the U.S. federal securities laws.

**We may incur significant costs and management time to avoid being considered an investment company under the United States Investment Company Act of 1940, which could have a significant negative impact on our results of operations**

We may be deemed to be an investment company under the United States Investment Company Act of 1940 (the 1940 Act ), and may suffer adverse consequences as a result. Generally, the 1940 Act provides that a company is not an investment company and is not required to register under the 1940 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 that of investing, reinvesting, owning, holding or trading in securities and has investment securities that comprise less than 40% of its total assets (exclusive of U.S. government securities or cash items) on an unconsolidated basis. Following the completion of our restructuring efforts in September 2008, we have devoted our efforts and resources to the gaming software products and application services and operating online games businesses primarily through our significant wholly-owned subsidiaries. From time to time, we also make strategic non-controlling investments in entities that we believe, at the time of such investments, complement or enhance our business ( Strategic Investments ). These Strategic Investments may be deemed to be investment securities under the 1940 Act. In April 2010, we consummated the sale of a 60 percent interest in our gaming software business to Mangas Gaming, a leading European sports betting and online gaming group, for US\$100 million in cash and the right to a possible earnout payment based on the future performance of the business. As part of the transaction, we purchased the shares of UIM, our then-major licensee which provided online gaming services, and sold all of UIM s material assets to the GigaMedia and Mangas strategic alliance. GigaMedia and Mangas also hold, respectively, put and call options on our 40 percent interest in the gaming software and services business exercisable at fair market value at various dates over the next several years. As a result of the transaction with Mangas in 2010, we no longer have majority control of the gaming software and services business and have a significant amount of cash on hand. See Item 5, Operating and Financial Review and Prospects A. Operating Results Subsequent Events Transaction with Mangas for additional information. Consequently, there is a risk that we could be deemed to be an investment company because our investment securities may be deemed to comprise more than 40% of our total assets (exclusive of U.S. government securities or cash items) on an unconsolidated basis pending investment of the proceeds of the sale into our remaining



businesses.

However, based on our historical and current business activities, the primary activities of our officers and directors and an analysis of our non-cash assets and income during 2009 and the first quarter of 2010, we do not believe that we are an investment company. Nevertheless, a part of the determination of whether we are an investment company is based upon the composition and value of our assets, a significant portion of which are presently comprised of our Strategic Investments. As a result, we could be deemed to be an investment company.

We intend to conduct our businesses and operations so as to avoid being required to register as an investment company. If, nevertheless, we were to be required to register as an investment company, because we are a foreign company, the 1940 Act would prohibit us and any person deemed to be an underwriter of our securities from offering for sale, selling or delivering after sale, in connection with a public offering, any security issued by the Company in the United States. Additionally, we may be unable to continue operating as we currently do and might need to acquire or sell assets that we would not otherwise acquire or sell in order to avoid becoming an investment company as defined under the 1940 Act. We may incur significant costs and management time to avoid being considered an investment company under the 1940 Act, which could have a significant negative impact on our results of operations.

**Table of Contents****We may be classified as a passive foreign investment company for U.S. federal income tax purposes. As a result, you may be subject to materially adverse tax consequences with respect to Shares**

In light of our significant cash balances resulting from the transaction with Mangas as described in Item 5, Operating and Financial Review and Prospects A. Operating Results Subsequent Events Transaction with Mangas, we may be classified as a passive foreign investment company, or PFIC, for the current taxable year. A non-United States corporation, such as us, will be treated as a PFIC for any taxable year in which 75% or more of its gross income consists of passive income or 50% or more of its assets (based on an average of the quarterly values during such taxable year) are classified as passive assets. For this purpose, cash and other liquid assets are generally classified as passive and goodwill and other unbooked intangibles associated with active business activities may generally be classified as active. Because the value of our assets for purposes of the PFIC test will generally be determined by reference to the market price of our Shares, fluctuations in the market price of our Shares will significantly affect the overall level of our active assets. In addition, the composition of our income and assets will be affected by how, and how quickly, we spend our liquid assets and the cash raised in our transaction with Mangas.

Because there are uncertainties in the application of the relevant rules and PFIC status is a fact-intensive determination made on an annual basis, no assurance can be given that we are not or will not become classified as a PFIC. If we were to be classified as a PFIC in any taxable year, a U.S. person (as defined in E. Taxation U.S. Tax Considerations Passive Foreign Investment Company Rules) would be subject to special rules generally intended to reduce or eliminate any benefits from the deferral of United States federal income tax that a U.S. person could derive from investing in a non-United States corporation that does not distribute all of its earnings on a current basis. Further, if we are classified as a PFIC for any year during which a U.S. person holds our Shares, we generally will continue to be treated as a PFIC for all succeeding years during which such U.S. person holds our Shares. For more information, see the section entitled E. Taxation U.S. Tax Considerations Passive Foreign Investment Company Rules.

**ITEM 4. INFORMATION ON THE COMPANY****A. History and Development of Our Company**

Our legal and commercial name is GigaMedia Limited. We trace our origin back to the incorporation of Hoshin GigaMedia in Taiwan in October 1998. For the purpose of a public equity offering, we were incorporated in Singapore in September 1999 as a company limited by shares. We acquired 99.99 percent of equity interest in Hoshin GigaMedia in November 1999 and the remaining 0.01 percent in October 2002.

In February 2000, we completed the initial public offering of our Shares. Our Shares are traded on the NASDAQ Stock Market under the symbol GIGM.

Prior to September 2002, we primarily provided broadband Internet access and services in Taiwan through Hoshin GigaMedia. In September 2002, we acquired Rose Records (formerly known as Point Records Co., Ltd.) and Tachung Records (formerly known as Music King Co., Ltd.), two of the largest music store chains in Taiwan. Subsequent to these two acquisitions, we commenced the recorded music distribution business.

In 2004, we began the restructuring of our principal business operations with a view to shifting our strategic focus to gaming software and services business and online games business. The following chart highlights some of the major historical developments of our restructuring and the relevant strategic acquisitions and investments from 2004 to 2008:

<b>Time</b>	<b>Event</b>
April 2004	We acquired the business and operations of Grand Virtual, Inc., a privately-held gaming software developer and application service provider, and its affiliates.
April 2004	We entered into an end user license agreement with UIM, pursuant to which we granted a nonexclusive, non-transferable worldwide license to UIM to use our software and certain operational and support services. The royalties under the agreement were determined based on a revenue sharing mechanism. The term of the agreement was 10 years. The end user license agreement with UIM was terminated in April 2010 as the

part of the transaction with Mangas.

September 2005

We sold all of our ownership interest in the Rose Records and Tachung Records music store chains with a view to eliminating non-core operations.

**Table of Contents**

<b>Time</b>	<b>Event</b>
January 2006	We acquired FunTown, an online games business operated in Taiwan and Hong Kong, to enhance our position in the online entertainment market.
May 2006	We disposed of our ADSL business, which was an operational line of our Internet access and services business.
December 2006	We entered into a strategic alliance with Infocomm Asia, an operator and distributor of online games in Southeast Asia. In connection with the strategic alliance, we acquired preferred shares convertible into the issued ordinary shares of Infocomm Asia. As of May 31, 2010, we held preferred shares convertible into 28.43 percent of the ordinary shares of Infocomm Asia. Upon conversion of the preferred shares held by us into the ordinary shares of Infocomm Asia, we expect to become the largest shareholder of Infocomm Asia.
June 2007	We completed the acquisition of the controlling interest in T2CN, one of the online casual game operators in the PRC. On August 8 and August 12, 2009, we acquired certain ordinary shares of T2CN from two existing shareholders respectively. As of May 31, 2010, we held approximately 67.09 percent of the total outstanding voting rights of T2CN.
October 2007	We entered into a strategic alliance with Neostorm Holdings Limited ( Neostorm ), a South Korean gaming developer. In connection with the strategic alliance, we acquired preferred shares convertible into the common shares of Neostorm. As of May 31, 2010, we held preferred shares convertible into approximately 33.33 percent of the common shares of Neostorm.
December 2007	We entered into a strategic alliance with XLGames Inc. ( XL Games ), a South Korean online game developer that focuses on the development of MMORPGs. In connection with the strategic alliance, we acquired preferred shares convertible into the common shares of XL Games. As of May 31, 2010, we held preferred shares convertible into 14.55 percent of the common shares of XL Games.
January 2008	We entered into a strategic alliance with Access China Holding Limited ( Access China ), an online game developer in the PRC. In connection with the strategic alliance, we acquired preferred shares convertible into the common shares of Access China. As of May 31, 2010, we held preferred shares convertible into approximately 24.74 percent of the common shares of Access China.
May 2008	We entered into certain agreements with SuperCup Entertainment (Holdings) Limited ( SuperCup ) and its affiliates, pursuant to which we purchased preferred shares convertible into the common shares of SuperCup and obtained worldwide exclusive rights to cooperate with SuperCup in MahJong and certain Asian card games business. As of May 31, 2010, we held preferred shares convertible into 39.65 percent of the issued share capital of SuperCup. SuperCup ceased its operation in 2009.
September 2008	

We sold our last remaining non-core business, our consumer cable modem and corporate ISP business, to China Network Systems Co., Ltd. and its affiliates. The disposal effectively completed our business restructuring process which we began in 2004. For additional information, see Item 5, Operating and Financial Review and Prospects Certain Significant Events affecting Our Results of Operations for 2007, 2008 and 2009 Divestiture of our legacy Internet access and service business and Item 10, Additional Information C. Material Contracts Sale of Internet Access and Service Business in this annual report.

October 2008

We entered into a software and supply agreement with a third-party gaming software developer with a view to adding the flash downloadable Internet casino games in our gaming platform.

December 2008

We entered into a strategic partnership with Victor Chandler, a renowned sports betting operator. Under the partnership, we cooperate with Victor Chandler in marketing its online sports betting on Everest Bets, an affiliate website utilizing our software solution, with a view to further enhancing cross-selling across the games on the Everest-branded platform. On December 16, 2009, we terminated such strategic partnership with Victor Chandler. We entered into a strategic alliance with Mangas, a leading French sports betting and online gaming group. Under the arrangement, Mangas will provide Mangas Everest with a sports betting solution in late 2010.

On January 1, 2009, we launched Holic Online, an adventure-themed MMORPG, in Taiwan.

In January 2009, in cooperation with Microsoft Corporation ( Microsoft ), we launched FunTown MahJong, our first Xbox 360 game title for worldwide release.

On January 22, 2009, we entered into a game license agreement with a third-party online game developer with respect to the licensing of an online game titled Luna Online in the PRC and Macau. On July 7, 2009, we launched Luna Online in the PRC. On June 1, 2010, we terminated the Luna Online game license agreement with its game developer by mutual agreement.

**Table of Contents**

On March 9, 2009, we entered into a strategic alliance with Numen Soft Co. Ltd. ( Numen Soft ), an online game developer in South Korea. In connection with the strategic alliance, we acquired the ordinary shares of Numen Soft. As of May 31, 2010, we held 10 percent of the ordinary shares of Numen Soft.

On May 26, 2009, we entered into a strategic alliance with Gorilla Banana Entertainment Corp. ( GBE ), an online game developer in South Korea. In connection with the strategic partnership, we acquired the ordinary shares of GBE. As of May 31, 2010, we held 19.92 percent of the ordinary shares of GBE.

On June 25, 2009, we launched Warhammer Online: Age of Reckoning, a war-themed MMORPG developed by Electronic Arts Inc., in Taiwan, Hong Kong and Macau. On April 22, 2010, we terminated the Warhammer Online license and distribution agreement with its game developer by mutual agreement.

On September 22, 2009, we acquired certain common shares of JC Entertainment Corporation ( JCE ). As of May 31, 2010, we held 12.5 percent of the common shares of JCE. We license Freestyle, a highly popular online basketball game, from JCE and currently operate Freestyle in the PRC through T2 Entertainment.

On December 23, 2009, we entered into a strategic alliance with Possibility Space Incorporated, an online game developer in the PRC. In connection with the strategic alliance, we acquired certain preferred shares of Possibility Space Incorporated. The transaction was closed in March, 2010. As of May 31, 2010, we held preferred shares convertible into 49 percent of the ordinary shares of Possibility Space Incorporated.

In 2009, we launched FunTown Game Zone. We also added World Tour Video Slot, Race Course Winner, Baccarat, Pirates Pachi Slot, Paradise Island, Red Dog, Roshambo, Pai Gow Poker, Double Double Bonus Poker and Grand Slam Mahjong to our online game contents.

On March 15, 2010, we secured an exclusive license from Neowiz Corporation, an online game company in South Korea, to operate Alliance of Valiant Arms, an online massively multiplayer first person shooter game which provides large-scale and team-based combat. We expect to launch Alliance of Valiant Arms in Taiwan, Hong Kong and Macau in the second half of 2010.

On March 18, 2010, we entered into a game development, publishing and distribution agreement with Nickelodeon Asia Holdings Pte Ltd ( Nickelodeon ), a division of Viacom International Inc. (NYSE: VIA, VIA.B) pursuant to which we agreed to develop, publish and distribute a massively multiplayer online game ( MMOG ) based upon and branded with the Nickelodeon animated television program *SpongeBob SquarePants* for Nickelodeon. On May 14, 2010, we entered into a development agreement with Blueark Limited ( Blueark ), an online game developer in South Korea under which Blueark agreed to develop and deliver to us an online game based on the *Spongebob SquarePants* intellectual property. The *SpongeBob SquarePants* MMOG is expected to launch in 2011 in multiple languages for players in the PRC, Korea, Japan, Taiwan, Southeast Asia and India.

On April 8, 2010, we completed the sale of a 60 percent interest in our online gaming software business to Mangas, a leading European sports betting and online gaming group. The strategic alliance with Mangas was structured as a stock and asset sale to a newly-formed French entity, Mangas Everest, in which we received a 40 percent stake. As part of and as a condition to the completion of the transaction, we purchased the shares of our then-major licensee, UIM, all of the material assets of which were sold to Mangas Everest as part of the transaction.

On April 30, 2010, we entered into several agreements with Infocomm Asia itself and certain shareholders of Infocomm Asia, to acquire additional preferred shares of Infocomm Asia. The acquisition of Infocomm Asia is expected to close in the third quarter of 2010. Upon closing, we will hold preferred shares convertible into approximately 80 percent of the common shares of Infocomm Asia. Infocomm Asia is a leading publisher, operator and distributor based in Singapore with over 35 million registered users in Southeastern Asia and operates several award-winning titles including *FIFA Online 2*, *Granado Espada* and *Dragonica*. Infocomm Asia entered into certain license agreements with Blizzard, under which Blizzard agreed to license its existing game library, *Diablo*, *StarCraft* and *Warcraft*, and a new game, *StarCraft II: Wings of Liberty*, to Infocomm Asia or its wholly owned subsidiary in Southeastern Asia.

On June 7, 2010, Everest Poker and BetClic Poker operations, owned by Mangas Everest, our joint venture with Mangas, received online poker licenses as part of the first grant of licenses in France. Everest Poker and BetClic Poker accounted for two of the seven licenses granted in the initial approvals and expect to begin French operations in late June 2010.

Our Singapore company registration number is 199905474H. Our principal executive offices are located at 8th Floor, 207 Tiding Boulevard, Section 2, Taipei 114, Taiwan, and our telephone number is 886-2-2656-8000. Our website address is: <http://www.gigamedia.com>.

**Table of Contents**

Descriptions of our principal capital expenditures and divestitures and descriptions of acquisitions of material assets are found in our discussion and analysis of financial condition and results of operation and in the notes to our consolidated financial statements included elsewhere in this annual report.

There have been no public takeover offers by third parties in respect of our shares or by us in respect of other companies' shares which have occurred during the last and current financial year.

**B. Business Overview**

We were a provider of gaming software and services to the online gaming industry, particularly the online poker and casino markets, and an operator of online games in Greater China, including the PRC, Taiwan, Hong Kong and Macau. We were incorporated in Singapore in September 1999. Our principal business operations remained limited to the provision of Internet access and service business, and recorded music distribution in Taiwan until 2004, when we commenced a business restructuring to shift our strategic focus to the gaming software and services and online games operations. We began our gaming software and services business in 2004 by acquiring the business of a gaming software provider. In 2006, through a series of strategic acquisitions, we expanded our operations into the online games market, which we believe has high growth potential. During the restructuring process, we disposed of our non-core businesses, including our retail music distribution and Internet and access service businesses. We completed the entire business restructuring in September 2008 with the sale of our last non-core business.

Subsequent to completion of the restructuring and through April 8, 2010, we generated our revenue primarily through providing gaming software products and application services and operating online games. We operated our gaming software and services through CESL, our wholly-owned subsidiary. Since 2004, we have been focused on developing software packages for online poker and casino operations. We provided the Everest-branded gaming platform to various online poker and casino game sites, including Everest Poker, one of the world's largest online poker websites in terms of seven-day average player counts according to PokerScout, a third-party online poker review service. Our products and services included online poker and casino gaming software packages, extensive online gaming management tools, and application and consulting services. To improve usability of our products in international markets and serve customers seeking geographic expansion, we developed the expertise and infrastructure to make our products suitable for the local markets in which the games are offered. Our gaming software products and services, now operated by Mangas Everest, are currently available in 15 major languages. Our gaming software and services business was historically dependent on our then-largest licensee, UIM. UIM operated various online poker and casino websites, including Everest Poker, primarily targeting players from Continental European markets. Fees earned by us were historically based on UIM's gross receipts from the operation utilizing the licensed software. Historically, we had experienced seasonality primarily as a result of UIM's slower sales in the second and third quarters, during which people tend to spend less time indoors and online as daylight hours increase and the weather conditions in Continental Europe improve. Typically, our first and fourth quarters were our strongest revenue periods. The financial results of UIM were historically incorporated into our consolidated financial statements in accordance with the FASB Accounting Standards Codification although we did not historically own any equity interest in UIM.

On April 8, 2010, we completed the sale of a 60 percent interest in our online gaming software business to Mangas, a leading European sports betting and online gaming group. The strategic alliance with Mangas was structured as a stock and asset sale to a newly-formed French entity, Mangas Everest, in which we received a 40 percent stake. As part of and as a condition to the completion of the transaction, we purchased the shares of our then-major licensee, UIM, all of the material assets (including the Everest Poker operations) of which were sold to Mangas Everest as part of the transaction. In accordance with the terms of the strategic alliance, Mangas Everest will endeavor to migrate all Mangas poker players to the Everest Poker platform creating one of the largest poker player liquidity platforms in Europe. Everest Poker will also be able to benefit from the sports betting solution of Mangas. In addition, the combined user base of Everest Poker and BetClic—both leading brands in France—strongly positions the alliance to capture potential growth from the soon to be opened and regulated French market, one of the largest in Europe. On June 7, 2010, Everest Poker and BetClic Poker operations, owned by Mangas Everest, received online poker licenses as part of the first grant of licenses in France. Everest Poker and BetClic Poker expect to begin French operations in late June 2010. From and after April 9, 2010, we no longer consolidate the results of CESL and UIM in our consolidated financial statements. From that date, we account for our interest in Mangas Everest using the equity



method of accounting. As a result, it may be difficult to compare our results of operations in future periods to our historical results of operations.

We operate an increasingly diversified online games business in Greater China markets. We conduct our online games business in the PRC primarily through T2CN and in Taiwan, Hong Kong and Macau primarily through FunTown. Our online game portfolio currently includes online MahJong, MMORPGs, advanced casual games and a variety of online card, chance-based and simple casual games. We offer online MahJong through FunTown-branded game platform, which we believe is one of the largest online MahJong networks in Taiwan. In accordance with our online games expansion strategy, we have added MMORPGs to our online game portfolio. We currently offer three licensed MMORPGs, including Warhammer Online: Age of Reckoning in Taiwan, Hong Kong and Macau, Holic Online in Taiwan and Luna Online in PRC. We are in the process of shutting down Warhammer Online and Luna Online due to poor commercial performance. In addition, we expect to launch a new MMORPG, XK Online in the PRC. Our online game portfolio also includes various advanced casual games which, as compared to MMORPGs, are easier to play and can attract a broader range of players. We currently offer four advanced casual games, including Tales Runner in Taiwan and Hong Kong, Freestyle in the PRC, Nanaimo in Hong Kong and Paipaijoy in the PRC. In addition, we expect to launch Alliance of Valiant Arms, a new online massively multiplayer first person shooter game which provides large-scale and team-based combat, in Taiwan, Hong Kong and Macau in the second half of 2010. We also expect to launch Freestyle Season 2 in the PRC in the second half of 2010. In addition, through our integrated FunTown-branded game platform, we offer over 34 online card, chance-based and simple casual games. To complement our online games, we offer various value-added services and virtual items for players to enhance their game experience, skills and online personal character. We focus on building community-based online platforms to cater to different social networking needs of our users and provide various channels to facilitate communications among them.

**Table of Contents**

We intend to continue to seek growth and enhance our market position in the online games industry. We will continue to focus on the Greater China markets and further diversify our online game portfolio. While we will continue to broaden our access to high quality online games through licensing, we intend to expand our in-house game development team and strengthen our online game development capabilities, particularly in development of MMORPGs and advanced casual games.

We also believe that Southeastern Asia is a large and fast growing market opportunity. We entered into a strategic alliance with Blizzard through Southeastern Asia games operator Infocomm Asia, of which we will be a controlling shareholder in the third quarter of 2010. We expect to bring both Blizzard's existing game library, Diablo, StarCraft and Warcraft, and also a new game, StarCraft II: Wings of Liberty, to Southeastern Asia. We believe that led by Infocomm Asia, Southeastern Asia will be a major area of growth and expansion for us.

While we have historically experienced significant growth in our operations of gaming software and services and online games, we experienced a significant downturn in 2009. For the years ended December 31, 2007, 2008 and 2009, our revenue from the gaming software and services segment was US\$119.0 million, US\$144.8 million and US\$112.7 million, respectively, and our revenue from the online games segment was US\$32.8 million, US\$45.6 million and US\$46.9 million, respectively. For the years ended December 31, 2007 and 2008, our consolidated net income was US\$38.9 million and US\$44.4 million and for the year ended December 31, 2009, our consolidated net loss was US\$49.1 million.

**Online Games Business*****Our Games***

We offer an increasingly diversified portfolio of online games, including MahJong, MMORPGs, advanced casual games, and a variety of card, chance-based and simple casual games. Our online games business is operated in Taiwan and Hong Kong primarily through FunTown and in the PRC primarily through T2CN.

***MahJong***

MahJong is a traditional and highly popular Chinese title game, which is widely played in Taiwan, Hong Kong, the PRC, Japan, South Korea and many other Asian regions. Similar to poker, MahJong involves skill, strategy, calculation, as well as a certain degree of chance.

Through our FunTown-branded platform, we offer various local versions of MahJong for players in Asia, particularly for those from Taiwan and Hong Kong. To play our online MahJong games, players install the client-end software which can be downloaded free of charge from our game websites. Players can compete with anyone throughout the FunTown network. Our MahJong games are designed for players of all levels of skills and experience. To accommodate various needs of players, we offer different online MahJong rooms based on skill levels or stakes. We believe our online MahJong game site is one of the largest online MahJong networks in Taiwan.

Players may play our online MahJong free of charge. To continue to play on a regular basis and establish a track record inside our online MahJong community, players may choose to purchase the game points or game-playing time through various distribution channels, such as convenient stores, telephones, computer-based payment processing terminals, and credit cards. By purchasing our game points, players may exchange for virtual currency and deposit into their virtual bank accounts. The virtual currency may be used to play MahJong and other games in the FunTown game site or to purchase in-game virtual items, but may not be redeemed for cash.

We continue to expand and diversify the game platforms for our online MahJong. In January 2009, in cooperation with Microsoft, we launched FunTown's online MahJong on the Xbox 360 game consoles for worldwide release. Since April 2009, in cooperation with Skype Limited, we integrated the Skype software's Voice over IP functions into our online MahJong game system, allowing our MahJong game players to add friends from Skype to our game system and use Skype's voice chatting function while playing our online MahJong games. Since July 2009, we have been providing a multi-login mechanism to enable players to play our MahJong and chance-based casual games at the same time. In September 2009, we entered into a strategic alliance with Pili International Multimedia, owner of popular puppet characters in Taiwan, and introduced the certain of these popular puppet characters into our online games. Our game players may create puppet characters using 13 items, consisting of avatars, voices, and wallpapers. We are also developing a Web version of MahJong as well as a Web version of Big2 to be released in 2010.



**Table of Contents**

We organize offline events from time to time with a view to attracting more players and enhancing our leading position in the online MahJong market. Pursuant to the agreement entered into among us, the World MahJong Organization and the World MahJong Contest Center, we co-hosted the World Series of MahJong in Taiwan, Japan and Europe and the first World MahJong Championship in the PRC in 2007. In the same year, we organized the annual MahJong tournament in Taipei which was open to anyone joining one of FunTown's MahJong clubs. Approximately 400 clubs and over 20,000 players attended the tournament. In 2008, we modified the application process for MahJong Tournaments in Taipei so that only the players who pass the preliminary heats are entitled to join the final match. The online preliminary heats were held for two months. Approximately 100 clubs and 3,264 players attended the final match in 2008 and approximately 100 clubs and 5,000 players attended the final match in 2009. On May 15, 2008, we made a strategic investment into SuperCup and obtained worldwide exclusive rights to cooperate with SuperCup in MahJong and certain Asian card games business. SuperCup hosted a series of tournaments for SuperCup Mahjong Competition from September 2008 to December 2008. According to SuperCup, over 12,500 players participated in the tournaments, from which approximately 340 were qualified to compete in the finals. SuperCup ceased its operation in 2009.

**MMORPGs**

MMORPGs are Internet-based computer games in which a large number of players interact with one another in an online virtual world. Like any role playing game, a player controls a character with an avatar, which he or she directs to complete tasks for experience, interact with other characters and acquire items.

Since 2006, we have expanded our online game operations to include several MMORPGs. From September 2006 to December 2008, we offered NeoSteam, the first MMORPG that we licensed from a third-party developer, in the PRC. We continue to enlarge and diversify our MMORPG portfolio, which includes four MMORPGs that we currently offer or expect to launch in various target markets in Greater China. Our MMORPGs encompass various genres, including adventure, action, war and casual fantasy. The following table summarizes the three MMORPGs that we offered as of the date of this annual report:

<b>Game</b>	<b>Description</b>	<b>Commercial Launch</b>	<b>Game Source</b>	<b>Revenue Model</b>	<b>Market</b>
Holic Online	Cartoon style adventure	January 2009	Licensed	Item-billing	Taiwan
Warhammer Online: Age of Reckoning	War	June 2009	Licensed	Pay-to-play	Taiwan Hong Kong Macau
Luna Online	Casual fantasy	July 2009	Licensed	Item-billing	PRC

We launched the Warhammer Online: Age of Reckoning and Luna Online in June and July 2009, respectively. These two games were not commercially successful in the territories in which they were launched. As a result, we terminated the Warhammer Online: Age of Reckoning license and distribution agreement and Luna Online game license agreement with the relevant game developers by mutual agreement on April 22, 2010 and June 1, 2010, respectively. As part of the termination of the operation of these games, we are currently executing a transition for end users by allowing end users to continue playing Warhammer Online and Luna Online as of the date of this annual report. The following table summarizes one MMORPG which we expect to launch in various geographic markets in 2010:

<b>Game</b>	<b>Description</b>	<b>Status</b>	<b>Game Source</b>	<b>Target Market</b>
XK Online	Martial arts adventure	Game Development	In-house Developed	PRC

Warhammer Online: Age of Reckoning is operated under the pay-to-play revenue model that requires users to purchase the retail copy of the game as well as the subscription or game cards for playing time. By subscribing or purchasing game cards, users may play for an unlimited amount of time within a specified number of days. Our other MMORPGs are operated or expected to be operated under the item-billing revenue model. Under item-billing model, users are able to play the basic functions of a MMORPG for free. Players may choose to purchase in-game value-added services as well as in-game virtual items and premium features to enhance the game experience. These services and items allow players to utilize more functions, improve performance and skills, and personalize the appearance of a game character. Game points are consumed as users purchase value-added services and in-game items.

**Table of Contents***Advanced Casual Games*

As compared to MMORPGs, advanced casual games have relatively simple rules and require no long-term commitment to play. They are targeted to the casual players across all game genres.

We operate a diversified portfolio of advanced casual games. We believe that advanced casual games provide us with certain benefits and opportunities not typically available through MMORPGs, including:

- broader range of players, including casual players, due to the casual nature and relatively short duration;
- and
- a greater breadth of tools, engines, middleware and server solutions that can make development of casual games relatively more cost-effective.

In Taiwan and Hong Kong, we offer various advanced casual games through FunTown. In June 2006, we launched our first advanced casual game, Tales Runner. Tales Runner is a multi-player obstacle running game in which players compete by running, jumping, dashing and using items. Since the launch, Tales Runner has become one of the most popular online sports games in Hong Kong. In December 2007, we launched Nanaimo, a cute style action-based casual game.

In the PRC, we operate our advanced casual games through T2CN. We currently operate Freestyle, a highly popular online basketball game in the PRC. Freestyle is a peer-to-peer street basketball game, in which players can form teams to compete against other teams and customize in-game character appearances and skills by purchasing virtual items. The cartoon characters and the scenes modes are embodied by full 3D graphics. Players improve the skills through more practice and competitions. In 2009, the peak current users, or PCCU, reached 118,832 for Freestyle. We also offer Paipaijoy, another sports game, in the PRC. Going forward, we intend to leverage our well-established sports game platform to offer a wide range of advanced casual games in the PRC.

The following table summarizes our four advanced casual games that we offered as of the date of this annual report:

<b>Game</b>		<b>Description</b>	<b>Commercial Launch</b>	<b>Game Source</b>	<b>Revenue Model</b>	<b>Market</b>
Tales Runner	Sports	Obstacle running	June 2006 in Taiwan	Licensed	Item-billing	Taiwan
			August 2006 in Hong Kong			Hong Kong
Freestyle	Sports	Basketball	December 2005	Licensed	Item-billing	PRC
Nanaimo	Action		December 2007	Licensed	Item-billing	Hong Kong
Paipaijoy	Sports	Tennis	June 2008	Licensed	Item-billing	PRC

The following table summarizes our advanced casual games which we expect to launch in various geographic markets as indicated at regular intervals in 2010:

<b>Game</b>		<b>Description</b>	<b>Status</b>	<b>Game Source</b>	<b>Target Market</b>
Alliance of Valiant Arms		Massively multiplayer first-person shooter	Game Localization	Licensed	Taiwan
					Hong Kong
					Macau
Freestyle Season 2	Sports	Basketball	Closed Beta Testing	Licensed	PRC



**Table of Contents**

We had secured an exclusive license from Electronic Arts Asia Pacific Pte. Ltd. to offer and operate NBA Street Online, an online basketball game featuring fast paced streetball action with star players of the NBA, in the PRC, Taiwan and Hong Kong. The NBA Street Online game has not been commercially launched in any territory and the exclusive license was terminated on December 4, 2009 by mutual agreement.

On March 15, 2010, we secured an exclusive license from Neowiz Corporation, an online game company in South Korea, to operate Alliance of Valiant Arms, an online massively multiplayer first person shooter game which provides large-scale and team-based combat. We expect to launch Alliance of Valiant Arms in Taiwan, Hong Kong and Macau in the second half of 2010. We also expect to launch Freestyle Season 2 in the PRC in the second half of 2010.

Players download and install client software from our websites. Our advanced casual games are offered free-of-charge to all players. In order to enhance their online game playing experience, players may purchase virtual items that enhance their characters' performance and game playing experience, or personalize their characters.

*Card, Chance-Based and Simple Casual Games*

Through our FunTown-branded platform, we offer various online games, including card, chance-based and simple casual games. These online games are Internet-based and developed through computer simulation and adaptation of non-computer games, which are traditionally played offline. The FunTown platform targets players from different regions, particularly Taiwan and Hong Kong.

We provide many different online card games, which are popular in various regions in Asia. Players can select their desired table based on the level of skill or stakes. These games are designed with online multiplayer features that allow players to compete against one another. To diversify FunTown products, we also offer chance-based games, including bingo, lotto, horse racing, Sic-Bo, slots and various simple casual games. We are working towards expanding the casual games platform by providing a variety of casual games. Since 2009, we introduced World Tour Video Slot, Race Course Winner, Baccarat, Pirates Pachi Slot, Paradise Island, Red Dog, Roshambo, Pai Gow Poker, Double Double Bonus Poker, and Grand Slam Mahjong into our game contents. These newly added games improve the competitiveness of our online games business and help to increase our revenues. We are working on 7 additional chance-based casual games which we expect to be released in 2010.

Like online MahJong, players may play our FunTown games for free. They may choose to purchase playing time or virtual currency to play on a continuous and regular basis. Virtual currencies may be used to play all the games in the FunTown game site or to purchase virtual items, but may not be redeemed for cash.

***Game Sources****In-house development of MahJong, Card, Chance-Based and Simple Casual Games*

We develop our games offered on FunTown's game platform, including online MahJong, card, chance-based and simple casual games. Our in-house development enables us to have better control of the game features and allow for seamless integration into our FunTown platform. In order to support product development capabilities and develop our proprietary online games, we have an in-house team, which was comprised of approximately 35 software engineers in Taipei and 12 software engineers in Shanghai as of May 31, 2010. In addition, T2CN had 152 software engineers in Shanghai as of May 31, 2010.

*Sources of MMORPGs and Advanced Casual Games*

We primarily source MMORPGs and advanced casual games through licensing from developers in various regions where online game development is well established. We monitor each of the United States, South Korean, the PRC, Japanese and European markets and maintain communications with a number of leading game development studios to identify and source new online games.

In selecting games, we evaluate the key factors that indicate the market trend and player demand and interest in the regions where we operate. We believe that our market analysis enables us to better assess the quality, risks, costs and potential returns of the games.

Prior to negotiating a license agreement with a game developer, our game testing team evaluates the game and prepares detailed evaluation reports covering the theme, storyline, in-game culture and environment, character progression, system architecture, game art and design, virtual articles and items.

We enter into the license agreement after we decide to operate the selected game based on the results of our evaluation. 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, or royalties, which are equal to a percentage of revenues generated from operation of the game. We may also have to provide certain minimum guarantees in royalties to developers.

**Table of Contents**

In preparing for the commercial launch of each new game, we cooperate with the game developer to localize the game to make it suitable for the target markets where we plan to launch. Once the developer completes the localization and provides the first-built version, we conduct closed beta testing of the game with a select group of users. During the test period, we identify and eliminate any technical problems, assess how likely users will be to play the game regularly over a period of time (referred to as user stickiness), and modify and add certain game features in order to increase user stickiness. The closed beta testing is followed by open beta testing, during which we operate our games under open market conditions and monitor the performance, consistency and stability of operational systems for the game. Following the commercial launch of a game, we continuously implement improvements and upgrades to our games. While we will continue to broaden our access to high quality MMORPGs and advanced casual games through licensing, we intend to expand our in-house game development team and strengthen our online game development capabilities. We are currently testing XK Online, which is expected to be our first in-house developed MMORPG.

***Our Primary Platforms and Services******FunTown***

Our FunTown platform provides many online game services for the users to enhance their playing and entertainment experiences, facilitate information communication among them and support the development of a strong player community. These services include:

**Player Clubs.** We offer online club services in the FunTown game community. FunTown players can form their own clubs, invite other players with similar interests or skill levels to join, and organize online and offline events for club members. Player clubs complement the strong social features of online games by helping to maintain an online game community.

**Tournaments.** As one of the key services, FunTown provides various tournaments for its online MahJong players. After players join a club, they can participate in online in-club tournaments and compete in weekly online inter-club tournaments. On an annual basis, FunTown organizes large-scale tournaments, in which a large number of players are invited to the tournament premises and compete online via computers.

**Avatars.** To enhance players' overall entertainment experience, FunTown offers many in-game virtual items which may be purchased by players to customize their online personal graphic profiles, or avatars. Players use avatars to create their own unique look while participating in the online community. The virtual items for avatars include facial expressions, clothes and different accessories. These items are particularly popular with younger players, who customize their avatars to establish unique identities and pursue distinct fashions in the online community.

**Friends and Family Messenger.** The FunTown platform has a unique function designed for players' personal contacts, which is similar to the contact list of instant message programs. This enables players to see when their friends and family members are online and invite people in their personal network to play games together.

**Social Networking.** The FunTown platform provides an online social networking community called FunTown Village, in which players meet each other through their online avatars. In FunTown Village, players can interact and communicate, purchase virtual items, and even get married virtually. We plan to introduce more virtual items within FunTown Village to address the strong social interests of our players and to help increase FunTown's overall appeal as a distinct online game community.

**Customer Services.** FunTown provides support and services to its customers primarily through walk-in customer service centers in Taipei and Hong Kong and e-mails and online bulletin boards where players can inquire and receive responses from us and other players.

***T2CN***

Our T2CN platform provides the following services and player support to our users in the PRC:

**Membership Management.** T2CN utilizes an integrated service platform, namely T2CN-Passport, to provide one-stop service to customers as well as distributors. T2CN-Passport is an integrated membership management and payment system, which allows T2CN to maintain a single customer database containing each customer's profile and transaction history. Customers may log in, pay and use

any of the fee-based products and services. In addition, T2CN-Passport allows our distributors to sell our game points to Internet cafés. Internet cafés can also use T2CN-Passport to check their point-balances and make payment on behalf of individual purchasers.

## **Table of Contents**

Social Networking. T2CN's integrated system also incorporates a variety of online community features, such as bulletin boards which allow registered users to post notes or inquiries and respond to other users' questions and comments. We believe these features increase the user stickiness on our site and facilitate player interaction. T2CN is currently building an online social networking community to further facilitate access to our online game offering and accommodate different social networking needs of our users in the PRC.

Game Masters. T2CN delegates game masters to provide various in-game services for our MMORPG players. Game masters are responsible for organizing in-game events, troubleshooting and actively and continuously monitoring the online game environment. They respond to players' inquiries, handle error reporting and removal process, and identify and deter inappropriate player behaviors. We believe that the provision of game masters is an important customer service function to maintain customer loyalty and effectively address technical problems as they arise.

Customer Services. T2CN focuses on providing quality customer service in order to retain its existing customers as well as attract new customers. T2CN offers multiple communication channels, including telephone hotline and customer service email, for the customers to provide feedback and complaints about our products or services at any time.

### ***Non-Computer Based Platforms for Certain Games***

As technologies advance and enable people to access the Internet in new ways, we plan to expand our offerings to match these new access technologies and platforms. We are currently working with Microsoft to develop and offer some of our games available on the Xbox 360 platform. In January 2009, we launched FunTown MahJong, our first Xbox 360 game title for worldwide release. We also offer certain of our popular games on the media-on-demand (MOD) digital TV platform, called FunTown Game Zone, which involves cooperation with Intel by utilizing its Viiv technology. In January 2009, FunTown Game Zone section was activated on the MOD system operated by Chungwa Telecom Co., Ltd. The titles of FunTown Game Zone include MahJong, Chinese Chess, Connect 5 and Blind Chess. We have also developed mobile phone versions of our certain games. In addition, as the video games become an emerging facet of in-flight entertainment, we offer various in-flight games to certain airlines, which are networked to allow interactive game play among multiple passengers on the same flight. We do not expect the games offered through non-computer based platforms to contribute materially to our revenue in the near future.

### ***Our Marketing***

Our marketing strategy is to capitalize on our established brand names and utilize our diverse distribution networks to retain our existing users and attract new users. We use various qualitative and quantitative market research methods to analyze our target market and to differentiate our product offerings from those of our competitors. We are engaged in a variety of traditional and online marketing programs and promotional activities, including the following:

#### ***In-Game Events and Marketing***

We organize in-game events for our users, which we believe encourages the development of online communication and teamwork among our users and increases user interest in our games. Examples of in-game events include scheduled challenges or competitions for prizes. In addition, we use in-game events to introduce new features of our games.

#### ***Cross-Marketing***

We have cross-marketing relationships with popular consumer brands, major technology companies and telecommunication carriers. We believe that our cross-marketing relationships with certain well-known companies, including Coca-Cola, 7-11 and Microsoft, will increase the recognition of our online game brands.

#### ***Open Beta Testing***

Our open beta testing is conducted under open market conditions. During open beta testing, we do not charge users to play the new game. Open beta testing serves important marketing functions, including instilling initial interests, establishing an initial user base, and generating word-of-mouth publicity to support the following commercial launch of the game.



## **Table of Contents**

### *Advertisements and Offline Promotions*

We advertise our brand names and our games across a variety of media, including newspapers, the Internet, television, radio and outdoor advertisements. From time to time we distribute game-related posters, promotional prepaid cards for new users and souvenirs at trade shows, selected Internet cafés and other locations. We also conduct events at popular venues to stage exhibitions, distribute software and game content-related merchandise, and interact directly with our users.

### *Game Magazines*

In addition to advertising certain games in various magazines, we also collaborate with certain game magazines for various promotions, including giving away copies of certain games free of charge with each magazine sold.

### *Direct Marketing*

We use telemarketing and email correspondence to inform our users of new games, promotions and other game-related services.

### ***Our Distribution and Payment Channels***

We sell game points for our online games through various channels. Our distribution and payment channels include:

#### *Offline Physical Distribution Channels*

Physical distribution channels include convenience chain stores and Internet cafés. At these locations, users may purchase pre-paid game cards with varying amounts of game points. Alternatively, users may purchase game packs to play specific games on FunTown s and T2CN s game platforms.

#### *Internet-Based Distribution Channels*

Internet-based distribution channels consist of various websites, including official websites of FunTown and T2CN. Users may purchase game points through these websites with their credit cards or computer-based payment processing terminals.

#### *Telecommunication Network Operators*

We also distribute game points through cooperation with telecommunication network operators and their service providers. Our cooperating operators and service providers charge the fees to the purchasers' phone bills, which are prepared and collected by the network operators.

We sell our game points to distributors at prices lower than the face value of the game points. The costs of distributing game points through Internet-based channels are generally lower than the costs involved in offline distribution of physical game cards. To encourage use of the Internet-based channels and provide more convenience for users, we give our users the computer-based payment processing terminals for free so that they can purchase game points online at home.

### ***Our Operation Architecture***

We have a scalable and modular operation architecture that enables us to support and expand our game offerings and services. The architecture consists of several key subsystems, including game services, central user database, billing and payment, online customer service, game telemetry and monitoring. Both FunTown and T2CN have their own unified user account systems, which allow players to use a single account to access all FunTown games and T2CN games, respectively. Our billing and game management system supports various billing models and deposit options, and is sufficiently flexible to accommodate in-house developed games and licensed games. Our customer service system enables us to assist our players inside and outside the games. Our game telemetry and monitoring system allows us to track our concurrent online users in real time and effectively identify and fix technical problems in our server network.

## **Table of Contents**

### ***Technology Infrastructure***

Due to the real-time interaction among thousands of users, the stable operation of our MMORPGs and advanced casual games requires a significant number of servers and a significant amount of connectivity bandwidth. We have developed an extensive technology infrastructure that supports the operation of our online games.

As of December 31, 2009, we owned approximately 871 servers and leased 23 servers from ISPs for our online games operation in the PRC. As of the same date, our server network in the PRC consisted of approximately 628 game servers.

As of December 31, 2009, we owned approximately 721 servers for our online games operation in Taiwan and Hong Kong. As of the same date, our server network in Taiwan and Hong Kong consisted of approximately 397 game servers.

We seek to adapt our infrastructure promptly in response to changing circumstances.

### ***Our Players***

In the PRC, as of December 31, 2009, we had an aggregate of over 101.52 million registered usernames of our online games. In the month of December 2009, we recorded over 277 thousand paying players, approximately 83 thousand peak concurrent users and 30 thousand average concurrent users.

In Taiwan and Hong Kong, as of December 31, 2009, we had an aggregate of over 15.2 million registered usernames of our online games. In the month of December 2009, we recorded over 69 thousand paying players, approximately 29 thousand peak concurrent users and 14 thousand average concurrent users.

### ***Competition***

Our primary competitors in the online games business are online game operators based in Taiwan and the PRC. Our major competitors in Taiwan include Gamania, Soft-World, IGS, UserJoy and GodGame. Our major competitors in the PRC include Shanda, Giant, Changyou, The9 Limited, Nineyou, Tencent, Ourgames.com and Chinagames.net. 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.

We expect more online games operating companies to enter into the markets where we operate, including Taiwan, the PRC and Hong Kong, and that a wider range of online games to be introduced to these markets given the relatively low entry barriers to the online games industry. Our competitors vary in size and include private and public companies, many of which have greater financial, marketing and technical resources as well as name recognition. We intend to continue to enhance our market position through providing competitive products and quality services that meet market trends and users' preferences, as well as strengthening sales effectiveness.

### ***Gaming Software and Service Business***

Prior to completing the sale of a 60 percent interest to Mangas, a leading European sports betting and online gaming group, on April 8, 2010, we operated our gaming software and service business through CESL, our wholly-owned subsidiary. We offered online gaming solutions primarily focused on the online poker and casino segments of the global online gaming industry. We historically partnered with UIM, our then-largest licensee, to provide a multilingual, multi-product game platform, namely the Everest-branded gaming platform.

### ***CESL's Products and Services***

We historically and primarily provided the software and services for the online poker rooms, casinos and the related marketing affiliate programs operated by UIM through CESL. CESL's online gaming solution comprised online gaming software, online gaming management tools, and application and consulting services.

### ***Online Gaming Software and Management Tools***

CESL's major software products were downloadable game client software programs, or game clients, which provided an intuitive user interface for players to register, deposit and withdraw funds, play free and real money games, manage their accounts and profiles, and seek assistance. CESL's game clients processed locally in each end-user's computer and interacted remotely with UIM's gaming servers to display virtual poker rooms and casinos, generated a sequence of random numbers for game playing, and enabled users to play poker and casino games through the Internet. To improve the usability of CESL's software and the accessibility of CESL's gaming platform for customers around the world, CESL localized its game clients to reflect the local languages and conventions. CESL's game clients were available in 15 supported languages. The game clients were installed directly from websites. Patches and updates were

provided automatically and applied to the product content each time the software programs started.



**Table of Contents**

CESL's gaming management tools included an e-commerce system, marketing support tools and back-office applications. CESL's e-commerce system accommodated a broad array of deposit and payment options such as credit card processors and various electronic wallet programs. CESL's marketing support tools provided UIM with a highly integrated web-based promotion platform, which could be interactively edited through a content management system. CESL's back-office applications provided tools for e-commerce promotions, player accounts and customer support. The back-office platform also included a sophisticated system that features data warehousing and management, business intelligence functions and provided tools for preventing and detecting fraud and other irregularities during the games as well the e-commerce transactions.

***Application and Consulting Services***

In addition to licensing CESL's software products, CESL also provided to UIM a variety of software application and support services including:

**Infrastructure Design and Management Services.** CESL provided the architectural design of various infrastructure elements, including the servers, databases, networks, routers, firewalls and management tools that are required for Internet gaming operations.

**Transaction Processing Services.** These services included (i) payment consultation for designing timely collection and distribution systems for payments through a variety of channels and merchants; (ii) billing consultation for designing real-time and out-of-band transaction processing and order management; and (iii) risk management consultation for creating and designing tools and processes for fraud detection, prevention and management.

**Customer Support Services.** CESL offered UIM a comprehensive round-the-clock consultation support to resolve infrastructure issues. CESL also provided platform technical support during periodic maintenance to update, patch, and fine-tune the system performance of our software solutions.

**Custom Gaming Software Development Services.** CESL customized the entertainment modules and interfaces for the gaming platform to meet specific requests of UIM's affiliates or partners.

**Marketing Support Services.** CESL created branded websites and provide marketing support services to assist UIM in attracting new players.

***CESL's Technology and Infrastructure***

CESL's online gaming platform was composed of multiple fault-tolerant distributed modules supporting a wide range of functionality, including the server application program, loyalty program management, financial stored-value management, e-commerce engines, and an extensive set of tools to perform fraud screening, data mining, player support and affiliate marketing programs. CESL's real-time gaming server software enabled integrated management of end user registration, account administration, deposit and transactions. CESL's transaction server software encapsulated business logic and abstract data and third-party services, such as payment processors.

***Relationship with UIM******Prior License Arrangement with UIM***

Our gaming software and services business was historically dependent on our largest licensee, UIM, an online gaming operator. On April 1, 2004, we entered into an end user license agreement with UIM, pursuant to which we granted a nonexclusive, non-transferable, worldwide license to UIM to use our software and certain operational and support services. The end user license agreement was amended on March 1, 2006, March 1, 2007, March 1, 2008 and April 1, 2009, respectively. The term of the agreement was 10 years. The license fees were determined based on a revenue sharing mechanism under the end user agreement, as amended. The end user license agreement with UIM was terminated in April 2010 as the part of the transaction with Mangas. See Item 5, Operating and Financial Review and Prospects A. Operating Results Subsequent Events Transaction with Mangas for additional information. In addition to licensing software, we provided UIM with application services and consulting services for its Internet infrastructure, including website design, payment gateways and database and operating systems, in return for a fixed percentage of UIM's gross receipt. The financial results of UIM were historically incorporated into our consolidated financial statements in accordance with the FASB Accounting Standards Codification although we did not historically own any equity interest in UIM.



**Table of Contents***UIM*

UIM was an online entertainment operator that provided online gaming entertainment, including online casinos and virtual poker rooms. UIM offered this entertainment content through several websites, including Everest Poker (www.everestpoker.com), which was awarded Poker Operator of the Year for each of 2007 and 2008 and the Online Marketing Campaign of the Year for 2009 by e-Gaming Review, a UK-based independent industry journal magazine. UIM marketed its game sites through affiliate programs where private and commercial owners of websites were invited to place, on their websites, banners containing links to UIM's websites, in return for fees with reference to the number of qualified new player sign-ups, or based on revenues generated by users that have been directed to UIM's website from such banners.

UIM operated exclusively from computer servers located in the Kahnawake Territory in Canada under a gaming license issued by the Kahnawake Gaming Commission. On March 1, 2010, UIM received two full remote gaming licenses (a Class 1 and a Class 3) issued by Malta Lotteries and Gaming Authority.

***Sale of Material Assets of CESL and UIM to Mangas Everest, and Investment in Mangas Everest***

On April 8, 2010, we completed the sale of a 60 percent interest in our online gaming software business to Mangas, a leading European sports betting and online gaming group. The strategic alliance with Mangas was structured as a stock and asset sale to a newly-formed French entity, Mangas Everest, in which we received a 40 percent stake. As part of and as a condition to the completion of the transaction, we purchased the shares of our then-major licensee, UIM, all of the material assets (including Everest Poker operation) of which were sold to Mangas Everest as part of the transaction. See Item 5, Operating and Financial Review and Prospects A. Operating Results Subsequent Events Transaction with Mangas for additional information.

Mangas Everest's games are available in 15 supported languages, including Danish, Dutch, English, Finnish, French, German, Greek, Hungarian, Italian, Japanese, Norwegian, Polish, Portuguese, Spanish and Swedish. Their poker offering includes popular poker games such as Texas Hold'em and Omaha. All poker games are real-time and multi-player capable and features 3D graphics and realistic visual effects. Mangas Everest also offers a full range of traditional and new casino games, including blackjack, video poker, slots, roulette, solitaire and others. Their casino game client can be skinned with different interfaces, enabling Mangas Everest to market casinos under a number of different brands and custom-branded casinos for its affiliates.

Mangas Everest operates under two full remote gaming licenses (a Class 1 and a Class 3) issued by Malta Lotteries and Gaming Authority and a license issued by the Kahnawake Gaming Commission, subject to continuing compliance with applicable licensing requirements. Mangas Everest's primary computer server operations are located in Malta with certain components of its business operating from servers in Kahnawake. See Regulation Regulation Relating to Online Gaming.

In accordance with the terms of the strategic alliance, Mangas Everest will endeavor to migrate all Mangas poker players to the Everest Poker platform creating one of the largest poker player liquidity platforms in Europe. Everest Poker will also be able to benefit from the sports betting solutions of Mangas. In addition, the combined user base of Everest Poker and BetClic both leading brands in France strongly positions the alliance to capture potential growth from the soon to be opened and regulated French market, one of the largest in Europe. On June 7, 2010, Everest Poker and BetClic Poker operations, owned by Mangas Everest, received online poker licenses as part of the first grant of licenses in France. Everest Poker and BetClic Poker accounted for two of the seven licenses granted in the initial approvals. Everest Poker and BetClic Poker expect to begin French operations in late June 2010.

***Competition***

Mangas Everest faces intense competition in the online gaming industry, which is characterized by low barriers to entry, rapid technological change and ever-changing consumer preferences. New entrants to the online gaming industry, increasingly competitive market consolidations and aggressive marketing and pricing by competitors may lead to a significant decline in the customer base, revenues and margins of Mangas Everest. In addition, online gaming industry is influenced by various other factors, including changes in policies and regulations and economic conditions in different jurisdictions. For example, as a result of the UIGEA and the subsequent closing of the online gaming market in the United States, Mangas Everest faces increased competition from entertainment service providers in markets in Continental Europe, which are also increasingly subject to regulation from governmental authorities.

Furthermore, some of Mangas Everest's competitors have greater experience, resources and distribution capabilities. To compete effectively against Mangas Everest's existing competitors and new competitors in the future, Mangas Everest intends to continue to improve the principal competitive factors that it believes can keep it competitive, including brand, technology, financial stability and resources, regulatory compliance, independent oversight and transparency of business practices.

**Table of Contents****Intellectual Property**

We rely on a combination of patent, trademark, copyright and trade secret laws in the U.S. and other jurisdictions as well as confidentiality procedures and contractual provisions to protect our proprietary technology and our brand. We have patents, copyrights and trademarks in certain jurisdictions and may apply for further trademark and copyright registrations and additional patents, which may provide such protection in relevant jurisdictions. However, there is no assurance that this will be sufficient to fully protect our proprietary technology. In addition, our technologies may not be able to withstand any third-party claims or rights against their use.

We also enter into confidentiality and invention assignment agreements with our employees and consultants and confidentiality agreements with other third parties, and we rigorously control access to proprietary technology.

**Regulation*****Regulations Relating to Online Games in Taiwan***

At present, there is no specific law in Taiwan governing online game services, nor are there any specific licensing requirements imposed on Internet content providers in connection with offering online game services. The National Communications Commission (the NCC) was established in March 2006. In December 2006, the NCC proposed the overhaul of the regulatory framework in the communications and broadcasting sectors by amending the Telecommunications Act, the Radio and Television Act, the Cable Radio and Television Act and the Satellite Radio and Television Act. Pursuant to the original proposal, the legislation at issue would be consolidated into a new legislative Act to be known as the Communications and Broadcasting Act. In December 2008, the NCC announced a change to its policy, stating that it had decided to delay enacting the Communication and Broadcasting Act for two to four years.

*Rating of Internet Content.* The Government Information Office, which was the agency in charge of Internet content prior to establishment of the NCC, promulgated the Regulations for the Rating of Internet Content in April 2004, as amended in October 2005. In general, Internet content shall not include any illegal or banned materials. To avoid negative impact on the physical or mental development of children or adolescents, Internet content containing any of the following materials shall be rated as restricted and shall not be viewed by those below the age of 18: (i) excessive depiction of gambling, robbery or other criminal offenses; (ii) excessive depiction of suicide; (iii) depiction involving terror, blood or cruelty which is presented in a manner acceptable to adults; or (iv) depiction of sexual acts or sexual obscenity which does not embarrass or disgust adults in general. If Internet content is in violation of the Regulations for the Rating of Internet Content, competent authorities may order the relevant ISPs to restrict access to children or adolescents or remove the offending content and impose an administrative fine on the offenders.

*Computer Software Ratings.* The Ministry of Economic Affairs announced in July 2006 the Regulations Governing Computer Software Rating, which took effect in January 2007. This regulation was amended in June 2009 and the amendment took effect in December 2009. Computer software includes the game software which can be installed in computers, televisions and handheld gaming devices. The provider of computer software shall identify the rating of the computer software when it provides it to users. There are four ratings: (i) Mature Audience Only (not suitable for those below the age of 18); (ii) Parental Guidance Advisable (not suitable for those below the age of 12; parental guidance is advisable for those between the ages of 12 to 18); (iii) Parental Guidance Strongly Suggested (not suitable for those below the age of 6; guidance from parents, teachers or adults is strongly suggested for those between the ages of 6 to 12); and (iv) General Audience (suitable for all ages).

*Online Game Contract Template.* The Ministry of Economic Affairs and the Consumer Protection Commission have published a model contract template which sets out permitted terms and limitations with respect to online game services offered in Taiwan, pursuant to the Consumer Protection Act. Generally, consumers should be given at least three days to review such contract. Amendments or changes to fees payable for services offered must be publicly announced at least thirty days prior to such amendment, and notification provided to consumers. Consumer game records must be maintained by each online game operator for a minimum period of thirty days and shall be open to inspection by such consumers. Suspension periods for consumers who have breached the terms of their online game contracts may not exceed a period of seven days.

*Personal Data Protection Act.* On April 27, 2010, the Legislative Yuan passed a bill to amend the Computer-processed Personal Data Protection Act, which was renamed as the Personal Data Protection Act.

Whenever an entity collects personal data from any individual, it shall inform such individual about (i) the name and identity of the collecting entity; (ii) the purpose of collection; (iii) how the collected personal data will be used; (iv) his/her rights; and (v) the consequences of his/her failure to provide the required personal data. If personal data is not provided by individuals, in addition to the information required to be disclosed as described above, the collecting entity shall inform such individual of the source of the data before processing or using the data. In principle, prior consent from the individual is required for use of his/her personal data. These requirements shall be exempted if relevant personal data of the individual (i) is used for public interests; or (ii) is available from the public domain and the interest to be protected is more important than the privacy of such individual. Depending on the gravity of a violation, damages of NT\$500 to NT\$20,000 may be claimed against a person for each violation of the Personal Data Protection Act even if the actual damage cannot be proved. If there is more than one victim in a single violation, the maximum damages would be up to NT\$200,000,000. However, if the interests involved therein exceed NT\$200,000,000, restrictions on maximum amount for damages to be claimed and on minimum amount for damages to be claimed (NT\$500 per person for each violation) shall not apply. This new Personal Data Protection Act will take effect pursuant to the announcement of the Executive Yuan, which is expected to be valid sometime in 2011.

**Table of Contents*****Regulations Relating to Online Games in the PRC***

As the online games industry is at an early stage of development in the PRC, the PRC laws and regulations governing the online games industry and related business in the PRC involve substantial uncertainties and are subject to further changes. See Item 3, Key Information D. Risk Factors Risks Related to Doing Business in Greater China The laws and regulations governing the online games industry in the PRC are evolving and new regulations may adversely affect our business in this annual report.

The principal PRC regulations governing the provision of Internet content and online gaming services include (among others) the Telecommunications Regulations (2000), the Administrative Rules for Foreign Investments in Telecommunications Enterprises (2001), the Tentative Measures for the Administration of Internet Publications (2002), the Tentative Measures for Administration of Internet Culture (2003), the Opinions on the Development and Management of Online Games (2005), the Anti-Internet Addiction Regulations (2007), the Administrative Measures for Telecommunications Business Operating Licenses (2009) and the Tentative Measures for Cyber Games Administration (2010).

Our provision of online games and online game-related content on our websites in the PRC is subject to various Chinese laws and regulations relating to the telecommunications industry, Internet and online games, and is regulated by various government and regulatory authorities, including:

- MIIT (formerly the Ministry of Information Industry);
- the Ministry of Culture, or MOC;
- the General Administration of Press and Publication, or GAPP (formerly known as the State Press and Publications Administration, or SPPA);
- the Ministry of Public Security;
- the State Administration of Industry and Commerce, or SAIC;
- the State Administration for Radio, Film and Television, or SARFT;
- the State Council Information Office, or SCIO; and
- the Ministry of Commerce, or MOFCOM.

***Foreign Ownership Restrictions***

Current PRC laws and regulations impose substantial restrictions on the foreign ownership of companies that provide Internet content services in the PRC. Foreign investors are also restricted from owning equity in entities which provide Internet publications. In addition, foreign or foreign-owned enterprises are currently not able to apply for the required licenses for operating online games in the PRC. These licenses can only be held by domestic PRC persons. Furthermore, pursuant to a notice promulgated by the GAPP, National Copyright Administration, and National Office of Combating Pornography and Illegal Publications on September 28, 2009, foreign investors are prohibited from participating in Internet game operating businesses via wholly owned, equity joint venture or cooperative joint venture investments in the PRC, and from controlling and participating in such businesses directly or indirectly through contractual or technical support arrangements. If applied literally and uniformly, such notice would render our ownership structure in the PRC invalid and illegal. To date, however, there are substantial uncertainties regarding the interpretation and application of such notice. Under PRC law, we are not considered to be a domestic PRC person for this purpose. In order to comply with foreign ownership restrictions, we operate our online games business in the PRC through contractual arrangements with T2 Entertainment, T2 Advertisement and Jinyou, all of which are VIEs. For further information of our VIEs, see C. Organizational Structure in this annual report.

**Table of Contents**

We believe that the ownership structure and business operation models of our PRC subsidiaries comply with all existing PRC laws, rules and regulations, and no consent, approval or license is required under any of the existing laws and regulations of the PRC for their ownership structure, businesses and operations, except those which we have already obtained or which would not have a material adverse effect on our business or operations as a whole. There are, however, substantial uncertainties regarding the interpretation and application of current or future PRC laws and regulations. Accordingly, we cannot assure you that PRC government authorities will ultimately take a view that is consistent with our view. See Item 3, Key Information D. Risk Factors Risks Related to Doing Business in Greater China PRC laws and regulations restrict foreign ownership and investment in the online game industry, and substantial uncertainties exist with respect to the application and implementation of PRC laws and regulations in this annual report.

*Licenses*

As Internet content providers, our PRC operating companies are required to either hold ICP licenses issued by MIIT. Internet content providers offering ICP services in multiple provinces, autonomous regions and centrally administered municipalities may be required to obtain an inter-regional ICP license. Since online games fall within the definition of

Internet culture products under the Tentative Measures for Internet Culture Administration of 2003, a commercial operator of online games must, in addition to the ICP licenses, obtain an Internet culture operation license from MOC for its operation of online games, and foreign investors are restricted from owning equity in such entities. The provision of online games is also deemed an Internet publication activity, within the meaning of the Tentative Measures for Internet Publication Administration of 2002, and therefore, an online game operator must also obtain the approval of the relevant press and publication administrative authorities or cooperate with a licensed Internet publisher, as well as the appropriate licenses, in order to carry on its online games business in the PRC.

T2 Entertainment and Jinyou hold the ICP licenses, Internet culture operation licenses and other licenses that are required to operate our online games business in the PRC. T2 Advertisement holds the advertising license that is required to sell advertisements on our websites in the PRC.

*Online Games Regulations*

In April 2007, eight PRC governmental authorities, including GAPP, MIIT, the Ministry of Education and the Ministry of Public Security, jointly promulgated the Notice on the Implementation of Online Game Anti-addiction System to Protect the Physical and Psychological Health of Minors, which requires online game operators to implement anti-addiction measures for users under eighteen years of age. Under this anti-addiction notice, the first three hours of game-playing time of a user are considered healthy time, the following two hours are designated fatigue time and any time spent playing beyond five consecutive hours is categorized as unhealthy time. Online game operators are required to establish anti-addiction system and develop software features on all existing online games to reduce fatigue time and unhealthy time such that, when a user has been playing in excess of specified periods of time, periodic in-game warnings will be sent to prompt the user to leave the game and the number of points or other benefits will be limited. Internet game operators are also required to develop identification verification system and registration software, which will require online game players to register their real identity information before they are allowed to play online games. Failure to comply with these requirements may subject the operator to penalties, including but not limited to suspension of operation of online games, revocation of operating licenses and approvals for operations, rejection or suspension of application for approvals, licenses, or filings for any new game, or prohibition of operating any new game. See Item 3, Key Information D. Risk Factors Risks Related to Doing Business in Greater China The laws and regulations governing the online games industry in the PRC are evolving and new regulations may adversely affect our business in this annual report.

In addition, the current PRC law prohibits any online game products involving illegal money-collecting. On February 15, 2007, 14 governmental authorities, including the Ministry of Culture, the Ministry of Information Industry, the State Administration for Industry and Commerce, and PBOC, jointly issued the Circular for Further Strengthening the Administration of Internet Café and Online Games. This circular grants the PBOC administrative authority over virtual currencies issued by online game operators for use by players in online games to avoid the potential impact such virtual currencies may have on the real-world financial systems. The circular also restricts the volume of virtual currency that may be issued and the purchase of such virtual currencies. Virtual currency must not



be used to purchase any physical products, refunded with a premium, or otherwise illegally traded. On June 4, 2009, the MOC and the MOFCOM jointly issued the Circular on Strengthening the Administration of Virtual Currency in Online Games. According to this circular, any PRC entities engaging in issuance or trade service of virtual currency in online games shall meet the requirements of Commercial Online Cultural Entities as prescribed in the Tentative Measures for Administration of Internet Culture (2003) and are required to apply to the MOC for an approval. This circular further provides, among others, that (i) the form, issuance scope and unit purchase price of virtual currency, the refund method in case of termination of online games, the purchase method for the users (including cash, bank card, payment via Internet, etc.), the protection measures for users' rights and interests, and the technology security safeguard measures, shall be filed with the MOC for record; (ii) the unit purchase price of virtual currency shall not be changed by online games operators; (iii) the new type of virtual currency shall be filed with the MOC for record before issuance by online games operators; and (iv) the virtual currency trade service shall not be open to the minors. See Item 3, Key Information D. Risk Factors Risks Related to Doing Business in Greater China Restrictions on virtual currency may adversely affect our revenues from online game operations in the PRC in this annual report.

**Table of Contents**

On June 3, 2010, the MOC issued the Tentative Measures for Cyber Games Administration, which will take effect as of August 1, 2010. The new measures govern the operation of online games, including the issuance or trading of virtual currency, the content of online games and the business operations of online game operators. According to the new measures, entities engaging in the operation of online games, or which issue or permit the trading of virtual currency in online games, are required to apply to the MOC for an Internet culture operation license. In addition, imported online games are required to pass a content examination by the MOC. Online games developed outside the PRC are not allowed to be put into operation in the PRC until they have been examined and approved by the MOC. Any material changes to the content of imported online games also require examination and approval by the MOC. The new measures further provide that the consent of users is required for games where users will engage in matches or battles with other users. In addition, online game operators are prohibited from using random selection methods to solicit to enable users to pay legal currency or virtual currency for obtaining online game products or services. In addition, all online game users are required to register using their real names and to provide to the game operator valid documentary proof of identity. Online game operators are required to keep records of such personal information.

*Internet Content and Publishing Regulations*

The PRC government has promulgated measures relating to Internet content through a number of ministries and agencies, including MIIT, MOC and GAPP. 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.

*Import Regulations*

Our ability to license online games from abroad and import them into China is subject to various registration requirements under the relevant PRC laws and regulations. We are required to register with the MOFCOM any license agreement with a foreign licensor that involves imports of technologies, including online game software into China. Without that registration, we cannot remit licensing fees out of China to any foreign game licensor. The State Copyright Bureau requires us to register copyright license agreements relating to imported software. Without the State Copyright Bureau registration, we are not allowed to publish or reproduce the imported game software in China. Furthermore, imported online game software is also required to obtain an approval by the GAPP and pass a content examination by the MOC. Any imported online game software, which has not been examined and approved by the GAAP and MOC, is not allowed to be put into operation in China.

*Information Security Regulations*

Internet content in the PRC is regulated and restricted from a State security standpoint. The Standing Committee of the National People's Congress, the PRC's national legislative body, issued a decision in December 2000, as amended in August 2009, according to which following conducts in China may be subject to criminal punishment in China; any effort to: (i) gain improper entry into a computer or system of strategic importance; (ii) disseminate politically disruptive information; (iii) leak State secrets; (iv) spread false commercial information; or (v) 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.

On May 14, 2004, the MOC issued the Notice Regarding the Strengthening of Online Game Censorship. The notice mandates the establishment of a new committee under the MOC that will screen the content of imported online games. In addition, all imported and domestic online games are required to be filed with the MOC.

On July 12, 2005, the MOC and the MIIT promulgated the Opinions on the Development and Administration of Online Game, which reflects the PRC government's intent to foster and control the development of the online game industry in China.

In addition, the MOC will censor online games that threaten state security, disturb the social order, or contain obscenity or violence.



**Table of Contents***Internet Café Regulation*

Internet cafés are required to obtain a license from MOC and SAIC, 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 cafés, many Internet cafés distribute our virtual pre-paid game cards. The PRC government has announced its intention, and has begun, to intensify its regulation of Internet cafés, which are currently one of the primary venues for our users to play online games. In April 2001, the PRC government began tightening its regulation and supervision of Internet cafés. In particular, a large number of Internet cafés without requisite government licenses have been closed. In addition, the PRC government has imposed higher capital and facility requirements for the establishment of Internet cafés. The PRC government's policy, which encourages the development of a limited number of national and regional Internet café chains and discourages the establishment of independent Internet cafés, may also slow down the growth in the number of new Internet cafés. In February 2004, the SAIC and other related government agencies issued a notice to suspend issuance of new Internet café licenses for a six month period. Though this nationwide suspension was generally lifted in 2005, local authorities have the authority of controlling the number and recipients of new Internet café licenses at their own discretion. In addition, local and higher-level governmental authorities may from time to time strictly enforce customer age limits and other requirements relating to Internet cafés as a result of the occurrence of, and media coverage of, gang fights, arson or other incidents in or related to Internet cafés. In February 2007, 14 PRC government authorities jointly issued a notice, which suspended approval for the establishment of new Internet cafés and called for strengthened regulation of existing Internet cafés. Intensified government regulation of Internet cafés could restrict our ability to maintain or increase our revenues and expand our customer base.

*Privacy Protection*

PRC laws do 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. However, 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. PRC government authorities have recently enacted legislation regarding the use of the Internet, which recognizes the importance of protecting personal information from unauthorized disclosure. Under the Internet Information Service Administrative Measures issued by the State Council on September 25, 2000, Internet information service providers are prohibited from producing, copying, publishing or distributing information that is humiliating or slanderous to others or that infringes the lawful rights and interests of others. If an Internet content provider violates these measures, the MIIT or its local bureaus may impose penalties, and the Internet content provider may be liable for damages caused to its users. In addition, the PRC government retains the power and authority to order Internet content providers to turn over personal information of Internet users if the users post any prohibited content or engage in illegal activities on the Internet.

*Global Regulatory Environment Relating to the Mangas Everest Business*

We historically operated our gaming software and services business primarily through providing software solutions for online poker rooms, casinos and the related marketing affiliate programs operated by UIM and its sub-licensees. We earned fees from UIM based upon revenues earned by UIM from its operations utilizing our software. After the completion of the transaction with Mangas, we operate our gaming software and services business primarily through Mangas Everest, our joint venture with Mangas.

We are incorporated in Singapore, and Singapore law does not prohibit us from providing software products and application services to online gaming operators. However, the end users of our software products, including the online gaming customers of Mangas Everest, are located around the world and it is, in many cases, uncertain which governments have authority to legislate or regulate different aspects of online gaming industries. Issues such as determining the physical location of an online gaming event as well as significant differences in the gaming laws and Cyberlaws of various countries all make traditional concepts of jurisdiction and conflicts of laws difficult to apply. Substantial uncertainties in the global regulatory environment relating to online gaming expose our Company to a real risk that regulatory authorities in various jurisdictions may determine that our gaming software and services business provided online gaming services (rather than only providing software and application services to UIM) and thus

subject our Company to the gaming laws and regulations in those jurisdictions.

The Internet gaming industry is still at an early stage of development. The very nature of Internet gaming creates new and unique forms of entertainment that were neither contemplated nor feasible in the past. While many jurisdictions have some form of legal framework applicable to games of chance, few provide clear guidance on how this framework applies to the online gaming industry. Although governments around the world are increasingly seeking to regulate online gaming, the shifting political and economic landscape subject online gaming industry to significant uncertainties. As a result, it is difficult for us to assess whether the Internet gaming services provided by Mangas Everest, are in compliance with all laws and regulations of the jurisdictions where it operates.

Mangas Everest operates under two full remote gaming licenses (a Class 1 and a Class 3) issued by Malta Lotteries and Gaming Authority and a license issued by the Kahnawake Gaming Commission, subject to continuing compliance with applicable licensing requirements. On June 7, 2010, Everest Poker and BetClic Poker operations, owned by Mangas Everest, received online poker licenses as part of the first grant of licenses in France. Everest Poker and BetClic Poker accounted for two of the seven licenses granted in the initial approvals and expect to begin French operations in late June 2010. Mangas Everest primarily targets non-U.S. markets, predominantly in Continental Europe.

**Table of Contents*****U.S. Regulations on Online Gaming***

The U.S. government has been of the view that Internet gambling that crosses state boundaries is unlawful. Under the Wire Act of 1961, the Department of Justice has prosecuted online gambling operators in the United States. Under the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, both U.S. and non-U.S. banks that process online gaming transactions for U.S. persons may face potential criminal proceedings, as U.S. jurisdiction extends to non-U.S. banks that have correspondent accounts in the United States. Internet gambling activity also constitutes illegal gambling activity in all 50 U.S. states, including those states where other forms of gambling are legal.

Effective October 13, 2006, the UIGEA prohibits the use of communication facilities and financial transactions in connection with Internet gambling by restricting the payment methods for such activities and by imposing criminal penalties on Internet gambling businesses which accept wagers or payment in violation of such restrictions. The UIGEA criminalizes any gambling business which arises from using a communication facility to transmit bets or wagers, or to transmit information assisting in the placing of bets and wagers, to or from the United States, and prevents gambling businesses from accepting credit cards or other bank instruments in connection with illegal Internet gambling. The UIGEA also directs various federal agencies to implement regulations that would require financial institutions with electronic payment systems to establish policies and procedures to identify and block unlawful Internet gambling transactions, and creates judicial procedures through which federal agencies could obtain injunctions directing interactive computer services to remove or disable access to online sites that violate the law. The United States Treasury drafted UIGEA regulations in late 2007 and implemented the regulations on January 19, 2009. Financial institutions were not required to comply with the UIGEA regulations until December 1, 2009. The UIGEA regulations, however, did not define what specifically constitutes an unlawful Internet gambling transaction under UIGEA. Congressman Barney Frank has recently introduced the bill entitled the Payment System Protection Act, which would seem clarify, among other things, what constitutes unlawful Internet gambling transactions under UIGEA. Congressman Barney Frank has announced his intention to resubmit the bill in the upcoming congressional session.

***Regulatory Environment in Europe***

According to the Report on Integrity of Online Gambling by the Committee on the Internal Market and Consumer Protection of European Parliament, dated February 17, 2009, the European online gambling markets are regulated and the regulatory frameworks for the online gambling market in the European Union ( EU ) member states are very much heterogeneous.

Several European countries have introduced regulatory frameworks on online gaming.

Spain and Ireland have announced their intentions to introduce a regulatory framework on online gaming. As of yet, no affirmative regulations have been issued, however there is speculation that a draft of the Spanish regulations may be issued as soon as the summer of 2010.

Italy has recently introduced a new set of regulations on online gaming. In Italy, there is a general prohibition on casino-type games. As soon as October or November of 2010, Italy will also prohibit cash games in online poker offerings, thereby restricting the poker activity to tournaments. Online poker tournaments, pari-mutual betting on horseraces and sports events are legal provided that the game operators are licensed by the relevant authorities.

The French government has recently published a gaming bill and has begun issuing licenses that allow an operator to conduct remote sports betting, pari-mutual horserace betting and poker. No regulations permitting the operation of online casino operations have yet been enacted. Mangas Everest, our joint venture with Mangas, was granted one of these licenses to operate online poker in France on June 7, 2010. Everest Poker and BetClic Poker operations, owned by Mangas Everest, are expected to begin French operations under the license in late June 2010.

Many European countries, where there are state-owned gaming monopolies, have taken actions or introduced legislation aimed at banning foreign online gaming operators, which could have a material adverse effect on our licensees and consequently on our Company. Such actions were in contrast with rulings from the European Court of Justice and have prompted the European Commission ( EC ) to explore the possibility of creating new legislation that could harmonize online gaming within the EU, in line with the EU 's principles regarding the European single market.

Denmark has also taken steps to liberalize its online gaming regulations and has passed an act whereby online operators can apply for a license, and if granted, may accept wagers from players in Denmark. The proposed act is tentatively scheduled to take effect on January 1, 2011, provided the EU determines that the high fees are not in violation of any EU community law.

The Netherlands continues to threaten to enforce domestic laws that permit online gaming to be offered only by domestic government-controlled monopolies, along with payment blocking directives for banks that process payments on behalf of foreign operators. The government has established an investigatory commission to determine the benefits and risks to liberalizing the online gaming market. No report from this commission has been issued to date, and it is unlikely any substantive moves forward will occur until 2011.

**Table of Contents**

In Germany, the German Interstate Gambling Treaty came into force on January 1, 2008, an agreement that seeks a prohibition on the use of the Internet for all gambling services (except horserace betting). Certain German states have sent out prohibition orders aimed at a number of online operators, however most operators have filed oppositions to these prohibition orders on various grounds. At least one state has stated its intention to abandon the German Interstate Gambling Treaty and attempt to liberalize its market as of 2012. In addition, a number of German cases are pending in the European Court of Justice, and the outcomes of those cases will very likely indicate the future of a liberalized market in Germany.

For additional information on the regulatory environment relating to online gaming, see Item 3, Key Information D. Risk Factors Risks Related to our Business and Industries The uncertain global legal and regulatory environment could have a negative impact on the Mangas Everest business and prospects.

**C. Organizational Structure**

We were incorporated in Singapore as a company limited by shares on September 13, 1999. As of the date of this annual report, our principal operating subsidiaries include Hoshin GigaMedia, FunTown World Limited and T2CN. Hoshin GigaMedia, our wholly owned subsidiary incorporated in Taiwan, operates our online games business in Taiwan. FunTown World Limited, our wholly owned subsidiary incorporated in The British Virgin Islands, operates our online games business in Hong Kong and Macau. T2CN, our majority owned subsidiary incorporated in The British Virgin Islands, operates our online games business in the PRC. We currently hold a 40 percent interest in Mangas Everest through GigaMedia Europe Limited S.à.r.l., our wholly owned subsidiary incorporated in Luxembourg. Our 40 percent interest in Mangas Everest is, from April 8, 2010, accounted for using the equity method.

Due to restrictions in the PRC on foreign equity ownership of companies providing Internet content services and certain other licensing restrictions, we operate the online games business in the PRC through our three VIEs, T2 Entertainment, T2 Advertisement and Jinyou, which hold the licenses required for the operation of our online games business in the PRC, and all of which are owned by PRC nationals. All of the three VIEs are controlled by T2CN through the following contractual arrangements:

Each of the shareholders of T2 Entertainment has irrevocably granted T2CN Information Technology (Shanghai) Co., Ltd. ( T2 Technology ), the wholly-owned subsidiary of T2CN in the PRC, the power to exercise all of their voting rights of T2 Entertainment pursuant to the relevant voting rights and proxy agreement;

Each of the shareholders of T2 Advertisement has irrevocably granted T2 Technology the power to exercise all of their voting rights of T2 Advertisement pursuant to the relevant voting rights and proxy agreement;

Each of the shareholders of Jinyou has irrevocably granted T2 Technology the power to exercise all of their voting rights of Jinyou pursuant to the relevant voting rights and proxy agreement;

Our majority-owned subsidiary in China has the power to appoint all directors and senior management members of the three VIEs;

Each of the shareholders of T2 Entertainment has pledged all of their respective equity interests in T2 Entertainment as security for the full performance of their respective obligations under all of their agreements with T2 Technology;

Each of the shareholders of T2 Advertisement has pledged all of their respective equity interests in T2 Advertisement as security for the full performance of their respective obligations under all of their agreements with T2 Technology;



**Table of Contents**

Each of the shareholders of Jinyou has pledged all of their respective equity interests in Jinyou as security for the full performance of their respective obligations under all of their agreements with T2 Technology;

Each of the shareholders of T2 Entertainment has granted T2 Technology an irrevocable option to acquire all or part of the equity interests held by them in T2 Entertainment pursuant to the relevant exclusive call option agreement, to the extent permitted by then-effective laws and regulations in the PRC;

Each of the shareholders of T2 Advertisement has granted T2 Technology an irrevocable option to acquire all or part of the equity interests held by them in T2 Advertisement pursuant to the relevant exclusive call option agreement, to the extent permitted by then-effective laws and regulations in the PRC; and

Each of the shareholders of Jinyou has granted T2 Technology an irrevocable option to acquire all or part of the equity interests held by them in Jinyou pursuant to the relevant exclusive call option agreement, to the extent permitted by then-effective laws and regulations in the PRC.

In addition, through T2 Technology, we have entered into certain exclusive technical service agreements and exclusive commercial service agreements with T2 Entertainment, T2 Advertisement and Jinyou, respectively, under which T2 Technology provides various technical consulting services, business consulting services and other services to these VIEs in exchange for substantially all of their net incomes. See Item 3, Key Information D. Risk Factors Risks Related to Doing Business in Greater China PRC laws and regulations restrict foreign ownership and investment in the online game industry, and substantial uncertainties exist with respect to the application and implementation of PRC laws and regulations and B. Business Overview Regulation Regulations Relating to Online Games in the PRC Foreign Ownership Restrictions in this annual report.

**Table of Contents**

The following organization chart and table set forth our business structure and selected information for each of our principal subsidiaries and VIEs as of the date of this annual report:

**Table of Contents**

<b>Entity</b>	<b>Year of Incorporation</b>	<b>Place of Incorporation</b>	<b>Our Percentage Holding</b>	<b>Principal Activities</b>
<i><b>Held by our Company</b></i>				
GigaMedia International Holdings Limited	2004	British Virgin Islands	100%	Holding company
GigaMedia (Taiwan) Limited	2004	Taiwan	100%	Holding company
<i><b>Held by GigaMedia International Holdings Limited</b></i>				
GigaMedia SuperCup Holdings Limited	2008	British Virgin Islands	100%	Holding company
GigaMedia Global Limited	2004	British Virgin Islands	100%	Online games
Cambridge Entertainment Software Limited	2004	British Virgin Islands	100%	Holding company
GigaMedia (HK) Limited	2004	Hong Kong	100%	Holding company
Crestmillion International Limited	2007	British Virgin Islands	100%	Holding company
GigaMedia Japan Pte. Ltd.	2007	Singapore	100%	Holding company
GigaMedia Finance International Limited	2000	Cayman Islands	100%	Holding company
Bridgepoint International Limited	2004	British Virgin Islands	100%	Holding company
Gloryland Asia Limited	2008	British Virgin Islands	100%	Online games
GigaMedia Online Entertainment Corp.	2009	Cayman Islands	100%	Holding company
<i><b>Held by GigaMedia Online Entertainment Corp.</b></i>				
FunTown World Limited	2005	British Virgin Islands	100%	Holding company
GigaMedia Asia Limited	2005	British Virgin Islands	100%	Holding company
GigaMedia Asia Pacific Limited	2006	British Virgin Islands	100%	Holding company
Skyace Pacific Limited	2006	British Virgin Islands	100%	Online games

Centermax Limited	2007	British Virgin Islands	100%	Holding company
-------------------	------	------------------------	------	-----------------

43

---

**Table of Contents**

<b>Entity</b>	<b>Year of Incorporation</b>	<b>Place of Incorporation</b>	<b>Our Percentage Holding</b>	<b>Principal Activities</b>
GigaMedia Capital Limited	2007	British Virgin Islands	100%	Holding company
GigaMedia Development Limited	2007	British Virgin Islands	100%	Online games
Giga Slam Dunk Corporation	2007	Malaysia	100%	Online games
Giga Wartime Corporation	2007	Malaysia	100%	Online games
E-Sports International Corporation Limited	2008	Hong Kong	100%	Online games
Dragon Mark Holdings Limited	2008	British Virgin Islands	100%	Holding company
Premier Vantage Holdings Limited	2009	British Virgin Islands	100%	Holding company
GigaMedia Freestyle Holdings Limited	2009	British Virgin Islands	100%	Holding company
Spring Asia Limited (formally known as New Media Investment Corporation)	2009	Labuan	100%	Holding company
Asia Online Games Corporation (formally known as GigaMedia (Labuan New) Limited)	2006	Labuan	100%	Holding company
GigaMedia (Labuan) Limited	2005	Labuan	100%	Holding company
Megabiz Limited	2010	British Virgin Islands	100%	Holding company
Nova Matrix Limited	2010	British Virgin Islands	100%	Holding company
<b><i>Held by FunTown World Limited</i></b>				
FunTown Hong Kong Limited	1999	Hong Kong	100%	Online games
<b><i>Held by FunTown Hong Kong Limited</i></b>				
FunTown Software (Shanghai) Limited	2006	PRC	100%	Online games
<b><i>Held by Skyace Pacific Limited</i></b>				

Dragongate Enterprises Limited	2006	British Virgin Islands	70%	Online games
<i>Held by Dragongate Enterprises Limited</i>				
GigaMedia Dragongate Limited	2007	Malaysia	100%	Online games

**Table of Contents**

<b>Entity</b>	<b>Year of Incorporation</b>	<b>Place of Incorporation</b>	<b>Our Percentage Holding</b>	<b>Principal Activities</b>
<b><i>Held by Cambridge Entertainment Software Limited</i></b>				
Cambridge Interactive Development Corporation	1997	U.S.A.	100%	Software development and application services
Cambridge Interactive Development Corporation (Quebec) Inc.	2005	Canada	100%	Financial and management services
Cambridge Interactive Development Co., Ltd	2008	United Kingdom	100%	Software support services
Internet Media Licensing Limited	2005	British Virgin Islands	100%	Software development and application services
<b><i>Held by Internet Media Licensing Limited</i></b>				
GigaMedia Europe Limited S.à.r.l.	2010	Luxembourg	100%	Holding company for 40% of Everest Mangas
Ultra Internet Media S.A.	2004	Nevis	100%	Online entertainment operator
<b><i>Held by GigaMedia Europe Limited S.à.r.l.</i></b>				
Mangas Everest	2010	France	40%	Online gaming operator
<b><i>Held by Dragon Mark Holdings Limited</i></b>				
Wolverine Holdings Group Limited	2009	British Virgin Islands	100%	Holding company
<b><i>Held by GigaMedia (Labuan) Limited</i></b>				
Leisure Alliance Sdn. Bhd.	2009	Malaysia	100%	Holding company

***Held by Leisure Alliance Sdn. Bhd.***

Hoshin GigaMedia Center Inc.	1998	Taiwan	100%	Online games
------------------------------	------	--------	------	--------------

***Held by Bridgepoint International Limited***

Implus International Limited	2004	British Virgin Islands	100%	Holding company
------------------------------	------	------------------------	------	-----------------

***Held by GigaMedia Asia Pacific Limited***

Spring Asia Limited	2005	British Virgin Islands	100%	Holding company
---------------------	------	------------------------	------	-----------------

Infocomm Asia Holdings Pte. Ltd.	2004	Singapore	28.43%	Online games
----------------------------------	------	-----------	--------	--------------



**Table of Contents**

Entity	Year of Incorporation	Place of Incorporation	Our Percentage Holding	Principal Activities
<i>Held by GigaMedia Asia Limited</i>				
GigaMedia China Limited	2005	British Virgin Islands	100%	Holding company
<i>Held by GigaMedia China Limited</i>				
T2CN Holding Limited	2004	British Virgin Islands	67.09%	Online games
<i>Held by T2CN Holding Limited</i>				
J-Town Information (Shanghai) Co., Ltd.	2005	PRC	100%	Online games
T2CN Information Technology (Shanghai) Co., Ltd.	2004	PRC	100%	Online games
<i>Controlled by T2CN Information Technology (Shanghai) Co., Ltd.</i>				
Shanghai T2 Entertainment Co., Ltd.	2004	PRC	*	Online games
Shanghai T2 Advertisement Co., Ltd.	2006	PRC	*	Advertising
Shanghai Jinyou Network & Technology Co., Ltd.	2007	PRC	*	Online games

\* We have entered into a series of contractual arrangements through which we have effective control over these entities.

**D. Property, Plant and Equipment**

Our headquarters are located on the 7<sup>th</sup> to 9<sup>th</sup> Floors, 207 Tiding Boulevard, Section 2, Taipei 114, Taiwan. As of May 31, 2010, our headquarters occupied approximately 35,398 square feet.

We also lease office and warehouse space, including space for our servers, in various other locations.

As of May 31, 2010, we leased approximately 8,992 square feet as office premises in Hong Kong.

As of May 31, 2010, we leased approximately 47,137 square feet as office premises for FunTown's head office in Taipei, Taiwan and approximately 4,831 square feet as office premises for FunTown's office in Hong Kong. In addition, we leased approximately 1,265 square feet of warehouse space in Hong Kong.

As of May 31, 2010, we leased approximately 37,497 square feet as office premises for T2CN's head office in Shanghai, the PRC. In addition, we leased approximately 375 square feet as office premises for our online games operation in Shanghai, the PRC.

**Table of Contents****ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS****A. Operating Results**

Unless stated otherwise, the discussion and analysis of our financial condition and results of operations in this section apply to our consolidated financial statements as prepared in accordance with U.S. GAAP. You should read the following discussion of our financial condition and results of operations together with the financial statements and the notes to these statements included elsewhere in this annual report.

**Overview**

We are a holding company. We operate two principal businesses through our subsidiaries:

Until April 8, 2010, through our gaming software and service business, we developed and licensed online poker and casino gaming software solutions and application services, primarily targeting continental European markets.

Our online games business operates a portfolio of online games, primarily targeting online Greater China markets.

In 2009, we recorded total operating revenues of approximately US\$159.6 million, a decrease of approximately US\$30.8 million year-over-year, primarily resulting from a decrease in revenue from our gaming software and service business. Our gaming software and service business had a decrease in operating revenues of approximately US\$32.1 million year-over-year, which was offset by an increase of approximately US\$1.3 million in revenue from our online game business. Our total costs and expenses increased by approximately US\$47.4 million year-over-year to US\$199.6 million. We recorded an operating loss of approximately US\$40.1 million, a decrease of approximately US\$78.2 million year-over-year. We recognized a net loss (net of that attributable to the noncontrolling interest) of approximately US\$49.1 million, a decrease of approximately US\$93.5 million year-over-over.

*Gaming Software and Service Business.* Until April 8, 2010, we operated our gaming software and service business through our subsidiary, CESL, and through its wholly-owned subsidiaries, CIDC and IMLL. Our gaming software and service business generated revenues of approximately US\$112.7 million, gross profit of approximately US\$92.6 million, and operating income of approximately US\$7.5 million in 2009. On April 8, 2010, we completed the sale of a 60 percent interest in our online gaming software business to Mangas, a leading European sports betting and online gaming group (the Mangas Transaction). The strategic alliance with Mangas was structured as a stock and asset sale to a newly-formed French entity, Mangas Everest, in which we received a 40 percent stake. As part of and as a condition to the completion of the transaction, we purchased the shares of our then-major licensee, UIM, all of the material assets of which were sold to Mangas Everest as part of the transaction.

Until the completion of the Mangas Transaction, the financial results of UIM were incorporated into our consolidated financial statements as UIM meets the criteria of variable-interest entities ( VIE ) as defined by the FASB Accounting Standards Codification. See A. Operating Results Certain Significant Events Affecting Our Results of Operations for 2007, 2008 and 2009 Consolidation of UIM, T2 Entertainment, T2 Advertisement, and Jinyou. Under the terms of the licenses granted by us to UIM, we are entitled to a share of the revenues of such licensee, and as such, we bear certain economic risks with respect to, and derive certain economic benefits from, their operations.

Following the completion of the Mangas Transaction, we no longer consolidate CESL or UIM. Our 40 percent interest in Mangas Everest is, from April 8, 2010, accounted for using the equity method. See Item 5. Operating and Financial Review and Prospects A. Operating Results Subsequent Events Transaction with Mangas .*Online Games Business.* We operate our online games business through FunTown and T2CN. We acquired FunTown in January 2006 and incorporated results of the business into our consolidated financial statements starting from January 1, 2006. We consolidated and incorporated T2CN's operating results into our consolidated financial statements starting from June 1, 2007. Our online games business generated revenues of approximately US\$46.9 million, a gross profit of approximately US\$30.1 million, and operating loss of approximately US\$34.6 million in 2009.

In December 2006, we entered into a strategic alliance with Infocomm Asia, a Southeast Asia online games operator and distributor offering online games. In April 2010, we entered into several agreements to acquire additional ownership of Infocomm Asia. The acquisition of a controlling interest in Infocomm Asia is expected to close in the third quarter of 2010. See Item 5. Operating and Financial Review and Prospects A. Operating Results Subsequent Events Transactions with Infocomm Asia .



**Table of Contents**

We also entered into strategic alliances with Neostorm, XL Games, Access China, Gorilla Banana Entertainment, JC Entertainment Corporation, and Possibility Space Incorporated in October 2007, December 2007, January 2008, May 2009, September 2009, and December 2009, respectively. Neostorm was formed by the merger of four previously independent game development studios creating one of the largest independent game development companies in South Korea. Neostorm focuses on medium-core casual game titles. XL Games was founded by the creator of one of the most popular online game franchises in history and focuses on MMORPGs with studios in Seoul, South Korea and Austin, Texas. Access China is an online game software developer in the PRC. Gorilla Banana Entertainment is an online game software developer in Korea. JC Entertainment is a listed company which operates online games in Korean. Possibility Space Incorporated is an online game software developer in the PRC. For additional information with respect to our acquisitions and investments, see Item 4, Information on The Company A. History and Development of Our Company in this annual report.

Online casual game operators in Greater China are currently our primary competitors. We also compete with online casual game and MMORPG operators throughout Greater China. Given the low barriers to entry in the online game industry and the increasing popularity of Internet-based businesses, there are a large number of potential competitors scattered throughout many different segments of the software and Internet industries. In addition to the aforementioned competitors, traditional entertainment service providers and other entities, many of which have significant financial resources and name brand recognition, may provide online game services in the future, and thus become our competitors.

Faced with our known competitors, and most likely several new competitors which may be established in the near future, we will continue to improve the principal competitive factors that we believe can differentiate our product offerings from those offered by our competitors, including: brand, technology, financial stability and resources, proven track record, independent oversight and transparency of business practices in our industry.

**Certain Significant Events Affecting Our Results of Operations for 2007, 2008 and 2009*****Divestiture of Our Legacy Internet Access and Service Business***

In September 2008, we completed the sale of our Internet access and service business, which included 100 percent of our wholly-owned subsidiaries, Koos Broadband Telecom Co., Ltd. ( KBT ) and Hoshin Multimedia Center Inc., as well as certain assets and liabilities related to our Internet access and service business, for a total transaction price of US\$20.0 million.

The transaction price, net of transaction costs, price adjustments and cash transferred, was approximately US\$16.5 million. The after-tax gain from the sale of the Internet access and service business was approximately US\$9.8 million.

An amount of US\$2.5 million of the transaction price was deposited into an escrow account established with the escrow agent for an agreed period, to be available for any price adjustment payment, severance payment, and indemnification payment set forth in the agreements. As of December 31, 2008, the escrow account balance was approximately US\$2.1 million after payment of the severance payment. The escrow account was released in September 2009.

In addition to the above purchase price, we may be entitled to receive additional cash payments of US\$3.0 million and US\$2.0 million if the Internet access and service business that we sold achieves certain earn-out targets by September 2009 and 2010. The earn-out targets are to be determined by future gross profits in accordance with a formula and timeline set forth in the agreements. As of December 31, 2009, we did not accrue any additional receivable for the sale of the Internet access and service business since the earn-out target for the first period ended September 2009 was not achieved.

Results for the Internet access and service operations are reported as discontinued operations in 2007, 2008 and 2009. In 2008, income from discontinued operations was US\$9.4 million, which included an after-tax loss from the Internet access and service business of US\$0.4 million and an after-tax gain on the sale of the business of US\$9.8 million.

**Table of Contents**

Summarized selected financial information for discontinued operations is as follows:

(in US\$ thousands)	2007	2008	2009
Revenue	\$ 15,164	\$ 9,289	\$ 159
Income (loss) from discontinued operations before tax	\$ 1,090	\$ (593)	\$ 222
Gain on sale of the discontinued operations before tax		11,014	
Income tax expenses	(2)	(986)	
Income from discontinued operations	\$ 1,088	\$ 9,435	\$ 222

Major classes of assets and liabilities which comprised the Internet access and service business at the date of disposal, September 2008, included the following:

(in US\$ thousands)	
Cash	\$ 493
Accounts receivable	2,325
Other current assets	1,125
Property and equipment	4,328
Other assets	165
Total assets	\$ 8,436
Accounts payable	\$ 1,056
Other current liabilities	759
Noncurrent liabilities	672
Total liabilities	\$ 2,487

***Consolidation of UIM, T2 Entertainment, T2 Advertisement, and Jinyou***

The financial statements of the following VIEs have been consolidated into our Company's consolidated financial statements in accordance with the FASB Accounting Standards Codification. Our Company entered into a software license and support service contract with UIM to provide Internet software support services for UIM's online gaming operations. The contract allows for us to charge a percentage of UIM gross receipts resulting from UIM's online gaming operations. The percentage of gross receipts varies depending upon the software and support services provided to UIM. We analyzed our contractual relationships with UIM and determined that we were and continue to be a primary beneficiary of UIM. As a result of such determination, we have incorporated the results of UIM into our consolidated US financial statements even though we own none of UIM's equity and recorded goodwill arising from the consolidation of UIM totaling US\$209 thousand. The net assets (liabilities), total assets and total liabilities of UIM were approximately US\$448 thousand, US\$87.4 million and US\$86.9 million, respectively, as of December 31, 2008, and US\$(932) thousand, US\$82.9 million and US\$83.8 million, respectively, as of December 31, 2009. For the years ended December 31, 2007, 2008 and 2009, total revenue and net income (loss) of UIM were as follows:

(in US\$ thousands)	2007	2008	2009
Total revenue	\$ 118,650	\$ 144,765	\$ 112,694
Net income (loss)	\$ 348	\$ (206)	\$ (1,226)

Beginning in June 2007, we consolidated T2CN. Pursuant to various agreements entered into between T2CN, Shanghai T2 Entertainment Co., Ltd. ( T2 Entertainment ), Shanghai T2 Advertisement Co., Ltd. ( T2 Advertisement ) and the equity owners of T2 Entertainment and T2 Advertisement, T2CN generally has control and the risks and rewards of ownership of T2 Entertainment and T2 Advertisement and is considered the primary beneficiary of T2 Entertainment and T2 Advertisement. T2 Entertainment and T2 Advertisement were established to hold the necessary licenses for our participation in online game and related advertisement services in the People's Republic of China ( PRC ). Accordingly, from the date that we consolidated T2CN, the results of T2 Entertainment and T2 Advertisement are included in the accompanying consolidated financial statements.

In November 2007, T2CN entered into various agreements with Shanghai Jinyou Network & Technology Co., Ltd. ( Jinyou ) and the equity owners of Jinyou. The agreements provided for T2CN to obtain conditional effective and enforceable clauses upon acquiring an Internet Content Provider ( ICP ) license by Jinyou. Jinyou was established to hold the necessary licenses for our participation in online games in the PRC. In September 2008, Jinyou acquired the ICP license and the above agreements became effective. T2CN generally has control and the risks and rewards of ownership of Jinyou and is considered the primary beneficiary of Jinyou. Accordingly, the results of Jinyou are included in the accompanying consolidated financial statements starting from September 2008.

**Table of Contents**

The net assets, total assets and total liabilities in the aggregate of T2 Entertainment, T2 Advertisement and Jinyou were approximately US\$3.3 million, US\$17.5 million and US\$14.2 million, respectively, as of December 31, 2008, and US\$1.6 million, US\$18.2 million and US\$16.6 million, respectively, as of December 31, 2009. For the years ended December 31, 2007, 2008 and 2009, total revenue and net income (loss) in the aggregate of T2 Entertainment, T2 Advertisement and Jinyou were as follows:

(in US\$ thousands)	2007	2008	2009
Total revenue	\$ 14,973	\$ 20,312	\$ 18,673
Net income (loss)	\$ 2,429	\$ 1,571	\$ (2,990)

See Item 3, Key Information D. Risk Factors Risks Related to Doing Business in Greater China The contractual arrangements with T2 Entertainment, T2 Advertisement and Jinyou and their shareholders may not be as effective in providing operational control as direct ownership and the shareholders of T2 Entertainment, T2 Advertisement and Jinyou may have potential conflicts of interest with us in this annual report.

**Acquisitions****T2CN**

Beginning in June 2007, we consolidated T2CN. We acquired T2CN in order to enhance our position in the online games market in Asia. This primary factor, among others, contributed to a purchase price in excess of the fair market value of the net tangible assets and intangible assets acquired. As of May 31, 2010, we owned 43,633,681 common shares of T2CN, which represents a controlling interest of 66.29 percent of the total outstanding voting rights of T2CN.

The following summarizes our acquisitions of T2CN during the period from 2006 to 2009:

(in US\$ thousands)	Purchase Price	Description	Accumulated voting interest
2006	\$ 15,000	Purchased 7,500,000 convertible voting preferred shares	19.02%
2007	\$ 23,736*	Acquired 38,613,681 common shares (including convertible voting preferred shares converted into common shares) in total	58.11%
2008	\$ 3,375	Purchased 4,500,000 common shares	65.68%
2009	\$ 285	Purchased 520,000 common shares	67.09%

\* Includes the issuance of 226,385 common shares of GigaMedia, valued at approximately US\$2.7 million.

**(a) Acquisition in 2007**

In connection with the step acquisitions through July 2007, we recorded goodwill of US\$29.4 million. Such goodwill amount is non-deductible for tax purposes. Since June 1, 2007, results of T2CN's operations have been included in our consolidated financial statements under the online game and service business.

**(b) Acquisition in 2008**

In connection with the purchase of additional common shares of T2CN in May 2008, we recorded additional goodwill of US\$1.7 million. Such goodwill amount is non-deductible for tax purposes. We also recorded additional identified intangible assets of US\$136 thousand which are being amortized on a straight-line basis over their useful lives of three



years.

In addition, T2CN bought back and cancelled part of its common shares owned by independent third parties for US\$1.3 million during 2008, resulting in an increase of our ownership interest in T2CN from 65.68 percent to 66.29 percent, and we recorded additional goodwill of US\$511 thousand.

**Table of Contents***(c) Acquisition in 2009*

In connection with the purchase of additional common shares of T2CN in August 2009, which resulted an increase of our ownership interest in T2CN to 67.09 percent, as we maintained control in T2CN, we recognized this transaction as an equity transaction and adjusted additional paid-in capital by US\$112 thousand.

***Impairment Loss Related to Underperforming Game Projects in Our Online Games And Service Business***

As a result of underperforming game projects including but not limited to Hellgate: Longon, Luna Online, Holic, Warhammer Online, and NBA Street Online, we recorded an impairment loss of approximately US\$37.7 million within our online games and service business in our consolidated financial statements for the year ended December 31, 2009 as follows:

- 1) US\$14.1 million impairment loss on goodwill. Our estimates of future cash flows for T2CN's business have been reduced due to lower than expected operating performance results in 2009, which indicated the goodwill from the acquisition of T2CN cannot be fully recovered. Goodwill is valued on a nonrecurring basis when impairment exists, using a discounted cash flow model to determine fair value, incorporating available market discount information, our estimate for liquidity risk and other cash flow model related assumptions based on unobservable inputs.
- 2) US\$18.3 million impairment loss on prepaid licensing and royalty fees, which was related to certain licensed games that we stopped operating or for which the carrying amounts were determined not to be recoverable due to lower than expected performances. Prepaid licensing and royalty fees are valued on a nonrecurring basis when impairment exists, using a discounted cash flow model to determine fair value, incorporating available market discount information, our estimate for liquidity risk and other cash flow model related assumptions based on unobservable inputs.
- 3) US\$4.5 million impairment loss on intangible assets for capitalized software costs to reflect a full provision relating to certain projects that we have ceased to further develop; and
- 4) US\$777 thousand impairment loss on fixed assets, which was related to servers used in certain impaired licensed games or internally developed games. Fixed assets are valued on a nonrecurring basis when impairment exists, using a discounted cash flow model to determine fair value, incorporating available market discount information, our estimate for liquidity risk and other cash flow model related assumptions based on unobservable inputs.

**Subsequent Events*****Litigation***

On April 1, 2010, a complaint was filed on behalf of UIM against Harrah's License Company, LLC (Harrah's) in connection with the promotion agreement for the World Series of Poker dated February 24, 2008 (the Agreement) for: 1) breach of the Agreement; 2) breach of the implied covenant of good faith and fair dealing; 3) unjust enrichment; 4) declaratory relief; and 5) injunctive relief. The complaint seeks compensatory damages, a declaration that Harrah's materially breached the Agreement and the Agreement is therefore terminated as of April 1, 2010, an injunction precluding Harrah's from violating the Agreement pending the outcome of the litigation, and attorney fees and costs. A letter of termination was also sent by UIM to Harrah's on April 1, 2010 to terminate the Agreement for multiple material breaches by Harrah's and to demand the refund of past payments.

An application for a temporary restraining order (TRO) and motion for preliminary injunction was also filed. The request for the TRO was subsequently denied by the court. On April 28, 2010, UIM had a hearing on its motion asking the court to force Harrah's to remove a certain non-Everest Poker name and logo reference from the broadcasts into France, as UIM has exclusive promotional and advertising rights pursuant to the Agreement. The motion was denied on the grounds that UIM failed to show that the broadcasts containing the other reference's digital overlay were certain to continue into the future. The court did not rule on the merits of the underlying claims in any way. The judge has yet to issue a formal order.

**Table of Contents**

Harrah's also filed a motion to dismiss the complaint. A date for a hearing has not yet been scheduled. In addition, on April 27, 2010, Harrah's Interactive Entertainment, Inc. (Harrah's Interactive) filed a separate lawsuit against UIM for 1) breach of the Agreement; 2) breach of the implied covenant of good faith and fair dealing; and, 3) unjust enrichment, and included GigaMedia as a defendant for tortious interference with contractual relations. In May 2009, the Agreement was assigned by Harrah's to Harrah's Interactive. UIM has asked Harrah's to stipulate to consolidation, and Harrah's has agreed to do so.

We are currently awaiting a hearing date for the lawsuit.

***Transactions with Mangas***

On April 8, 2010, we completed the sale of a 60 percent interest in our online gaming software business to Mangas Gaming, a leading European sports betting and online gaming group. Mangas is jointly owned by former media tycoon Stephane Courbit's Lov Group and the world renowned Monte Carlo Casino owner Société des Bains de Mer de Monaco, controlled by the Principality of Monaco. Mangas has an extensive European gambling portfolio, including BetClic, Expekt, and Bet-at-Home, together offering sports betting, poker and casino services to over four million registered users in over 25 countries. The strategic alliance with Mangas was structured as a stock and asset sale to a newly-formed French entity, Mangas Everest, in which we received a 40 percent stake.

As part of and as a condition to the completion of the transaction, we purchased the shares of our then-major licensee UIM all of the material assets of which were sold to Mangas Everest as part of the transaction. We had historically consolidated UIM's assets, liabilities and results of operations in our consolidated financial statements in accordance with the FASB Accounting Standards Codification, although we did not historically hold any equity ownership in UIM. UIM was an online entertainment operator that provided online gaming services, including online casinos and virtual poker rooms. We sometimes refer to our online gaming software business and UIM's business as the Everest Business. At the time the sale of the Everest Business was completed, UIM held gaming licenses issued by the Kahnawake Gaming Commission and the Lotteries and Gaming Authority of Malta.

For its 60 percent stake in the Everest Business, Mangas made an initial cash payment of approximately US\$100 million, which may be followed by a final earn-out payment in 2012 to be determined by reference to the fair-market value of Mangas Everest in May 2012, as defined in the agreement.

GigaMedia holds the remaining 40 percent of Mangas Everest with a put option to sell all or part of its share to Mangas. The put option is exercisable in 2013, 2014 and 2015. Mangas holds a call option on any remaining Mangas Everest interests held by GigaMedia which it may exercise in 2015 and 2016. For both GigaMedia's put option and Mangas' call option, the price paid will be determined based upon the fair market value of Mangas Everest as of December 31 of the prior year, as determined by mutual agreement between the parties or, failing that, an appraisal process.

GigaMedia has retained the liability, if any, for certain potential tax claims, if any, and existing liabilities of the Everest Business, and also has agreed to provide a limited indemnity with respect to breaches of representations and warranties (which generally survive until December 31, 2011) and covenants contained in the purchase agreement. While Mangas will generally control the day-to-day operations of Mangas Everest, so long as we own at least 20 percent of Mangas Everest's share capital, we will have approval rights over certain material actions of Mangas Everest, including certain issuances of securities of Mangas Everest, certain acquisitions and dispositions of assets and material changes to the principal business of Mangas Everest. In addition, so long as GigaMedia holds at least 10 percent of Mangas Everest's share capital, we will have representation on the board of directors of Mangas Everest. Mangas has agreed that it will not acquire other online poker businesses without first giving Mangas Everest the opportunity to acquire such business, at GigaMedia's discretion, so long as GigaMedia holds at least 20 percent of Mangas Everest's share capital.

The foregoing summary is qualified in its entirety by the Stock and Asset Purchase Agreement entered into in connection with the transaction, which is attached hereto as Exhibit 4.42.

**Table of Contents*****Transactions with Infocomm Asia***

On April 30, 2010, GigaMedia entered into several agreements with certain shareholders of Infocomm Asia, as well as with Infocomm Asia itself, to acquire additional preferred shares of Infocomm Asia. The acquisition of Infocomm Asia is expected to be closed in the third quarter of 2010, after the closing conditions set forth in the agreements are met. The total purchase price pursuant to the agreements for the preferred shares is approximately US\$17.2 million. After the acquisition, the total number of preferred shares owned by GigaMedia can be converted into approximately 80 percent of Infocomm Asia's outstanding common shares.

On April 30, 2010, GigaMedia signed an agreement to provide a loan facility to Infocomm Asia with a principal amount of US\$7 million. The loan is to be used by Infocomm Asia to support its current operations. The loan has a five year term and bears interest at 3% per annum. GigaMedia also provided a guarantee on behalf of Infocomm Asia to a licensor of certain games to Infocomm Asia and its subsidiaries. The guarantee includes but is not limited to payment of the royalties, license fees and the minimum guarantees associated with the licensed games as set forth within the licensing agreements. The total amount of GigaMedia's guarantee, taking into account funds received by Infocomm Asia from subscription money and the loan from GigaMedia, is approximately US\$13.6 million.

On April 30, 2010, GigaMedia entered into a share purchase agreement with Infocomm Asia to acquire one of its wholly-owned subsidiaries in exchange for US\$6 million. The agreement was closed on May 7, 2010. The agreement includes certain put/call arrangements commencing immediately upon the expiration of the first anniversary of the closing date, for a period of three years thereafter.

***Critical Accounting Policies***

The discussion and analysis of our financial condition and results of operations are derived from our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the U.S., or U.S. GAAP. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosure of contingent assets and liabilities as of the date of the consolidated financial statements. We continually evaluate our estimates and assumptions, which are based on historical experience and other various factors that we believe are reasonable under the circumstances. The results of these estimates and assumptions form the basis for making judgments about the carrying values of certain assets and liabilities. Our actual results could differ significantly from those estimates under different assumptions and conditions. We believe that the following discussion addresses the most critical accounting policies applicable to our Company, which are those that are most important to the portrayal of the financial condition and results of operations of our Company, and require management's most difficult, subjective and complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

***Consolidation***

The consolidated financial statements include the accounts of GigaMedia and our wholly-owned and majority-owned subsidiaries after elimination of all inter-company accounts and transactions. In addition, the accounts of our Company's VIEs as defined by the FASB Accounting Standards Codification are included in the consolidated financial statements. See note 3 to our consolidated financial statements for additional information. The accounting policies for other less than majority-owned investments are described in note 1 to our consolidated financial statements in the paragraphs headed "Marketable Securities" and "Investments".

***Acquisitions***

Before January 1, 2009, our Company accounted for its business acquisitions using the purchase method as required by the FASB. Under the purchase method, the acquiring company allocates the purchase price to the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition, including intangible assets that can be identified. The purchase price in excess of the fair value of the net assets and liabilities identified is recorded as goodwill. Business acquisitions that our Company enters into after January 1, 2009 are being accounted for in accordance with the new accounting guidance issued by the FASB using the acquisition method. Under the new accounting guidance, our Company recognizes and measures the identifiable assets acquired, the liabilities assumed and any noncontrolling interest at their acquisition-date fair values, with limited exceptions. Acquisition-related costs will generally be expensed as incurred.



**Table of Contents*****Revenue Recognition***

Our Company recognizes revenues when persuasive evidence of an arrangement exists, delivery occurs or services are rendered, the sales price is fixed or determinable and collectability is reasonably assured. We present the sales taxes assessed by governmental authorities on our revenue transactions on a net basis in our consolidated financial statements.

Our Company enters into multiple-element revenue arrangements, which may include any combination of services, software, and/or products. To the extent that a deliverable in a multiple-element arrangement is subject to specific accounting guidance, whether and/or how to separate multiple deliverable arrangements into separate units of accounting (separability) and how to allocate the arrangement consideration among those separate units of accounting (allocation) for that deliverable is accounted for in accordance with such specific guidance.

In addition to the aforementioned general policies, the following are the specific revenue recognition policies for each major category of revenue.

***Gaming Software and Service Revenues***

Gaming software and service revenues for 2007, 2008 and 2009 are related to software products we develop and license and support services we provide for online real-money gaming solutions and applications.

Until the completion of the Mangas Transaction on April 8, 2010, the financial results of UIM were incorporated into our consolidated financial statements as UIM meets the criteria of VIE as defined by the FASB Accounting Standards Codification. Our software licensing and support service revenues for 2007, 2008 and 2009 were based upon a percentage of gross receipts generated by UIM's online gaming operations, and were recognized monthly. Software licensing and support service revenues we received from providing such services to UIM were eliminated in consolidation.

UIM historically generated revenues by providing and promoting online games of skill and chance that are available on its free download gaming software. We considered multiple-element revenue arrangements involving UIM's provision of software and software-related elements to customers. UIM's online gaming service was inseparable from the software element involved and UIM did not sell each element separately. UIM's online gaming service did not involve significant production, modification, or customization of the gaming software. Revenues derived from UIM's online gaming software platform were recognized at the time games were played and were net of player winnings. Transaction fee revenues derived from UIM's online multi-player poker platform were recognized as services were provided.

Following the completion of the Mangas Transaction, we no longer consolidate CESL or UIM. Our 40 percent interest in Mangas Everest is, from April 8, 2010, accounted for using the equity method. See Item 5. Operating and Financial Review and Prospects A. Operating Results Subsequent Events Transaction with Mangas.

***Online Game and Service Revenues***

Online game and service revenues are related to our online game and service business that operates play-for-fun games online in Asia.

Online game revenues are earned through the sale of online game points, pre-paid cards, and game packs. Virtual online game points are sold directly to end-users who can make the payments through credit cards, the Internet ATMs or telecommunication service operators. Physical pre-paid cards and game packs are sold through distributors and convenience stores. Proceeds from sales of physical cards and game packs, net of sales discounts, and online game points are deferred when received and revenue is recognized upon the actual usage of the playing time or in-game virtual items by the end-users; over the estimated useful life of virtual items; or when the sold game points expire and can no longer be used to access the online games or products in accordance with our published game points expiration policy.

**Table of Contents**

We report sales of virtual online game points on a gross basis. In the sales of virtual online game points, we act as principal and we have latitude in establishing price. Fixed percentage fees retained by service providers for payment processing related to our online game services are recognized as cost of online game revenues.

Online game and service revenues also include revenues derived from online advertising arrangements, sponsorship arrangements, or a combination of both. These service arrangements allow advertisers to place advertisements on particular areas of our Company's websites and online game platforms over a stated period of time. Service revenues from online advertising arrangements are recognized ratably over the displayed period of the contract when the collectability is reasonably assured.

***Revenue included within Discontinued Operations***

For 2007, 2008 and 2009, a portion of our Company's revenue was generated from our Internet access and service business. We disposed of the remaining portion of our Internet access and service business in September 2008, and as a result, have classified the income from these revenue-generating activities as part of discontinued operations. See note 4 to our consolidated financial statements for additional information.

Our Internet access and service business revenues were recorded net of discounts and net of fees paid to cable partners, and were recognized on a straight-line basis over the subscription period or for the period in which the service was performed. Any advanced payment receipts were recorded as deferred revenues included in other current liabilities in our consolidated balance sheets and were amortized over the subscription period. The sale of other Internet access-related products and rental income from the lease of Internet access-related equipment to subscribers were recognized when products were delivered or services were provided.

***Player Account Balances***

Player account balances are related to player deposits from our gaming software and service business. Player account balances are presented as current liabilities, which are first accrued for in full upon the receipt of player deposits, and increased or decreased based on player activities, including player wins or losses, withdrawals and refunds. See note 5 to our consolidated financial statements for additional information.

***Deferred Revenues***

Deferred revenues are included in other current liabilities, and consist of the prepaid income related to our online game and service business.

***Operating Costs***

Operating costs primarily consist of processing costs, online game royalties, bandwidth, production costs for prepaid game cards and game packs, amortization of intangible assets, customer service department costs, depreciation, maintenance and other overhead expenses directly attributable to our gaming software and service revenues and online game and service revenues.

***Prepaid Licensing and Royalty Fees***

Our Company, through our subsidiaries and VIE subsidiaries, routinely enters into agreements with licensors to acquire licenses for using, marketing, distributing, selling and publishing of multi-player online games.

Prepaid licensing fees paid to licensors are capitalized when technological feasibility is achieved, and amortized on a straight-line basis over the shorter of the useful economic life of the relevant online game or license period, which is usually within two to five years. The annual amortization is modified if the amount computed using the ratio that current gross revenues for a game license bear to the total of current and anticipated future gross revenues for that game license is greater than the amount computed using the straight-line method.

**Table of Contents**

Prepaid royalty fees and related costs are recognized in the period in which the related online game revenue is recognized.

***Fair Value Measurement***

We adopted the guidance issued by FASB for fair value measurements and the fair value option for financial assets and financial liabilities on January 1, 2008. We did not record an adjustment to retained earnings as a result of the adoption of the guidance for fair value measurements, and the adoption did not have a material impact on our consolidated financial statements. The guidance for the fair value option for financial assets and financial liabilities provides companies the irrevocable option to measure many financial assets and liabilities at fair value with changes in fair value recognized in earnings. Our Company has not elected to measure any financial assets or liabilities at fair value that were not previously required to be measured at fair value.

Our Company generally determines or calculates the fair value of financial instruments using quoted market prices in active markets when such information is available or using appropriate present value or other valuation techniques, such as discounted cash flow analyses, incorporating adjusted available market discount rate information and our Company's estimates for non-performance and liquidity risk. These techniques rely extensively on the use of a number of assumptions, including the discount rate, credit spreads, and estimates of future cash flows.

***Allowance for Doubtful Accounts***

An allowance for doubtful accounts is provided based on an evaluation of the collectability of notes receivable, accounts receivable, and other receivables. An allowance for doubtful accounts is also provided, when considered necessary, to loans receivable. We review the collectability of loans receivable on an individual basis and the evaluation primarily consists of an analysis based upon current information available about the borrower.

For those accounts in which a loss is probable, we record a specific reserve. Receivable losses are charged against the allowance when the Company believes the uncollectability of the receivable is confirmed. Subsequent recoveries, if any, are credited to the allowance.

***Marketable Securities***

All of our Company's investments in marketable securities are classified as available-for-sale. These marketable securities are stated at fair value with any unrealized gains or losses recorded in accumulated other comprehensive income (loss) within equity until realized.

Other-than-temporary impairments, if any, are charged to non-operating expense in the period in which the loss occurs. In determining whether an other-than-temporary impairment has occurred, our Company primarily considers, among other factors, the length of the time and the extent to which the fair value of an investment has been less than cost. When an other-than-temporary loss is recorded, the fair value of the investment becomes the new cost basis of the investment and is not adjusted for subsequent recoveries in fair value. Realized gains and losses also are included in non-operating income and expense in the consolidated statements of operations.

As a result of our assessment of the recoverability of our marketable securities, we recognized other-than-temporary impairment of US\$14.7 million in 2009. See note 10 to our consolidated financial statements for additional information.

***Investments***

Equity investments in non-publicly traded securities of companies over which our Company has no ability to exercise significant influence are accounted for under the cost method. The equity investments accounted for under the cost method as of December 31, 2008 and 2009 totaled US\$1,830 thousand and US\$3,255 thousand, respectively.



**Table of Contents**

Equity investments in companies over which our Company has the ability to exercise significant influence but does not hold a controlling interest are accounted for under the equity method and our Company's income or loss on equity method investments is recorded in non-operating income or expenses. The difference between the cost of the acquisition and our Company's share of the fair value of the net identifiable assets is recognized as goodwill and is included in the carrying amount of the investment. When our Company's carrying value in an equity method investee is reduced to zero, no further losses are recorded in our consolidated financial statements unless our Company guaranteed obligations of the investee or has committed additional funding. When the investee subsequently reports income, our Company will not record its share of such income until it equals the amount of its share of losses not previously recognized.

Unrealized losses that are considered other-than-temporary, if any, are charged to non-operating expenses. Realized gains and losses, measured against carrying amount, are also included in non-operating income and expenses in the consolidated statements of operations. As a result of our assessment of the recoverability of our investments, we recognized other-than-temporary impairment of US\$1.0 million in 2009. See note 10 to our consolidated financial statements for additional information.

***Impairment of Intangible Assets, Goodwill and Long-Lived Assets***

Potential impairment of intangible assets with indefinite useful lives is evaluated, at the reporting unit level, at least annually, or whenever events or changes in circumstances indicate that the carrying value of an asset might not be recoverable from its related future undiscounted cash flows. Impairment is measured as the difference between the carrying amounts and the fair value of the assets, and is recognized as a loss from operations.

Potential impairment of goodwill is tested annually, or sooner when circumstances indicate an impairment may exist, using a fair-value approach at the reporting unit level. A reporting unit is the operating segment, or a business, which is one level below that operating segment (the component level) if discrete financial information is prepared and regularly reviewed by management at the segment level. Components are aggregated as a single reporting unit if they have similar economic characteristics. After completing our annual impairment reviews during the fourth quarters of 2007 and 2008, we concluded that goodwill was not impaired in fiscal years of 2007 and 2008. In fourth quarter of 2009, we assessed the recoverability of goodwill and recognized impairment charges of US\$14.1 million. See note 10 to our consolidated financial statements for additional information.

Potential impairment of long-lived assets other than goodwill and intangible assets not being amortized (which includes prepaid licensing and royalty fees) is evaluated, at least annually, or whenever events or changes in circumstances indicate that the carrying value of an asset might not be recoverable from its related future undiscounted cash flows. If such assets are considered to be impaired, the impairment to be recognized is measured by the extent to which the carrying amounts of the assets exceeds the fair value of the assets. When an impairment is identified, the carrying amount of the asset is reduced to its estimated fair value, and is recognized as a loss from operations. Impairment charges relating to long-lived assets other than goodwill and intangible assets not being amortized amounting to US\$0, US\$1.5 million and US\$24.3 million were recognized in 2007, 2008 and 2009, respectively. See note 10 to our consolidated financial statements for additional information.

***Software Cost***

Costs to develop our gaming software until the completion of the Mangas Transaction on April 8, 2010 and online game products are capitalized after technological feasibility has been established, and when the product is available for general release to customers, costs are expensed. Costs incurred prior to the establishment of technological feasibility are expensed when incurred and are included in product development and engineering expenses.

Capitalized amounts are amortized using the straight-line method, which is applied over the useful economic life of the software, ranging from three to five years. The annual amortization is modified if the amount computed using the ratio that current gross revenues for a product bear to the total of current and anticipated future gross revenues for that product is greater than the amount computed using the straight-line method.

We capitalize certain costs incurred to purchase or to internally create and implement internal-use computer software, which includes software coding, installation, testing and certain data conversion. These capitalized costs are amortized on a straight-line basis over the shorter of the useful economic life of the software or its contractual license period, which range from three to five years.



**Table of Contents*****Advertising***

Direct-response advertising costs incurred related to the acquisition or origination of a customer relationship are capitalized and deferred. The deferred costs are recognized in the consolidated statements of operations over the estimated lives of customer relationships. Costs of communicating advertising are recorded as expenses as advertising airtime is used. Other advertising expenditures are expensed as incurred.

Advertising expenses incurred in 2007, 2008 and 2009 totaled US\$50.1 million, US\$60.1 million and US\$63.6 million, respectively (including US\$28 thousand, US\$42 thousand, and US\$0 reported in discontinued operations in 2007, 2008 and 2009, respectively). As of December 31, 2008 and 2009, prepaid advertising amounted to US\$8.3 million and US\$6.8 million, respectively (of which US\$6.8 million is included separately in assets held for sale and retained ownership of gaming software and service business, see note 5 to our consolidated financial statements for additional information).

***Income Taxes***

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. We recognize the tax benefit from investment credits and certain equity investments using the flow-through method. Loss carryforwards and investment credits are measured using the enacted tax rate and laws that will be in effect in different jurisdictions in which we operate when the differences are expected to reverse. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the tax rate's enactment date. Deferred tax assets are subject to valuation allowances based upon the management's estimate of realization. Due to slow market growth and the strong competition we face in our Internet access and service business and certain subsidiaries and VIE subsidiaries of our online game and services business that will not be able to utilize their operating loss carryforwards, we made a substantial allowance for all of the aggregate net deferred tax assets as of December 31, 2007. As of December 31, 2008, we evaluated the available evidence and determined that it was more likely than not that we would realize the benefit of the deferred tax assets. The primary reason for the reversal of the valuation allowance in 2008 was that the sale of our Internet access and service operation was completed in September 2008. Based on weighing all available evidence, we determined that evidence exists to conclude that it is more likely than not that we will generate sufficient taxable income to utilize the majority of the deferred tax assets within the allowable carryforward periods. In 2009, the valuation allowance on the deferred tax assets increased by US\$962 thousand to US\$1.1 million primarily because certain subsidiaries and VIE subsidiaries of our online game and service business are not likely to be able to utilize all of the deferred tax assets based on their estimated future taxable income. See note 23 to our consolidated financial statements for additional information.

Actual results may differ significantly from management's estimate.

Our Company recognizes the financial statement impact of a tax position when it is more likely than not that the position will be sustained upon examination. If the tax position meets the more-likely-than-not recognition threshold, the tax effect is recognized at the largest amount of the benefit that has greater than a fifty percent likelihood of being realized upon ultimate settlement. The interest and penalties are reflected as income tax benefits (expenses) on our consolidated financial statements. See note 23 to our consolidated financial statements for additional information.

***Noncontrolling Interest***

We adopted the new accounting guidance issued by the FASB for noncontrolling interest on January 1, 2009. This guidance requires that the noncontrolling interest in the equity of a subsidiary be accounted for and reported as equity, provides revised guidance on the treatment of net income and losses attributable to the noncontrolling interest and changes in ownership interests in a subsidiary and requires additional disclosures that identify and distinguish between the interests of the controlling and noncontrolling owners. As a result, we have retrospectively applied the presentation and disclosure requirements of the new standard and adjusted prior periods for comparative purposes as required. Changes in our Company's ownership interest in a subsidiary that do not result in deconsolidation are accounted for as equity transactions. Any retained noncontrolling equity investment upon the deconsolidation of a subsidiary is initially measured at fair value.



**Table of Contents*****Share-Based Compensation***

Share-based compensation represents the cost related to share-based awards granted to employees. We measure share-based compensation cost at the grant date, based on the estimated fair value of the award. Share-based compensation is recognized for the portion of the award that is ultimately expected to vest and the cost is amortized on a straight-line basis (net of estimated forfeitures) over the vesting period. Our Company estimates the fair value of stock options using the Black-Scholes valuation model. The cost is recorded in operating costs and operating expenses in the Consolidated Statement of Operations based on the employees' respective function.

For shares and stock options granted to non-employees, we measure the fair value of the equity instruments granted at the earlier of the performance commitment date or when the performance is completed.

***Foreign Currency Translation***

The consolidated financial statements of our Company and our subsidiaries have been reported in U.S. dollars. Assets and liabilities denominated in non-U.S. currency are translated to U.S. dollars at year-end exchange rates. Income and expense items are translated at weighted-average rates of exchange prevailing during the year. Cumulative translation adjustments resulting from this process are charged or credited to other comprehensive income within equity. Gains and losses on foreign currency transactions are included in other income and expenses. Cumulative translation adjustments as of December 31, 2007, 2008 and 2009 were (US\$27) million, (US\$27) million, and (US\$26) million, respectively.

***Taxation***

The corporate income tax rate in Taiwan is 25 percent. Effective from 2010, the corporate income tax rate in Taiwan is reduced to 17 percent. In addition to the corporate income tax rate, all retained earnings generated beginning January 1, 1998 by our subsidiaries under Taiwan law and not distributed to us as dividends in the following year are assessed a 10 percent retained earnings tax. This rule applies primarily to our Internet access and service business, which was sold in September 2008 and our FunTown online games portal, whose principal operating entities are incorporated under Taiwan law.

On January 1, 2006, the Taiwanese government enacted the AMT Act. Taxes imposed under the AMT Act are supplemental tax payable if the income tax payable pursuant to the R.O.C. Income Tax Act is below the minimum amount prescribed under the AMT Act. The AMT rate for business entities is 10 percent. The taxable income for calculating the AMT includes most income that is exempted from income tax under various legislation such as tax holidays and investment tax credits. For example, gains on disposal of marketable securities from our Taiwan-based entities were exempt from income tax based on Taiwan tax laws prior to the AMT Act. However, such gains will need to be included for the purpose of calculating the AMT.

Effective from January 1, 2008, T2CN's subsidiaries and its VIE subsidiaries that are incorporated in the PRC, are subject to Enterprise Income Tax (EIT) on the taxable income as reported in their respective statutory financial statements adjusted in accordance with the Corporate Income Tax Law of the PRC (the New CIT Law) as enacted by the National People's Congress on March 16, 2007.

Pursuant to the New CIT Laws, T2CN's subsidiaries and its VIE subsidiaries in the PRC are generally subject to EIT at a statutory rate of 25 percent unless they qualify under certain limited exceptions.

In 2007, T2 Entertainment and J-Town Information Co. (Shanghai), Ltd. (J-Town) received approval from certain government authorities to be classified as a Software Enterprise. This classification, subject to annual inspection, entitles these two entities to two years of EIT exemption for 2006 and 2007 followed by three years of a 50 percent EIT tax reduction for 2008, 2009 and 2010, for which the related tax authorities have granted approval. The New CIT Law provides grandfather treatment for Software Enterprises that received special tax holidays under the previous Corporate Income Tax Law, which allow them to continue to enjoy their tax holidays until expiration. The applicable income tax rate of T2 Entertainment and J-Town is 12.5 percent for the year ended December 31, 2009.

In 2008, T2 Technology received approval from certain government authorities to be classified as a Software Enterprise. This classification, subject to annual inspection, entitles T2 Technology to two years of EIT exemption for 2008 and 2009 followed by three years of a 50 percent EIT tax reduction for 2010, 2011 and 2012, for which the related tax authorities have granted approval.



**Table of Contents**

The majority of our gaming software and service business is located outside the United States, with the exception of CIDC, an entity registered in Delaware which is subject to U.S. federal income tax, state tax and local tax. Current U.S. federal income tax rates and state and local tax rates applicable to our business for the year ended December 31, 2009 are 34.0 percent and 8.14 percent, respectively. Our operations in the United States did not have a significant tax impact on our consolidated financial statements.

**Recent Accounting Pronouncements**

In January 2010, the FASB issued additional disclosure requirements for fair value measurements. In accordance with the new guidance, the fair value hierarchy disclosures are to be further disaggregated by class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. In addition, significant transfers between Levels 1 and 2 of the fair value hierarchy will be required to be disclosed. These additional requirements will be effective for our Company on January 1, 2010. These amendments will not have a material impact on our consolidated financial statements, however they will require additional disclosures. In addition, the guidance requires more detailed disclosures of the changes in Level 3 instruments. These changes will be effective for our Company on January 1, 2011 and are not expected to have a material impact on our consolidated financial statements.

In October 2009, the FASB issued amended revenue recognition guidance for arrangements with multiple deliverables. The new guidance eliminates the residual method of revenue recognition and allows the use of management's best estimate of selling price for individual elements of an arrangement when vendor-specific objective evidence (VSOE), vendor objective evidence (VOE) or third-party evidence (TPE) is unavailable. The changes will be effective for our Company on January 1, 2011. The adoption is not expected to have a material effect in our consolidated financial statements.

In October 2009, the FASB issued guidance which amends the scope of existing software revenue recognition accounting. Tangible products containing software components and non-software components that function together to deliver the product's essential functionality would be scoped out of the accounting guidance on software and accounted for based on other appropriate revenue recognition guidance. This guidance must be adopted in the same period that our Company adopts the amended accounting for arrangements with multiple deliverables described in the preceding paragraph. The changes will be effective for our Company on January 1, 2011. The adoption is not expected to have a material effect on our consolidated financial statements.

In July 2009, the FASB issued the FASB Accounting Standards Codification (the Codification). The Codification became the single source of authoritative nongovernmental U.S. GAAP, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF) and related literature. The Codification eliminates the previous U.S. GAAP hierarchy and establishes one level of authoritative GAAP. All other literature is considered non-authoritative. The Codification was effective for annual periods ending after September 15, 2009. Our Company adopted the Codification accordingly and there was no material impact to our consolidated financial statements.

In June 2009, the FASB issued amendments to the accounting rules for VIEs and for transfers of financial assets. The new guidance for VIEs eliminates the quantitative approach previously required for determining the primary beneficiary of a variable interest entity and requires ongoing qualitative reassessments of whether an enterprise is the primary beneficiary. In addition, qualifying special purpose entities (QSPEs) are no longer exempt from consolidation under the amended guidance. The amendments also limit the circumstances in which a financial asset, or a portion of a financial asset, should be derecognized when the transferor has not transferred the entire original financial asset to an entity that is not consolidated with the transferor in the financial statements being presented, and/or when the transferor has continuing involvement with the transferred financial asset. These changes will be effective for our Company on January 1, 2010. We are in the process of evaluating what effect, if any, the adoption may have in our consolidated financial statements.

In May 2009, the FASB issued guidelines on subsequent event accounting which set forth: 1) the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements; 2) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements; and 3) the

disclosures that an entity should make about events or transactions that occurred after the balance sheet date. These guidelines were effective for annual periods ending after June 15, 2009. In February 2010, the FASB amended this standard whereby companies that file with the Securities and Exchange Commission ( SEC ), like our Company, are required to evaluate subsequent events through the date the financial statements are issued, but are no longer required to disclose in the financial statements that they have done so or disclose the date through which subsequent events have been evaluated. Our Company adopted the guidance accordingly, and there was no impact to our consolidated financial statements.



**Table of Contents**

**Discussion of Results of Operations**

***Factors Affecting Our Performance***

We believe that the following are the principal factors affecting our results of operations:

*Acquisitions and disposals.* We have made several significant acquisitions and dispositions of businesses during the past several years, and may enter into additional acquisition and disposition transactions in the future. Past acquisitions and dispositions have had a significant impact on our results of operations over the past several years, and if we engage in such transactions in the future, the nature, amounts and timing of our revenues, expenses and cash flows and the nature and amounts our assets and liabilities are likely to be materially affected.

*Development of gaming software and service and online games industries.* The online gaming and online games industries are in relatively early stages of development. We believe that our results of operations are likely to be affected by developments in these industries, including:

- the development and regulation of these industries generally;
- our adaptation to technological change;
- changing consumer preferences;
- legal development affecting these industries, in particular the gaming software and service industry; and
- general economic conditions in the markets where we or our licensees operate.

*Competition.* All of our businesses are in industries that are extremely competitive. Our gaming software and online games businesses are characterized by rapid technological change and we face significant and intense competition from online gaming software design houses, application service providers and casual games operators.

For each of our businesses, we cannot assure you that we will be successful in adapting to technological developments and achieving widespread acceptance of our services before our competitors offer services similar to our current or prospective offerings. As a consequence, we may lose our existing customers and not expand our client base, which would have a material adverse effect on our revenues and financial condition.

**Table of Contents**

The table below presents, for the periods indicated, information regarding certain revenues and expense items for our consolidated operations.

	For the year ended December 31,					
	2007		2008		2009	
Particulars	Amount in US\$ thousands	% of total revenues	Amount in US\$ thousands	% of total revenues	Amount in US\$ thousands	% of total revenues
<b>OPERATING REVENUES</b>						
Gaming software and service revenues	118,950	78.4	144,765	76.0	112,694	70.6
Online game and service revenues	32,764	21.6	45,604	24.0	46,887	29.4
Total operating revenues	151,714	100.0	190,369	100.0	159,581	100.0
<b>OPERATING COSTS</b>						
Cost of gaming software and service revenues	16,201	10.7	22,770	12.0	20,102	12.6
Cost of online game and service revenues	9,118	6.0	12,404	6.5	16,785	10.5
Total operating costs	25,319	16.7	35,174	18.5	36,887	23.1
Gross profit	126,395	83.3	155,195	81.5	122,694	76.9
<b>OPERATING EXPENSES</b>						
Product development and engineering expenses	7,338	4.8	13,455	7.1	14,195	8.9
Selling and marketing expenses	60,106	39.6	74,173	39.0	79,421	49.8
General and administrative expenses	20,983	13.8	25,035	13.2	29,692	18.6
Bad debt expense	548	0.4	2,905	1.5	1,092	0.7
Impairment loss on property, plant, and equipment					1,250	0.8
Impairment loss on goodwill					14,103	8.8
Impairment loss on prepaid licensing fees and intangible assets			1,524	0.8	23,002	14.4
Total operating expenses	88,975	58.6	117,092	61.5	162,755	102.0
Income from operations	37,420	24.7	38,103	20.0	(40,061)	(25.1)

NON-OPERATING INCOME (EXPENSES)	2,064	1.4	(1,324)	(0.7)	(15,524)	(9.8)
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	39,484	26.1	36,779	19.3	(55,585)	(34.9)
INCOME TAX EXPENSE	(401)	(0.3)	(1,069)	(0.6)	(517)	(0.3)
INCOME (LOSS) FROM CONTINUING OPERATIONS	39,083	25.8	35,710	18.7	(56,102)	(35.2)
INCOME FROM DISCONTINUED OPERATIONS	1,088	0.7	9,435	5.0	222	0.2
NET INCOME (LOSS)	40,171	26.5	45,145	23.7	(55,880)	(35.0)
LESS: NET (INCOME) LOSS ATTRIBUTABLE TO NONCONTROLLING INTEREST	(1,281)	(0.9)	(757)	(0.4)	6,795	4.2
NET INCOME (LOSS) ATTRIBUTABLE TO GIGAMEDIA	38,890	25.6	44,388	23.3	(49,085)	(30.8)

**Table of Contents**

The key items included in our income statement are:

**OPERATING REVENUES.** Our operating revenues consist of revenues from our gaming software and service business, and online games business. Revenues from the gaming software and service business include revenues of UIM, our licensee, from providing and promoting online games of skill and chance. Software licensing and support services revenues received by our subsidiary, CESL, from UIM have been eliminated in consolidation. Online game revenues are related to our online games business in Asia and are collected through the sale of online game points, pre-paid cards and game packs.

**OPERATING COSTS.** Operating costs consist primarily of gaming software and online game processing costs, online game royalties, production costs for prepaid game cards and game packs, amortization of intangible assets, customer service department costs, operational department costs, depreciation, maintenance and other overhead expenses directly attributable to the provision of gaming software and services and online games and services.

**OPERATING EXPENSES.** Operating expenses include product development and engineering expenses, selling and marketing expenses, general and administrative expenses, bad debt expenses and impairment losses.

**NON-OPERATING INCOME (EXPENSES).** Non-operating income and expenses consist of interest income and expenses, gain or loss on sales of marketable securities, foreign exchange gain or loss, gain or loss on disposal of property, plant and equipment, loss on equity method investments, and impairment loss on marketable securities and investments.

**INCOME TAX EXPENSES.** Taxes include current income tax in various jurisdictions in which our subsidiaries operate and deferred tax expenses related to temporary tax assets or liabilities that arise due to the timing differences between book profits and taxable profits that originate in one period and are capable of reversal in one or more subsequent periods. Taxes are measured using the tax rates and laws that have been enacted or subsequently enacted as of the date of the financial statements.

**NONCONTROLLING INTEREST.** Noncontrolling interest represents the portion of net income allocated to the non-controlling voting stock of our majority-owned subsidiaries (T2CN and Dragongate Enterprises) as well as UIM, which is consolidated pursuant to the FASB Accounting Standards Codification.

The financial information in relation to our business segments is provided net of inter-segment transactions.

**For the Years Ended December 31, 2009 and 2008*****Consolidated Results of Operations***

**OPERATING REVENUES.** Operating revenues for 2009 declined by approximately 16.2 percent to approximately US\$159.6 million from approximately US\$190.4 million in 2008. The decrease was primarily a result of a 22.2 percent revenue decline in our gaming software and service business, which contributed approximately US\$112.7 million or 70.6 percent of our total revenues in 2009. Our online games and service business revenues increased by 2.8 percent to approximately US\$46.9 million, or 29.4 percent of our total revenues in 2009.

**OPERATING COSTS.** Operating costs increased by approximately 4.9 percent to approximately US\$36.9 million in 2009 from approximately US\$35.2 million in 2008. The increase in total operating costs was mainly due to a US\$4.4 million or 35.3 percent increase in operating costs in our online games and service business related to a higher level of license fee and fixed costs resulting from newly launched games, which was offset by a US\$2.7 million or 11.7 percent decrease in operating costs in our gaming software and service business, which was in line with the revenue decrease.

**GROSS PROFIT.** Gross profit decreased by approximately 20.9 percent to approximately US\$122.7 million in 2009 from approximately US\$155.2 million in 2008. The decrease in consolidated gross profit resulted from respective 24.1 percent and 9.3 percent decreases in gross profits in our gaming software and service business and our online games and service business.

**OPERATING EXPENSES.** Total operating expenses increased by approximately 39.0 percent to approximately US\$162.8 million in 2009 from approximately US\$117.1 million in 2008. The increase in total operating expenses was mainly due to a US\$39.5 million or 156.9 percent increase in expenses in our online games and service business, while operating expense was flat in 2009 compared to 2008 in our gaming software and service business.



**Table of Contents**

Consolidated product development and engineering expenses increased by approximately 5.5 percent in 2009 to approximately US\$14.2 million from US\$13.5 million in 2008, mainly due to a US\$305 thousand or 2.5 percent increase in our gaming software and service business.

Consolidated selling and marketing expenses increased by approximately 7.1 percent to approximately US\$79.4 million in 2009 from US\$74.2 million in 2008, primarily due to an increase of US\$5.2 million or 51.1 percent in selling and marketing expenses in our online games and service business related to promotion and activities held for newly launched games.

Consolidated general and administrative expenses increased by approximately 18.6 percent in 2009 to US\$29.7 million from US\$25.0 million in 2008, primarily reflecting a US\$872 thousand or 9.4 percent increase in our gaming software and service business and a US\$771 thousand or 8.1 percent increase in our online games and service business. The remaining US\$3.0 million increase was related to corporate headquarter expenses.

Consolidated impairment loss increased by approximately US\$36.8 million to approximately US\$38.4 million in 2009 from US\$1.5 million in 2008, primarily resulting from an increase of US\$36.2 million in our online games and service business. The total consolidated impairment loss was composed of a US\$4.7 million impairment loss on intangible assets for capitalized software costs, a US\$18.3 million impairment loss on prepaid licensing and royalty fees, a US\$1.3 million impairment loss on fixed assets, and a US\$14.1 million impairment loss on goodwill related to T2CN. **OPERATING INCOME.** Operating income for 2009 decreased by approximately US\$78.2 million to a loss of US\$40.1 million from approximately US\$38.1 million in 2008. The decrease was primarily due to a decrease of US\$28.9 million in operating income in our gaming software and service business and a decrease of US\$42.6 million in operating income in our online games business.

**NON-OPERATING INCOME (EXPENSES).** Non-operating items decreased from a loss of approximately US\$1.4 million in 2008 to a loss of approximately US\$15.5 million in 2009. This was primarily due to US\$15.7 million impairment losses on marketable securities and investments.

**INCOME FROM DISCONTINUED OPERATIONS.** Income from discontinued operations decreased by approximately US\$9.2 million to approximately US\$222 thousand in 2009 from approximately US\$9.4 million in 2008. The decrease was principally due to the sale of our legacy Internet access and service business in September 2008, which contributed approximately US\$9.8 million of an after tax disposal gain in 2008.

**NET INCOME (LOSS) ATTRIBUTABLE TO GIGAMEDIA.** Net income attributable to GigaMedia for 2009 decreased by approximately US\$93.5 million to a loss of approximately US\$49.1 million from net income of approximately US\$44.4 million in 2008.

**Business Segment Results***Gaming Software and Service Business*

On April 8, 2010, we completed the sale of 60 percent interest in our online gaming software and service business to Mangas. From then on, we no longer consolidate CESL or UIM. Our 40 percent interest in Mangas Everest is, from April 8, 2010, accounted for using equity method onward. See Item 5. Operating and Financial Review and Prospects A. Operating Results Subsequent Events Transaction with Mangas .

**OPERATING REVENUES.** Consolidated revenues of our gaming software and service business include the revenues of UIM, our licensee. Software licensing and support services revenues received by us from UIM have been eliminated in consolidation. Total operating revenues in 2009 decreased by 22.2 percent to approximately US\$112.7 million from US\$144.8 million in 2008. Such decrease was attributable to decline in both our poker software business and casino software business in 2009. Software licensing and support services revenues received by us from UIM decreased by 38.1 percent from US\$66.2 million in 2008 to US\$41.0 million in 2009. Revenues from our poker software business declined from approximately US\$104.5 million in 2008 to US\$73.7 million in 2009 and accounted for approximately 65.4 percent of our gaming software and service revenues in 2009 compared to 72.2 percent in 2008. Revenues from our casino software business decreased to approximately US\$39.0 million in 2009 from US\$40.2 million in 2008.

**OPERATING COSTS.** Costs of our gaming software and service revenues decreased by 11.7 percent to approximately US\$20.1 million in 2009 from US\$22.8 million in 2008. The decrease was due to less business volume and the associated decrease in payment processing costs in 2009.

**GROSS PROFIT.** Gross profit decreased by 24.1 percent to approximately US\$92.6 million in 2009 from US\$122.0 million in 2008. The decrease was primarily due to revenue decline in both poker software business and casino software business in the period. Gross profit margin decreased from approximately 84.3 percent in 2008 to approximately 82.2 percent in 2009 because the revenue decline outpaced certain fixed cost.

**Table of Contents**

**OPERATING EXPENSES.** Total operating expenses decreased by approximately US\$515 thousand to approximately US\$85.1 million in 2009 from approximately US\$85.6 million in 2008. The decrease in total operating expenses resulted primarily from a 2.9 percent or approximately US\$1.8 million decrease in selling and marketing expenses, which was offset by a 2.5 percent or US\$305 thousand increase in product development and engineering expenses and a 9.4 percent or US\$872 thousand increase in general and administrative expenses.

**Selling and marketing expenses.** Selling and marketing expenses decreased by approximately 2.9 percent to approximately US\$62.2 million in 2009 from US\$64.1 million in 2008, which was attributable to a decrease in payments to marketing affiliates.

**General and administrative expenses.** General and administrative expenses increased by approximately US\$872 thousand to US\$10.1 million in 2009 from US\$9.3 million in 2008. The increase was due to additional general and administrative departmental cost being incurred in 2009.

**Product development and engineering expenses.** Product development and engineering expenses increased by approximately US\$305 thousand to US\$12.6 million in 2009 from US\$12.2 million in 2008, mainly due to increases in headcount related cost.

**OPERATING INCOME.** Operating income in 2009 decreased by 79.5 percent to approximately US\$7.5 million from US\$36.4 million in 2008. The decrease was attributable to lower revenue, gross profit and operating expenses which despite a decrease in absolute terms were proportionately higher, resulting in a decrease in operating margin to 6.6 percent in 2009 from 25.1 percent in 2008. Operating income does not reflect certain corporate headquarters expenses. For a reconciliation of business segment results to our consolidated net income, see note 27 to our consolidated financial statements.

*Online Games Business*

**OPERATING REVENUES.** Total operating revenues increased by approximately 2.8 percent to approximately US\$46.9 million in 2009 from approximately US\$45.6 million in 2008. Such increase was driven by a 10.3 percent increase related to FunTown in Taiwan and Hong Kong, which was offset by a 7.1 percent decrease related to T2CN in China. Revenue from FunTown increased by approximately US\$2.7 million to US\$28.6 million in 2009 from US\$25.9 million in 2008. Revenue from T2CN decreased by approximately US\$1.4 million to US\$18.3 million in 2009 from US\$19.7 million in 2008.

**OPERATING COSTS.** Costs of our online game revenues increased by 35.3 percent to approximately US\$16.8 million in 2009 from US\$12.4 million in 2008. The increase was due to increased bandwidth costs, royalty fees and licensing fees related to newly launched games in 2009.

**GROSS PROFIT.** Gross profit decreased by 9.3 percent to approximately US\$30.1 million in 2009 from US\$33.2 million in 2008. The decrease resulted from cost increases outpacing revenue growth. Gross profit margin decreased from approximately 72.8 percent in 2008 to approximately 64.2 percent in 2009.

**OPERATING EXPENSES.** Total operating expenses increased by approximately US\$39.5 million to approximately US\$64.8 million in 2009 from approximately US\$25.2 million in 2008. The increase was due to increased selling and marketing expenses related to newly launched games and impairment losses primarily on prepaid licensing and royalty fees, intangible assets, and goodwill.

**Selling and marketing expenses.** Selling and marketing expenses increased by approximately US\$5.2 million to US\$15.3 million in 2009 from US\$10.1 million in 2008. The increase was primarily related to new games launched in 2009.

**General and administrative expenses.** General and administrative expenses increased by approximately 8.1 percent to approximately US\$10.3 million in 2009 from US\$9.5 million in 2008, primarily due to additional professional fees and general and administrative department cost being incurred in 2009.



**Table of Contents**

Bad debt expenses. Bad debt expenses decreased by approximately US\$2.5 million to US\$372 thousand in 2009 from US\$2.9 million in 2008 as we recognized US\$2.6 million of bad debt expenses related to the loans to Flagship in 2008.

Impairment loss. Impairment loss increased by approximately US\$36.2 million to approximately US\$37.7 million in 2009 from US\$1.5 million in 2008. The impairment loss in 2009 was composed of a US\$4.5 million impairment loss on intangible assets for capitalized software costs, a US\$18.3 million impairment loss on prepaid licensing and royalty fees, a US\$777 thousand impairment loss on fixed assets, and a US\$14.1 million impairment loss on goodwill related to T2CN.

OPERATING INCOME. Operating income in 2009 decreased by approximately US\$42.6 million to a loss of US\$34.6 million from US\$8.0 million in 2008. The decrease was due to the aforementioned higher selling and marketing expenses as well as impairment losses. Operating income does not reflect certain corporate headquarter expenses.

NON-OPERATING INCOME (EXPENSES). Non-operating items decreased by approximately US\$11.6 million from a loss of US\$2.0 million in 2008 to a loss of US\$13.6 million in 2009. This was primarily due to \$13.7 million of impairment losses on marketable securities and investments in 2009.

For a reconciliation of business segment results to our consolidated net income, see note 27 to our consolidated financial statements.

**For the Years Ended December 31, 2008 and 2007*****Consolidated Results of Operations***

OPERATING REVENUES. Operating revenues for 2008 grew by approximately 25.5 percent to approximately US\$190.4 million from approximately US\$151.7 million in 2007. The increase was primarily due to a 21.7 percent revenue growth in our gaming software and service business, which contributed approximately US\$144.8 million or 76.0 percent of our total revenues in 2008. Our online games and service business revenues also increased by 39.2 percent to approximately US\$45.6 million, or 24.0 percent of our total revenues in 2008.

OPERATING COSTS. Operating costs increased by approximately 38.9 percent to approximately US\$35.2 million in 2008 from approximately US\$25.3 million in 2007. The increase in total operating costs was mainly due to a US\$6.6 million or 40.6 percent increase in operating costs in our gaming software and service business related to higher volume in 2008, and a US\$3.3 million or 36.0 percent increase in operating costs in our online games and service business which was also related to higher volume in 2008.

GROSS PROFIT. Gross profit increased by approximately 22.8 percent to approximately US\$155.2 million in 2008 from approximately US\$126.4 million in 2007. The increase in consolidated gross profit resulted from 18.7 percent and 40.4 percent increases in gross profits in our gaming software and service business and our online games and service business, respectively.

OPERATING EXPENSES. Total operating expenses increased by approximately 31.6 percent to approximately US\$117.1 million in 2008 from approximately US\$89.0 million in 2007. The increase in total operating expenses was mainly due to a US\$20.6 million or 31.7 percent increase in expenses in our gaming software and service business, and a US\$8.4 million or 50.0 percent increase in expenses in our online games and service business.

Consolidated product development and engineering expenses increased by approximately 83.4 percent in 2008 to approximately US\$13.5 million from US\$7.3 million in 2007, mainly due to a US\$4.9 million or 67.2 percent increase in our gaming software and service business.

Consolidated selling and marketing expenses increased by approximately 23.4 percent to approximately US\$74.2 million in 2008 from US\$60.1 million in 2007, primarily due to an increase of US\$14.0 million or 28.0 percent in selling and marketing expenses in our gaming software and service business, and a US\$0.4 million or 4.1 percent increase in selling and marketing expenses in our online games business.

**Table of Contents**

Consolidated general and administrative expenses increased by approximately 19.3 percent in 2008 to US\$25.0 million from US\$21.0 million in 2007, primarily reflecting a US\$1.6 million or 20.8 percent increase in our gaming software and service business and a US\$2.9 million or 44.7 percent increase in our online games and service business.

**OPERATING INCOME.** Operating income for 2008 increased by approximately 1.8 percent to US\$38.1 million from approximately US\$37.4 million in 2007. The increase was primarily due to a 16.9 percent increase in operating income in our online games business, offset by a 3.6 percent decrease in operating income in our gaming software and service business.

**NON-OPERATING INCOME (EXPENSES).** Non-operating items decreased from approximately US\$2.1 million income in 2007 to a loss of approximately US\$1.3 million in 2008. This was principally due to an investment loss on CJIT2, an equity method investment, of approximately US\$2.9 million recognized in 2008.

**INCOME FROM DISCONTINUED OPERATIONS.** Income from discontinued operations increased in 2008 by approximately 767.0 percent to approximately US\$9.4 million in 2008 from approximately US\$1.1 million in 2007. The increase was principally due to the sale of our legacy Internet access and service business in September 2008, which contributed approximately US\$9.8 million of an after tax disposal gain.

**NET INCOME ATTRIBUTABLE TO GIGAMEDIA.** Net income attributable to GigaMedia for 2008 increased by approximately 14.1 percent to US\$44.4 million from approximately US\$38.9 million in 2007.

**Business Segment Results***Gaming Software and Service Business*

**OPERATING REVENUES.** Consolidated revenues of our gaming software and service business include the revenues of UIM, our licensee. Software licensing and support services revenues received by us from UIM have been eliminated in consolidation. Total operating revenues in 2008 increased by 21.7 percent to approximately US\$144.8 million from US\$119.0 million in 2007. Such increase was attributable to growth in both our poker software business and casino software business in 2008. Software licensing and support services revenues received by us from UIM increased by 23.6 percent from US\$53.6 million in 2007 to US\$66.2 million in 2008. Revenues from our poker software business grew from approximately US\$89.7 million in 2007 to US\$104.5 million in 2008 and accounted for approximately 72.2 percent of our gaming software and service revenues in 2008 compared to 75.6 percent in 2007. Revenues from our casino software business increased to approximately US\$40.2 million in 2008 from US\$29.0 million in 2007.

**OPERATING COSTS.** Cost of our gaming software and service revenues increased by 40.6 percent to approximately US\$22.8 million in 2008 from US\$16.2 million in 2007. The increase was due to higher business volume and the associated increase in payment processing costs in 2008.

**GROSS PROFIT.** Gross profit increased by 18.7 percent to approximately US\$122.0 million in 2008 from US\$102.7 million in 2007. The increase was primarily due to revenue growth in both poker software business and casino software business in the period. Gross profit margin decreased from approximately 86.4 percent in 2007 to approximately 84.3 percent in 2008. The decrease was due primarily to increased payment processing fees and departmental costs in both the customer service department and operational department.

**OPERATING EXPENSES.** Total operating expenses increased by approximately 31.7 percent to approximately US\$85.6 million in 2008 from approximately US\$65.0 million in 2007. The increase in total operating expenses resulted from increases in selling and marketing expenses, general and administrative expenses, and product development and engineering expenses incurred to support revenue growth.

**Selling and marketing expenses.** Selling and marketing expenses increased by approximately 28.0 percent to approximately US\$64.1 million in 2008 from US\$50.0 million in 2007. The increase was attributable to increases in payments to marketing affiliates, as well as increases in sales and marketing headcount and our sponsorship of the World Series of Poker.

**Table of Contents**

General and administrative expenses. General and administrative expenses increased by approximately US\$1.6 million to US\$9.3 million in 2008 from US\$7.7 million in 2007. The increase was due to more professional fees and general and administrative departmental cost incurred to support revenue growth.

Product development and engineering expenses. Product development and engineering expenses increased by approximately US\$4.9 million to US\$12.2 million in 2008 from US\$7.3 million in 2007, mainly due to increases in product development and engineering headcounts incurred to support revenue growth.

OPERATING INCOME. Operating income in 2008 decreased by 3.6 percent to approximately US\$36.4 million from US\$37.7 million in 2007. The decrease was due to operating margin decline from 31.7 percent in 2007 to 25.1 percent in 2008. The decrease was primarily due to increases in sales and marketing, general and administrative, and product development and engineering expenses. Operating income does not reflect certain corporate headquarters expenses. For a reconciliation of business segment results to our consolidated net income, see note 27 to our consolidated financial statements.

*Online Games Business*

OPERATING REVENUES. Total operating revenues increased 39.2 percent to approximately US\$45.6 million in 2008 from approximately US\$32.8 million in 2007. Such increase was driven by organic growth of FunTown in Taiwan and Hong Kong and full year consolidation of T2CN in China. Revenue from FunTown grew 9.0 percent from US\$23.8 million in 2007 to US\$25.9 million in 2008. Revenue from T2CN increased by 118.7 percent to approximately US\$19.7 million in 2008 from US\$9.0 million in 2007, for the seven months of 2007 from initial consolidation of T2CN in June 2007.

OPERATING COSTS. Cost of our online game revenues increased by 36.0 percent to approximately US\$12.4 million in 2008 from US\$9.1 million in 2007. The increase was due to increased bandwidth costs, increased royalty fees and licensing fees related to the licensing of new games.

GROSS PROFIT. Gross profit increased by 40.4 percent to approximately US\$33.2 million in 2008 from US\$23.6 million in 2007. The increase resulted from organic revenue growth of FunTown and full year consolidation of T2CN in 2008. Gross profit margin slightly increased from approximately 72.2 percent in 2007 to approximately 72.8 percent in 2008.

OPERATING EXPENSES. Total operating expenses increased by approximately 50.0 percent to approximately US\$25.2 million in 2008 from approximately US\$16.8 million in 2007. The increase was due to increased general and administrative expenses incurred to support revenue growth, bad debt expenses related to the loans to Flagship, as well as an a loss on impairment of capitalized license costs and intangible assets.

Selling and marketing expenses. Selling and marketing expenses increased by approximately US\$400 thousand to US\$10.1 million in 2008 from US\$9.7 million in 2007. The increase was primarily due to full year consolidation of T2CN.

General and administrative expenses. General and administrative expenses increased by approximately 44.7 percent to approximately US\$9.5 million in 2008 from US\$6.6 million in 2007, primarily due to full year consolidation of T2CN.

Bad debt expense and impairment loss. Bad debt expenses increased by approximately 430.3 percent to US\$2.9 million in 2008 from 548 thousand in 2007 as we recognized US\$2.6 million of bad debt expenses related to the loans to Flagship. We also recognized a loss of US\$1.5 million in 2008 on the impairment of capitalized license costs and intangible assets.

OPERATING INCOME. Operating income in 2008 increased by approximately 16.9 percent to US\$8.0 million from US\$6.8 million in 2007. The increase was due to revenue growth during the period. Operating margin declined from 20.9 percent in 2007 to 17.6 percent in 2008, which reflected the aforementioned higher general and administrative expenses, and bad debt expense related to the loans to Flagship as well as the impairment loss. Operating income does not reflect certain corporate headquarter expenses.

**Table of Contents**

NON-OPERATING INCOME (EXPENSES). Non-operating income (expenses) decreased from US\$1.6 million income in 2007 to a loss of US\$2.0 million in 2008. The decrease was due to the equity investment loss on CJIT2 of approximately US\$2.9 million in 2008.

For a reconciliation of business segment results to our consolidated net income, see note 27 to our consolidated financial statements.

**B. Liquidity and Capital Resources**

Our principal sources of liquidity consist of cash generated from our operations, proceeds generated from the disposal of our investments and other assets, bank borrowings, and interest derived from our investments. Our cash and cash equivalents are held primarily in U.S. dollars, RMB and NT dollars. Our policy with respect to liquidity management is to maintain sufficient cash and cash equivalents to fund operations and strategic transactions, while placing remaining funds in higher yield investment instruments.

Our future cash requirements will depend on a number of factors including: