

KONGZHONG CORP  
Form 20-F  
April 29, 2009

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

FORM 20-F

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

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2008

OR

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

OR

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
Date of event requiring this shell company report \_\_\_\_\_

Commission file number 000-50826

KONGZHONG CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

N/A  
(Translation of Registrant's Name Into English)

Cayman Islands  
(Jurisdiction of Incorporation or Organization)

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(Name, Telephone, Email and/or Facsimile Number and Address of Company Contact Person)

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

Title of Each Class	Name of Each Exchange On Which Registered
Ordinary shares, par value US\$0.0000005 per share* American Depositary Shares, each representing 40 ordinary shares	The NASDAQ Stock Market LLC (The NASDAQ Global Select Market)

\* Not for trading, but only in connection with the listing on The NASDAQ Global Select Market of American Depositary Shares, or ADSs, each representing 40 ordinary shares.

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

None

(Title of Class)

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

None

(Title of Class)

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.

As of December 31, 2008, 1,434,232,520 ordinary shares, par value US\$0.0000005 per share, were issued and outstanding.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

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

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

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

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

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

U.S. GAAP

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

Other

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

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## FORWARD-LOOKING STATEMENTS

This annual report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. Such forward-looking statements include, without limitation, statements that are not historical facts relating to:

- our financial performance and business operations;
- our ability to successfully execute our business strategies and plans;
- the state of our relationship with telecommunications operators in the People’s Republic of China, or the PRC;
- our dependence on the substance and timing of the billing systems of the telecommunications operators in the PRC for our performance;
- our development and capital expenditure plans;
- the expected benefit and future prospects of our strategic alliances and acquisitions, and our ability to cooperate with our alliance partners or integrate acquired businesses;
- management estimations with respect to revenues from our wireless value-added services, or WVAS, mobile games and our wireless Internet businesses;
- the development of our latest product offerings, including but not limited to offerings in our WVAS, mobile games and wireless Internet businesses;
- the development of the regulatory environment and changes in the policies or guidelines of the PRC telecommunications operators;
- the effects of the restructuring of the telecommunications industry in the PRC as announced by the Ministry of Industry and Information Technology, or the MII (which also refers to its predecessor, the Ministry of Information Industry prior to the PRC government restructuring in March 2008), the National Development and Reform Commission and the Ministry of Finance of the PRC in May 2008; and
- competitive pressures and future growth in the WVAS, mobile games, wireless Internet, mobile advertising, telecommunications and related industries in the PRC.

The words “forecast,” “anticipate,” “believe,” “could,” “estimate,” “expect,” “intend,” “may,” “plan,” “seek,” “will,” “would” expressions, as they relate to us, are intended to identify a number of these forward-looking statements.

These forward-looking statements are subject to risks, uncertainties and assumptions, some of which are beyond our control. In addition, these forward-looking statements reflect our current views with respect to future events and are not a guarantee of future performance. Actual results may differ materially from the information contained in the forward-looking statements as a result of a number of factors, including, without limitation, the risk factors set forth in “Item 3 — Key Information — Risk Factors” and the following:

- any changes in our relationship with telecommunications operators in the PRC;



- any changes in the regulatory regime or the policies for the PRC telecommunications industry, including changes in the structure or functions of the primary industry regulator, the MII, or its policies, or the policies or other regulatory measures of other relevant government or industry authorities relating to, among other matters, the granting and approval of licenses, procedures for customers to access and subscribe to WVAS or mobile games, restrictions on wireless Internet content, or the introduction of new technology platforms, products and services;
  - the effects of competition on the demand for or the price of our products or services;
  - any changes in customer demand or usage preference for our products or services;
- any changes in the telecommunications operators' systems for billing users of our WVAS or mobile games or remitting payments to us;
- any changes in technologies related to telecommunications, WVAS, mobile games or wireless Internet or applications based on such technologies;
- any changes in political, economic, legal or social conditions in the PRC, including the PRC government's specific policies with respect to foreign investment and entry by foreign companies into the telecommunications, WVAS, mobile games or wireless Internet market, economic growth, inflation, foreign exchange or the availability of credit; and
- changes in population growth or gross domestic product, or GDP, growth or the impact of those changes on the demand for our products or services.

We do not intend to update or otherwise revise the forward-looking statements in this annual report, whether as a result of new information, future events or otherwise. Because of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this annual report might not occur in the way we expect, or at all. You should not place undue reliance on any forward-looking information.

## PART I

## Item 1. Identity of Directors, Senior Management and Advisers

Not Applicable.

## Item 2. Offer Statistics and Expected Timetable

Not Applicable.

## Item 3. Key Information

## Selected Financial Data

The following selected historical consolidated financial data should be read in conjunction with our audited historical consolidated financial statements, the notes thereto and “Item 5 — Operating and Financial Review and Prospects.” The selected historical consolidated statement of operations data for the years ended December 31, 2006, 2007 and 2008 and the selected historical consolidated balance sheet data as of December 31, 2007 and 2008 set forth below are derived from our audited historical consolidated financial statements included elsewhere in this annual report. The selected historical consolidated statement of operations data for the years ended December 31, 2004 and 2005 and the selected historical consolidated balance sheet data as of December 31, 2004, 2005 and 2006 set forth below are derived from our audited historical consolidated financial statements, which are not included in this annual report.

Our audited historical consolidated financial statements have been prepared and presented in accordance with the generally accepted accounting principles in the United States, or U.S. GAAP.

For the year ended December 31,

Consolidated statements of operations data	2004	2005	2006 (2)	2007	2008
	(in thousands of U.S. dollars, except shares and per shares data)				
Revenues	\$ 47,969.2	\$ 77,752.8	\$ 106,769.2	\$ 74,016.9	\$ 96,689.7
WVAS	47,185.6	74,111.8	103,974.2	70,178.8	86,911.7
Mobile games	783.6	3,041.0	2,506.0	2,835.9	7,743.3
WIS	—	—	289.0	1,002.2	2,034.7
Cost of revenues	(15,704.8)	(31,323.1)	(47,665.4)	(36,495.6)	(51,612.5)
WVAS	(15,011.7)	(29,207.4)	(45,863.4)	(34,440.3)	(46,985.4)
Mobile games	(693.1)	(2,115.7)	(1,266.0)	(1,375.9)	(3,479.8)
WIS	—	—	(536.0)	(679.4)	(1,147.3)
Gross profit	32,264.4	46,429.7	59,103.8	37,521.3	45,077.2
Operating expenses:					
Product development	(4,483.4)	(8,530.8)	(12,026.2)	(12,535.2)	(15,180.8)
Selling and marketing	(3,287.9)	(5,389.8)	(16,755.2)	(18,094.2)	(21,338.9)
General and administrative	(4,704.6)	(7,607.0)	(9,105.2)	(7,221.0)	(11,640.0)
Provision for impairment of goodwill and intangibles	—	—	—	—	(21,623.3)
Class action lawsuit settlement and legal expenses	—	(4,843.4)	—	—	—
Total operating expenses	(12,475.9)	(26,371.0)	(37,886.6)	(37,850.4)	(69,783.0)
	19,788.5	20,058.7	21,217.2	(329.1)	(24,705.8)



(Loss) Income from operations					
Other (expenses) income, net	(23.9)	6.5	(49.1)	—	—
Interest income, net	604.7	2,639.5	3,866.9	3,810.0	4,897.4
Gain on sales of investment	—	—	1,240.8	207.6	—
Net (loss) income before income taxes	20,369.3	22,704.7	26,275.8	3,688.5	(19,808.4)
Income tax expense	—	530.4	1,584.2	856.8	851.9
Net (loss) income	\$ 20,369.3	\$ 22,174.3	\$ 24,691.6	\$ 2,831.7	\$ (20,660.3)
Net income (loss) per share:					
Basic	\$ 0.02	\$ 0.02	\$ 0.02	\$ 0.00	\$ (0.01)
Diluted	\$ 0.02	\$ 0.02	\$ 0.02	\$ 0.00	\$ (0.01)
Weighted average shares used in calculating net income per share:					
Basic	903,010,929	1,377,102,380	1,399,872,743	1,423,156,120	1,424,581,293
Diluted (1)	1,250,640,982	1,424,683,570	1,418,252,296	1,430,910,421	1,424,581,293

(1) As of December 31, 2004, 2005, 2006, 2007 and 2008, we had 33,260,000, nil, 60,464,840, 82,346,060 and 137,452,493 ordinary share equivalents, respectively, outstanding that could potentially dilute income per share in the future, but that were excluded in the computation of diluted income per share in the periods, because the exercise prices of such ordinary share equivalents were above the average market values of our ordinary shares in 2004, 2005, 2006 and 2007 and the inclusion of such ordinary share equivalents would have an anti-dilutive effect in 2008 due to a net loss per share in 2008.

(2) The amounts of share-based compensation included in operating expenses for 2006, 2007 and 2008 reflect the adoption of Statement of Financial Accounting Standard No. 123 (revised 2004), or SFAS 123(R), "Share-Based Payment," effective on January 1, 2006. If our company had applied the fair value recognition provisions of SFAS 123(R) to prior periods, it would have reported net income of \$19.5 million and \$20.7 million for 2004 and 2005, respectively, and net income per share (diluted) of \$0.02 and \$0.01 for 2004 and 2005, respectively.

Consolidated balance sheet data	As of December 31,				
	2004	2005	2006	2007	2008
	(in thousands of U.S. dollars)				
Cash and cash equivalents	\$ 90,714.1	\$ 117,141.5	\$ 131,402.0	\$ 122,342.7	\$ 136,054.3
Accounts receivable, net	10,198.8	10,833.9	11,568.6	14,992.9	16,196.0
Property and equipment, net	2,484.2	3,116.4	3,100.8	4,498.1	3,369.3
Acquired intangible assets, net	—	260.6	1,997.6	1,266.3	673.4
Long-term investment	—	500.0	—	—	2,963.0
Goodwill	—	1,169.1	15,835.9	34,918.7	15,683.1
Total assets	104,372.7	135,083.2	166,741.0	181,891.9	178,852.4
Total current liabilities	4,443.6	11,285.3	10,821.5	11,293.1	18,108.7
Total shareholders' equity	99,808.3	123,773.7	155,777.0	170,475.8	160,688.2
Total liabilities, minority interests and shareholders' equity	104,372.7	135,083.2	166,741.0	181,891.9	178,852.4
		For the year ended December 31,			
Consolidated cash flow data	2004	2005	2006	2007	2008
	(in thousands of U.S. dollars)				
Net cash (used in) provided by:					
Operating activities	\$ 15,844.7	\$ 29,569.0	\$ 28,010.2	\$ 3,315.3	\$ 12,521.5
Investing activities	(2,430.2)	(4,081.7)	(17,916.5)	(18,720.1)	(4,811.9)
Financing activities	73,555.5	205.8	2,190.3	152.2	(759.3)

#### Exchange Rate Information

We present our historical consolidated financial statements in U.S. dollars. In addition, this annual report contains translations of certain Renminbi amounts to U.S. dollar amounts for transactions denominated in Renminbi. Unless otherwise specified or indicated by context, the translations of Renminbi amounts into U.S. dollar amounts have been made at the rate of RMB6.8353 = US\$1.00, the base exchange rate set by the People's Bank of China, China's central bank, at 0:00 a.m., Beijing time, on December 31, 2008. The translations are not a representation that the Renminbi amounts could actually be converted to U.S. dollars at this rate. For a discussion of the exchange rates used for the presentation of our financial statements, see note 2 to our financial statements.

The People's Bank of China sets and publishes daily a base exchange rate with reference primarily to the supply and demand of Renminbi against a basket of currencies in the market during the prior day. The People's Bank of China also takes into account other factors such as the general conditions existing in the international foreign exchange

markets. Although PRC governmental policies were introduced in 1996 to reduce restrictions on the convertibility of Renminbi into foreign currency for current account items, conversion of Renminbi into foreign exchange for capital items, such as foreign direct investment, loans or security, requires the approval of the State Administration for Foreign Exchange and other relevant authorities. We make no representation that the Renminbi or U.S. dollar amounts referred to in this annual report could have been or could be converted into U.S. dollars or Renminbi, as the case may be, at any particular rate or at all.

The noon buying rate in New York City for cable transfers as certified for customs purposes by the Federal Reserve Bank of New York was RMB 6.8250 = US\$1.00 on April 24, 2009. The following table sets forth the high and low noon buying rates between Renminbi and U.S. dollars for each of the periods shown:

Period	Noon Buying Rate RMB per \$1.00	
	High	Low
October 2008	6.8521	6.8171
November 2008	6.8373	6.8220
December 2008	6.8842	6.8225
January 2009	6.8403	6.8225
February 2009	6.8470	6.8241
March 2009	6.8438	6.8240
April 2009 (through April 24, 2009)	6.8361	6.8250

The following table sets forth the average noon buying rates between Renminbi and U.S. dollars for each of 2004, 2005, 2006, 2007, 2008 and 2009 (through April 24, 2009), calculated by averaging the noon buying rates on the last day of each month of the periods shown:

Period	Average Noon Buying Rate RMB per \$1.00
2004	8.2768
2005	8.1826
2006	7.9579
2007	7.5806
2008	6.9193
2009 (through April 24, 2009)	6.8342

#### Capitalization and Indebtedness

Not applicable.

#### Reasons for the Offer and Use of Proceeds

Not applicable.

## Risk Factors

You should consider carefully all of the information in this annual report, including the risks and uncertainties described below. If any of the following risks actually occurs, our business, financial condition or results of operations could be harmed. In such an event, the trading price of our ADSs, could decline and you might lose all or part of your investment.

### Risks Relating to Our Business

We depend on China Mobile and other PRC telecommunications operators for the majority of our revenues, and any loss or deterioration of our relationship with these telecommunications operators may result in severe disruptions to our business operations and the loss of the majority of our revenues.

We derive substantially all of our revenues from the provision of WVAS and mobile games through the networks of the PRC telecommunications operators. We rely primarily on the networks of China Mobile Communications Corporation, or China Mobile, to deliver our services. For each of the two years ended December 31, 2007 and December 31, 2008, we derived 75% of our total revenues from our cooperation arrangements with China Mobile. The remainder of our revenues is derived from cooperation arrangements with China United Telecommunications Corporation, or China Unicom (which acquired China Network Communications Group Corporation, or China Netcom, in October 2008), and China Telecommunications Corporation, or China Telecom.

Through Beijing AirInbox Information Technologies Co., Ltd., or Beijing AirInbox, Beijing Boya Wuji Technologies Co., Ltd., or Beijing Boya Wuji, Beijing Wireless Interactive Network Technologies Co., Ltd., or Beijing WINT, Beijing Chengxitong Information Technology Co., Ltd., or Beijing Chengxitong, Beijing Xinrui Technology Co., Ltd., or BJXR, and Shanghai Mailifang Communications Ltd., or Mailifang, as the case may be, we have entered into a series of cooperation agreements with China Mobile and other PRC telecommunications operators and their provincial subsidiaries to provide WVAS and mobile games through the telecommunications operators' networks. Pursuant to our agreements with the telecommunications operators, the telecommunications operators bill and collect fees from phone users for the WVAS and mobile games we provide. Our agreements with the telecommunications operators are generally for terms of one year or less and they do not all have automatic renewal provisions. We usually renew these agreements or enter into new ones when the prior agreements expire, but on occasion the renewals or new contracts can be delayed by periods of one month or more.

Furthermore, telecommunications operators may discontinue the use of external WVAS providers such as our company. If any of the PRC telecommunications operators ceases to cooperate with us, it is unlikely that such operator's customers will continue to use our services. In particular, if China Mobile ceases to cooperate with us, it is unlikely that we will be able to build up sufficient new customers through the networks of other PRC telecommunications operators to develop a customer base comparable to that which we have developed through China Mobile. Due to our reliance on China Mobile and other PRC telecommunications operators to deliver our WVAS and mobile games to our customers, any loss or deterioration of our relationship with China Mobile or other PRC telecommunications operators may result in severe disruptions to our business operations, the loss of the majority of our revenues and a material adverse effect on our financial condition and results of operations.

In addition, in May 2008, in order to optimize the allocation of telecommunications resources in the PRC and improve the competitive landscape, the MII, the National Development and Reform Commission and the Ministry of Finance jointly announced a policy initiative to further reform the PRC telecommunications industry by encouraging the formation of three telecommunications services providers of comparable scale and standing, each with nationwide network resources, full-service capabilities and competitive strength, by way of a series of restructuring transactions. Under this initiative, China Unicom acquired China Netcom, China Telecom purchased the code-division multiple access, or CDMA, network and related business from China Unicom and China Mobile acquired China Tietong

Telecommunications Corporation, a fix-line telecommunications services provider, in 2008. In January 2009, the MII issued licenses for operating businesses on the third-generation standard, or 3G, of wireless telecommunications transmissions to China Mobile, China Unicom and China Telecom. We cannot predict at this point the precise impact that the restructuring transactions or the issuance of the 3G licenses may have on our business and prospects, particularly our relationship with China Mobile and other PRC telecommunications operators. While we are currently assessing the impact that the restructuring transactions or the issuance of the 3G licenses may have on us, we cannot assure you that any potential change in the telecommunications industry in the PRC would not impact our relationship with telecommunications operators or such change would not have a material adverse effect on our business or results of operations.

The termination or alteration of our cooperation agreements with China Mobile or other PRC telecommunications operators would materially and adversely impact our business operations and financial conditions.

Our negotiating leverage with China Mobile and other PRC telecommunications operators is limited because China Mobile and other PRC telecommunications operators operate the telecommunications networks through which we deliver our products and services to mobile phone users. Our revenues and profitability could be materially and adversely affected if China Mobile or other PRC telecommunications operators decide to change the terms of the cooperation agreements with us, such as materially increase their transmission fees or service fees or do not comply with the terms of such agreements.

In addition, China Mobile or other PRC telecommunications operators could impose monetary penalties upon us or even terminate cooperation with us under the terms of the cooperation agreements with us, for a variety of reasons, such as the following:

- if we fail to achieve the performance standards established by the relevant operator from time to time;
- if we breach certain provisions under the agreements, which include, in many cases, the obligation not to deliver content that violates the relevant operator's policies and applicable law; or
- if the relevant operator receives a high level of customer complaints about our services.

Due to our dependence on our relationship with China Mobile and other PRC telecommunications operators, any termination or material alteration of our cooperation agreements with China Mobile or other PRC telecommunications operators would materially and adversely impact our business operations and financial conditions.

We cannot guarantee that China Mobile or any of the other PRC telecommunications operators will not impose penalties upon us in the future, and such penalties could have a material impact on our results of operations. In August 2004, China Mobile notified us that it had imposed sanctions on 22 WVAS providers, including us. In our case, the notice stated that China Mobile had determined that one of our interactive voice response, or IVR, services in early June 2004 had contained inappropriate content. For this infraction, China Mobile suspended until the end of 2004 approval of our new applications for new products and services on all platforms and also suspended joint promotions with us. In addition, China Mobile suspended for one year, until June 30, 2005, the approval of our applications to operate on new platforms.

Significant changes in the policies or guidelines of China Mobile or other PRC telecommunications operators with respect to services provided by us may result in lower revenues or additional costs for us and materially adversely affect our business operations, financial condition or results of operations.

China Mobile or other PRC telecommunications operators may from time to time issue policies or guidelines, requesting or stating their preferences for certain actions to be taken by all WVAS providers using their networks. Due to our reliance on China Mobile and other PRC telecommunications operators, a significant change in their policies or guidelines may result in lower revenues or additional operating costs for us. We cannot assure you that our financial condition and results of operations will not be materially adversely affected by policy or guideline changes by China Mobile or other PRC telecommunications operators.

For example, since the second half of 2004, China Mobile and its provincial subsidiaries have been gradually implementing a series of policies designed to improve customer service and satisfaction. These policies include:

- not charging customers on their monthly statements for multimedia messaging service, or MMS, that cannot be delivered because of network or handset problems;
- canceling monthly subscriptions of customers who have not accessed their WVAS subscriptions for a certain period of time;
- implementing more complicated procedures for customers to confirm new monthly subscriptions to certain WVAS; and
- removing from subscriber lists those customers who fail to pay China Mobile or the provincial subsidiaries, or who cannot be billed because they use pre-paid telecommunications service cards.

On July 6, 2006, China Mobile announced a series of additional measures with respect to the billing of customers of WVAS on its network, with focus on customers' monthly subscriptions to WVAS. Among the measures announced by China Mobile, those which have had a significant impact on our results of operations and financial condition are summarized as follows:

- beginning July 10, 2006, for any new monthly subscriptions to WVAS, China Mobile sends customers two reminder notices prior to charging monthly subscription fees in the customers' monthly mobile phone bills, and customers must confirm twice, once in response to each reminder, that they wish to subscribe to those services on a monthly basis. Previously, China Mobile sent one reminder notice immediately after a monthly subscription order was placed, and customers needed to confirm only once;
- customers enjoy a free trial period of 11 to 41 days, depending on the day of the month on which they place their monthly subscriptions. Previously, customers enjoyed a free trial period of three to 11 days; and
- China Mobile cancels wireless application protocol, or WAP, monthly subscriptions that have not been active for more than four months.

During the fourth quarter of 2006, other PRC telecommunications operators also began implementing new policies requiring double confirmation of monthly subscriptions. In May 2007, China Mobile started to send to its customers' handsets notices of transmission fees to be incurred by using general packet radio services, or GPRS, when those customers launched their browsers, which discouraged some customers from purchasing our WAP products or visiting our wireless Internet sites Kong.net and Ko.cn.

Mainly because of these new policies and measures of the telecommunications operators, our WVAS revenues in 2007 decreased 32.5% as compared to 2006. We cannot assure you that China Mobile or other PRC telecommunications operators will not introduce additional requirements with respect to the procedures for ordering monthly subscriptions or single-transaction downloads of our WVAS, notifications to customers, the billing of customers or other consumer-protection measures, or adopt other policies that may require significant changes in the way we promote and sell our WVAS and develop our wireless Internet sites, any of which new requirements or policies could have a material adverse effect on our financial condition and results of operations.



Competition with the competing services offered by China Mobile and other PRC telecommunications operators may lower our revenues and materially adversely affect our business operations, financial condition and results of operations.

The PRC telecommunications operators have launched services competing with ours. For example, China Mobile has begun to develop and market its own MMS and WAP products that compete with ours. The PRC telecommunications operators may launch additional competing services in the future. Similar to our practice, China Mobile and other PRC telecommunications operators have entered into cooperation agreements with mobile handset manufactures to pre-load their icons and codes in new handsets to make it easier for handset users to access and subscribe to the WVAS provided by China Mobile and other telecommunications operators. Furthermore, in the past, China Mobile entered into strategic alliances with selected handset manufacturers pursuant to which it embedded menus in their handsets for all the best-selling products on China Mobile's Monternet™ wireless portal, including certain of our products. However, beginning in May 2007, China Mobile has promoted only its own WVAS products in such menus and not those of ours or other third-party WVAS providers. In addition, we have developed our own wireless Internet sites, Kong.net and Ko.cn, which are independent of the wireless Internet portals of China Mobile and other PRC telecommunications operators and which China Mobile and other PRC telecommunications operators may view as engaging in direct competition with their Internet sites. Competition with the competing services offered by China Mobile and other PRC communications operators may lower our revenues and harm our relationship with China Mobile and other PRC telecommunications operators, which may materially adversely affect our business operations, financial condition and results of operations.

Our dependence on the substance and timing of the billing systems of the telecommunications operators and their subsidiaries may require us to estimate portions of our reported revenues and cost of revenues for WVAS and mobile games. As a result, subsequent adjustments may have to be made to our financial statements.

As we do not bill our WVAS and mobile games customers directly, we depend on the billing systems and records of the telecommunications operators to record the volume of our WVAS and mobile games provided, bill our customers, collect payments and remit to us our portion of the fees. We record revenues based on monthly statements from the telecommunications operators confirming the value of our services that the telecommunications operators billed to customers during the month. It is our practice to release our unaudited quarterly financial statements to the market. Due to our past experience with the timing of receipt of the monthly statements from the operators, we expect that we may need to rely on our own internal estimates for the portion of our reported revenues and cost of revenues for which we will not have received monthly statements. In such an instance, our internal estimates would be based on our own internal data of expected revenues and related fees from services provided. As a result of reliance on our internal estimates, we may overstate or understate our revenues and cost of revenues for the relevant reporting period, and may be required to make adjustments in our financial reports when we actually receive the telecommunications operators' monthly statements for such period. We endeavor to reduce the discrepancy between our revenue estimates and the revenues calculated by the telecommunications operators and their subsidiaries, but we cannot assure you that such effort will be successful. Moreover, to the extent that the telecommunications operators may take longer to send us monthly statements, we may be required to increase our reliance on our internal estimates when preparing our quarterly financial statements. For example, beginning with the statement for April 2007, it has taken China Unicom on average about 105 days as compared to about 40 days it previously had taken to send us a statement after the end of each month. As a result, estimated revenues may account for a larger proportion of our reported revenues during 2007 and 2008 than in previous years. If we are required to make adjustments to our quarterly financial statements in subsequent quarters, it could adversely affect market sentiment toward us.

In addition, we generally do not have the ability to independently verify or challenge the accuracy of the billing systems of the telecommunications operators. We cannot assure you that any negotiations between us and telecommunications operators to reconcile billing discrepancies would be resolved in our favor or that our results of operations would not be adversely affected as a result. See "Item 5 — Operating and Financial Review and Prospects —

Critical Accounting Policies — Revenue Recognition.”

Our effort to develop additional distribution channels for our WVAS and mobile games may not succeed or may be restricted or halted by the MII or the telecommunications operators.

Cooperation with mobile handset manufacturers has provided us with an important distribution channel for our WVAS and mobile games. We pre-load into the menus of certain mobile handsets our mobile games, WAP icons and short codes for products offered on the MMS, short messaging service, or SMS, Java™ and IVR platforms. A consumer who buys a new handset pre-loaded with our mobile games, icons and codes can access and subscribe to our services quickly and easily. Over the years, cooperation with mobile handset manufacturers has become one of the most important distribution channels for us and a significant portion of our revenues is derived from such cooperation. However, in recent years, China Mobile and other PRC telecommunications operators have entered into cooperation agreements with mobile handset manufacturers similar to our agreements with mobile handset manufactures. We cannot guarantee that mobile handset manufacturers will continue their cooperation with us or maintain their current revenue-sharing arrangements with us.

In addition, we cannot guarantee that the MII, China Mobile or other PRC telecommunications operators will not restrict or halt our cooperation with the mobile handset manufacturers. For example, in addition to pre-loading our mobile games, WAP icons and MMS, SMS, Java™ and IVR short codes into the menus of selected mobile handsets, until recently we also embedded our icons and codes in selected handsets. On April 11, 2007, the MII issued a notice barring the production of mobile handsets with embedded icons and codes that cannot be changed or deleted by consumers. We have altered our arrangements with mobile handset manufacturers to comply with the notice, which took effect on June 1, 2007. Although mobile handset manufacturers are still permitted to pre-load our icons into the handset menus as long as such icons can be changed, such as change to other WVAS providers' icons, or deleted, we cannot assure you that the MII will not expand its regulation to bar pre-loading icons and codes in the future.

Beginning in May 2007, China Mobile has promoted only its own WVAS products and not those of ours or other third-party value-added service providers in the embedded menus of those handsets with whose manufacturers China Mobile has entered into strategic alliance. We cannot assure you that China Mobile or other telecommunications operators will not take other steps to limit or halt our use of mobile handsets as a distribution channel. Any further actions by the telecommunications operators or the MII to limit or halt our use of mobile handsets as a distribution channel could materially adversely affect our revenues and growth of revenues.

We have made significant effort in developing our mobile games business, based on the expectation that such business could contribute a significant part of our revenues in the future, but our mobile games business has a short operating history, which may make it difficult for us to evaluate such business, and the mobile games market in the PRC is subject to many uncertainties, which may prevent us from generating significant revenues from offering mobile games.

We have made significant effort in recent years, especially in 2008, in developing our mobile games business, which includes our downloadable mobile games and online mobile games. Prior to 2008, we operated in two segments, WVAS and WIS. As our mobile games business grows, it has required separate management in respect of decision making, allocation of resources and assessment of performance. We anticipate that mobile games could provide significant contributions to our future revenues. As a result, we started to have three operating segments in 2008, WVAS, mobile games and WIS. However, our mobile games business, especially our online mobile games, has a short operating history. We launched our first online mobile game on China Mobile's Online Game Platform in September 2008. As a result, we have limited financial data that can be used to evaluate our mobile games business and its potential to generate revenues in the future. Moreover, our past success and financial data regarding the mobile games segment may not be indicative of our future performance. We cannot guarantee that we will be successful in developing our mobile games business, which will depend, among other things, on our abilities to:

- respond to market developments, including the development of new platforms and technologies, and changes in pricing and distribution models;
- maintain and diversify our distribution channels, including through our own wireless Internet sites and handset manufacturers;
- develop new high-quality mobile games that can achieve significant market acceptance, and timely improve our existing mobile games to extend their life spans and to maintain their competitiveness in the mobile games market;
- supplement our internally developed mobile games by acquiring mobile games from third-party mobile games developers or cooperating with third-party mobile games developers to jointly develop mobile games;
- develop and upgrade our technologies;
- execute our business and marketing strategies successfully; and



- attract, integrate, retain and motivate qualified personnel.

In addition, the mobile games market is an emerging market in the PRC. The growth of this market and the level of demand and market acceptance of our mobile games are subject to many uncertainties. The development of this market and our ability to derive revenues from this market depend on a number of factors, some of which are beyond our control, including but not limited to:

- the growth rate of mobile data services in the PRC;
- changes in consumer demographics and public tastes and preferences;
- potential competition from established companies that develop and operate personal-computer-based online games and may enter the mobile online game market; and
- the popularity and price of new mobile games and merchandise and premium features embedded in games that we and our competitors may launch and distribute in the future.

Due to the uncertainties in connection with our mobile games business in particular and the mobile games market in the PRC generally, we cannot guarantee that our mobile games business would contribute significantly to our future revenues. Our failure to successfully develop this business could have a material adverse effect on our business operations, financial condition and results of operations.

Our effort to develop our wireless Internet sites is based on the expectation that the sale of advertising on our wireless Internet sites could become a more significant part of our future revenues, but the mobile advertising market is subject to many uncertainties that could prevent us from generating significant revenues from advertising.

We have expended significant effort in recent years in developing our wireless Internet sites, Kong.net and Ko.cn, with the expectation that the sale of advertising on these sites will provide more significant contributions to future revenues. However, the growth of mobile advertising in the PRC is subject to many uncertainties. Many of our current and potential advertisers have limited experience with wireless Internet sites as an advertising medium, have not traditionally devoted a significant portion of their advertising expenditures to mobile advertising, and may not find mobile advertising to be effective for promoting their products or services relative to traditional print, broadcast or Internet media. Our ability to generate and maintain significant advertising revenue will depend on a number of factors, many of which are beyond our control, including but not limited to:

- the development and retention of a large base of wireless Internet users possessing demographic characteristics attractive to advertisers;
  - the maintenance and enhancement of our brand in a cost-effective manner;
  - the level of competition and its impact on mobile advertising prices;
- changes in government policies or the policies of the PRC telecommunications operators that could curtail or restrict our mobile advertising services;
  - the acceptance of mobile advertising as an effective way for advertisers to market their business;
- the development of independent and reliable means of verifying levels of mobile advertising and wireless Internet traffic; and

- the effectiveness of our advertising delivery, tracking and reporting systems.

If any developments impede the establishment of the wireless Internet generally as an accepted medium for advertising or the ability of our wireless Internet sites specifically to attract significant advertising, our ability to generate increased mobile advertising revenue could be negatively affected.

We face increasing competition in the PRC from providers of WVAS, mobile games and wireless Internet services, which could reduce our market share and materially adversely affect our financial condition and results of operations.

The PRC WVAS market has seen increasingly intense competition. The MII reported on its website that more than 1,700 service providers held nationwide licenses as of April 8, 2009 to supply WVAS on the PRC telecommunications operators' networks. We compete with these companies primarily on the basis of brand, price, type and timing of service offerings, content, customer service, business partners and distribution channel relationships. We also compete for experienced and talented employees. While we believe that we have certain advantages over our competitors, some of them may have more human and financial resources and a longer operating history than we do. For example, Internet portal companies that provide WVAS may have an advantage over us with their more established brand names, user base and Internet distribution channels. Furthermore, our competitors may be able to develop or exploit new technologies faster than we can, or offer a broader range of products and services than we are presently able to offer.

The development, distribution and sale of mobile games are also highly competitive in the PRC. We compete for customers, primarily on the basis of game quality, brand and price. We compete for telecommunications operators to distribute our mobile games, primarily on the basis of the popularity of our games among customers, our historical performance, perception of our sales potential and our relationships with content and brand licensors. We compete for content and brand licensors who supply game content and brands, primarily on the basis of the economic terms, such as royalty rates, of our cooperation agreements with the licensors, the licensors' perception of our ability to develop games and pre-load games in mobile handsets, our speed of execution, diversity of distribution channels and relationships with telecommunications operators. We also compete for experienced and talented employees in the mobile games business. Furthermore, the entry of new competitors, such as developers of personal-computer-based online games, major media companies, traditional video game developers, content aggregators, mobile software providers and independent mobile games developers, would likely intensify competition in the mobile games market. Growing competition in this market could make it difficult for us to maintain and increase our market share and have a material adverse effect on our business operations, financial condition and results of operations.

In addition, barriers to entry of wireless Internet services are relatively low and current and new competitors can launch new wireless Internet sites at a relatively low cost. We compete with the operators of other wireless Internet sites for visitors, employees and advertisers, and also compete with traditional media companies such as newspapers, television networks and radio stations for advertisers.

Also, China Mobile has begun to develop and market its own MMS, WAP and other wireless Internet services that compete with ours. Other PRC telecommunications operators may decide to do the same. If the PRC telecommunications operators decide to enter the mobile games market, they may refuse or limit the distribution of some or all of our mobile games or deny us access to all or parts of their networks. The PRC telecommunications operators' Internet sites also compete with our wireless Internet sites. Growing competition from the telecommunications operators could have a material adverse effect on our business operations, financial condition and results of operations.

We have a limited operating history and operate in an evolving and highly dynamic market, which may make it difficult for you to evaluate our business.

We were incorporated in May 2002. Because we have a limited operating history and operate in an evolving and highly dynamic market, the revenues and income potential of our business and markets are unproven and our

historical operating results may not be useful to you for evaluating our business or predicting our future operating results. In addition, we face numerous risks, uncertainties, expenses and difficulties frequently encountered by companies at an early stage of development. Some of these risks and uncertainties relate to our ability to:

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- maintain our current cooperation arrangements and develop new cooperation arrangements upon which our business depends;
- increase the number of our users by expanding the type, scope and technical sophistication of the content and services we offer;
  - respond effectively to competitive pressures;
  - increase awareness of our brand and continue to build user loyalty; and
  - attract and retain qualified management and employees.

We cannot predict whether we will meet internal or external expectations of our future performance. If we are not successful in addressing these risks and uncertainties, our business, financial condition and results of operations may be materially adversely affected.

Our historical financial information may not be indicative of our future results of operations.

We historically experienced rapid growth in our business in some years in part due to the growth in the WVAS industry in the PRC, and such industry growth may not be indicative of future growth. In addition, we are developing new businesses such as mobile games and wireless Internet services, or WIS. We cannot assure you that our historical financial information is indicative of our future operating or financial performance, or that our profitability will be resumed and sustained.

Our operating results may fluctuate as a result of a number of factors, many of which are outside of our control. For these reasons, comparing our operating results on a period-to-period basis may not be meaningful, and you should not rely on our past results as an indication of our future performance. Our quarterly and annual revenues and costs and expenses as a percentage of our revenues may be significantly different from our historical or projected rates. Our operating results in future quarters may fall below expectations. Any of these events could cause the price of our ADSs to fall. Any of the risk factors listed in this “Risk Factors” section, and in particular, any of the possible developments indicated below, could cause our operating results to fluctuate from quarter to quarter:

- any changes in our relationship with telecommunications operators in the PRC;
- any changes in the regulatory regime or the policies for the PRC telecommunications industry, including changes in the structure or functions of the primary industry regulator, MII, or its policies, or the policies or other regulatory measures of other relevant government or industry authorities relating to, among other matters, the granting and approval of licenses, procedures for customers to access and subscribe to WVAS or mobile games, restrictions on wireless Internet content, or the introduction of new technology platforms, products and services;
  - the effects of competition on the demand for or the price of our products or services;
  - any changes in customer demand or usage preference for our products or services;
- any changes in the telecommunications operators’ systems for billing users of our WVAS or mobile games or remitting payments to us;
- any changes in technologies related to telecommunications, WVAS, mobile games or wireless Internet or applications based on such technologies;

- any changes in political, economic, legal or social conditions in the PRC, including the PRC government's specific policies with respect to foreign investment and entry by foreign companies into the telecommunications, WVAS, mobile games or wireless Internet market, economic growth, inflation, foreign exchange or the availability of credit; and

- changes in population growth or GDP growth or the impact of those changes on the demand for our products or services.

The trading price of our ADSs has been volatile and may continue to be volatile regardless of our operating performance.

The trading price of our ADSs has been and may continue to be subject to wide fluctuations. During the period from July 9, 2004, the first day on which our ADSs were listed on Nasdaq, until April 24, 2009, the closing prices of our ADSs ranged from \$2.44 to \$15.04 per ADS and the closing price on April 24, 2009 was \$6.44 per ADS. The market price for our ADSs may continue to be volatile and subject to wide fluctuations in response to factors including, among others, the following:

- China Mobile and other PRC telecommunications operators' future policies and measures taken toward WVAS providers;
  - actual or anticipated fluctuations in our quarterly operating results;
  - changes in financial estimates by securities research analysts;
  - conditions in the WVAS, mobile games, wireless Internet, mobile advertising and mobile games markets;
- changes in the economic performance or market valuations of other companies that are perceived to be comparable to us;
- announcements by us or our competitors of new products, acquisitions, strategic partnerships, joint ventures or capital commitments;
  - addition or departure of key personnel;
  - fluctuations of exchange rates between RMB and the U.S. dollar;
  - intellectual property litigation;
  - general conditions in the global financial markets; and
  - general economic or political conditions in the PRC.

The stock market in general and the market prices for Internet and wireless Internet related companies with operations in the PRC in particular, have experienced volatility that has sometimes been unrelated to the operating performance of such companies. These broad market and industry fluctuations may adversely affect the price of our ADSs, regardless of our operating performance. In addition, sales of our ADSs in the public market, or the perception that such sales could occur, could cause the market price of our ADSs to decline. Certain of our executive officers who hold our shares or ADSs may sell their shares or ADSs subject to applicable volume and other restrictions under Rule 144 of the Securities Act. To the extent that such shares or ADSs are sold into the market, the market price of our ADSs could decline.

Our business and growth prospects may be severely disrupted if we lose the services of our key personnel, and we may not be able to grow effectively if we cannot attract and retain skilled management.

Our future success depends heavily upon the continued service of our key executives. In particular, we rely on the expertise and experience of Leilei Wang, the Chairman of our Board of Directors and our Chief Executive Officer, in our business operations, and on his personal relationships with the regulatory authorities, our clients, our suppliers, the telecommunications operators and our operating companies, Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong, BJXR, Tianjin Mammoth Technology Co., Ltd., or Tianjin Mammoth, and Mailifang. If Leilei Wang becomes unable or unwilling to continue in his present positions, or if he joins a competitor or forms a competing company in contravention of his employment agreement, we may not be able to replace him easily, our business may be significantly disrupted and our financial condition and results of operations may be materially adversely affected.

In addition, the incentives to attract and retain employees, in particular skilled management personnel, provided by our equity incentive plans may not be as effective as in the past, in light of the volatility of market conditions and the price of our ADSs in recent years. If we do not succeed in attracting skilled management personnel or retaining or motivating existing management personnel, we may be unable to manage or develop our business effectively.

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

In December 2001, in order to comply with the PRC's commitments with respect to its entry into the World Trade Organization, or the WTO, the State Council of the PRC promulgated the Administrative Rules for Foreign Investments in Telecommunications Enterprises, or the 2001 Telecom FIE Rules. In September 2008, the State Council promulgated the Decision of the State Council on Amending Provisions on the Administrative Rules for Foreign Investments in Telecommunications Enterprises, or the Decree of the State Council No. 534, or together with the 2001 Telecom FIE Rules, the Telecom FIE Rules. The Telecom FIE Rules set forth detailed requirements with respect to capitalization, investor qualifications and application procedures in connection with the establishment of a foreign-invested telecommunications enterprise. Pursuant to the Telecom FIE Rules, the ultimate ownership interest of a foreign investor in a foreign-funded telecommunications enterprise that provides value-added telecommunications services, including Internet content services, shall not exceed 50%.

We and our subsidiaries, KongZhong Information Technologies (Beijing) Co., Ltd., or KongZhong Beijing, KongZhong China Co., Ltd., or KongZhong China, and Anjian Xingye Technology (Beijing) Co., Ltd., or Beijing Anjian Xingye, are considered foreign persons or foreign-invested enterprises under PRC laws. As a result, we operate our WVAS, mobile games and wireless Internet sites in the PRC through Beijing AirInbox, Beijing Boya Wuji, Beijing WINT (since February 2005), Beijing Chengxitong (since November 2005), BJXR (since January 2006) and Mailifang (since April 2009), each of which is owned by PRC citizens or entities. We do not have any equity interest in these operating companies and instead enjoy the economic benefits of them through contractual arrangements, including agreements on provision of loans, provision of services and certain corporate governance and shareholder rights matters. These operating companies conduct substantially all of our operations and generate substantially all of our revenues. They also hold the licenses and approvals that are essential to our business.

There are substantial uncertainties regarding the interpretation and application of current or future PRC laws and regulations, including but not limited to the laws and regulations governing the validity and enforcement of our contractual arrangements. Accordingly, we cannot assure you that PRC regulatory authorities will not determine that our contractual arrangements with Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong, BJXR and Mailifang violate PRC laws or regulations.

If we or our operating companies were found to violate any existing or future PRC laws or regulations, the relevant regulatory authorities would have broad discretion in dealing with such violation, including, without limitation, the following:

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- levying fines;
- confiscating our or our operating companies' income;
- revoking our or our operating companies' business license;
- shutting down our or our operating companies' servers or blocking our or our operating companies' websites;
- restricting or prohibiting our use of the proceeds from our initial public offering to finance our business and operations in the PRC;
  - requiring us to revise our ownership structure or restructure our operations; and/or
  - requiring us or our operating companies to discontinue our respective businesses.

Any of these or similar actions could cause significant disruptions to our business operations or render us unable to conduct our business operations and may materially adversely affect our business, financial condition and results of operations.

Our contractual arrangements with Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong, BJXR and Mailifang may not be as effective in providing operational control as direct ownership of these businesses and may be difficult to enforce.

PRC laws and regulations currently restrict foreign ownership of companies that provide value-added telecommunications services, which include WVAS, mobile games and Internet content services. As a result, we conduct substantially all of our operations and generate substantially all of our revenues through Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong, BJXR and Mailifang pursuant to a series of direct or indirect contractual arrangements with them and their respective shareholders. These agreements may not be as effective in providing control over our operating companies as direct ownership. In particular, our operating companies could fail to perform or make payments as required under the contractual agreements, and we will have to rely on the PRC legal system to enforce these agreements, which we cannot be certain would be effective.

Failure to achieve and maintain effective internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act of 2002 could have a material adverse effect on our business, our results of operations and the market price of our ADSs.

We are subject to reporting obligations under the U.S. securities laws. We are required by the U.S. Securities and Exchange Commission, or SEC, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley Act, to include a report by our management on our internal control over financial reporting in our Annual Reports on Form 20-F that contains an assessment by management of the effectiveness of our internal control over financial reporting. In addition, our Annual Reports on Form 20-F shall include an independent registered public accounting firm's attestation report on the effectiveness of our internal control over financial reporting.

Although our management and an independent registered public accounting firm have concluded that our internal controls over our financial reporting were effective as of December 31, 2008, the end of the period covered by this annual report, we may fail to maintain effective internal controls over financial reporting in the future, in which case we and the independent registered public accounting firm may not be able to conclude that we have effective internal control over financial reporting at a reasonable assurance level. In addition, even if our management concludes at the end of future reporting periods that our internal controls are effective, the independent registered public accounting firm may disagree. If such independent registered public accounting firm is not satisfied with our internal control over

financial reporting or the level at which our internal control over financial reporting is documented, designed or operated, or if such independent registered public accounting firm interprets the requirements, rules or regulations differently from us, then it may issue an adverse opinion. Any of these possible outcomes could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our consolidated financial statements, which ultimately could have a material adverse effect on the market price of our ADSs. We also may need to incur significant costs and use significant management and other resources in an effort to comply with Section 404 of the Sarbanes-Oxley Act and other requirements.

Moreover, 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 control over financial reporting can provide only reasonable assurance with respect to the preparation and fair presentation of financial statements. If we fail to maintain the adequacy of our internal control over financial reporting, including any failure to implement required new or improved controls, or if we experience difficulties in their implementation, our business and operating results could be harmed, we could fail to meet our reporting obligations, and there could be a material adverse effect on the market price of our ADSs.

Business growth and a rapidly changing operating environment may strain our limited resources.

We have limited operational, administrative and financial resources, which may be inadequate to sustain the growth we want to achieve. As our user base increases, we will need to increase our investment in our technological infrastructure, facilities and other areas of operations. In particular, our product development, customer service and sales and marketing are important to our future success. If we are unable to manage our growth and expansion effectively, the quality of our services and our customer support may deteriorate and our business may suffer. For example, any deterioration in performance could prompt China Mobile or other PRC telecommunications operators to cease offering our services over their networks. Our future success will depend on, among other things, our ability to:

- develop and quickly introduce new services, adapt our existing services and maintain and improve the quality of all of our services, particularly as new mobile technologies such as 3G are introduced;
  - effectively maintain our relationships with China Mobile and other PRC telecommunications operators;
- expand the percentage of our revenues that are recurring and are derived from monthly subscription-based services;
  - enter into and maintain relationships with desirable content providers;
- continue training, motivating and retaining our existing employees, attract new employees and integrate new employees, including into our senior management;
  - develop and improve our operational, financial, accounting and other internal systems and controls; and
- maintain adequate controls and procedures to ensure that our periodic public disclosure under applicable laws, including U.S. securities laws, is complete and accurate.

We may need additional capital and may not be able to obtain such capital on acceptable terms.

Capital requirements are difficult to plan in our rapidly changing industry. We currently expect that we will need capital to fund our future acquisitions, service development, technological infrastructure and sales and marketing activities. Our ability to obtain additional capital on acceptable terms is subject to a variety of uncertainties, including:

- investors' perceptions of, and demand for, securities of telecommunications value-added services companies;
  - conditions of the U.S. and other capital markets in which we may seek to raise funds;



- our future results of operations, financial condition and cash flows;
- PRC governmental regulation of foreign investment in value-added telecommunications companies;
  - economic, political and other conditions in the PRC; and
  - PRC governmental policies relating to foreign currency borrowings.

Any failure by us to raise additional funds on terms favorable to us, or at all, may have a material adverse effect on our business, financial condition and results of operations. For example, we may not be able to carry out parts of our growth strategy to acquire assets, technologies and businesses that are complementary to our existing business or necessary to maintain our growth and competitiveness.

The dividends and other distributions on equity we may receive from our subsidiaries are subject to restrictions under PRC law or agreements that our subsidiaries may enter into with third parties.

We are a holding company. Our wholly-owned subsidiaries, KongZhong Beijing, KongZhong China and Beijing Anjian Xingye, have entered into contractual arrangements with Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong, BJXR and Mailifang through which we conduct business and receive revenues in the form of service fees. We rely on dividends and other distributions on equity paid by KongZhong Beijing, KongZhong China and Beijing Anjian Xingye, as well as service fees from Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong, BJXR and Mailifang, for our cash requirements in excess of any cash raised from investors and retained by us. If any of KongZhong Beijing, KongZhong China or Beijing Anjian Xingye incurs debt in the future, the instruments governing the debt may restrict its ability to pay dividends or make other distributions to us.

Furthermore, PRC law requires that payment of dividends by each of KongZhong Beijing, KongZhong China and Beijing Anjian Xingye can be made only out of their respective net income, if any, determined in accordance with PRC accounting standards and regulations. Under the PRC law, KongZhong Beijing, KongZhong China and Beijing Anjian Xingye also are required to set aside no less than 10% of their respective after-tax net income each year as reserve funds unless such reserve funds have reached 50% of their respective registered capital, and these reserves are not distributable as dividends. See note 15 to our historical consolidated financial statements included in this annual report. Any limitation on the payment of dividends by our subsidiaries could have a material adverse effect our ability to grow, fund investments, make acquisitions, pay dividends, and otherwise fund and conduct our business.

In addition, under the PRC enterprise income tax law that took effect on January 1, 2008 and its implementation regulation, a non-PRC-resident enterprise's net income originating from "sources within the PRC" will be subject a 20% enterprise income tax, or EIT, rate. Whether a dividend payment constitutes income from "sources within the PRC" is determined by the location of the enterprise which pays the dividend. Income tax on dividends from the PRC payable to a non-PRC-resident enterprise is at a rate of 10%. As a result, KongZhong Beijing, Beijing Anjian Xingye and KongZhong China may be required to withhold all or part of such income tax when paying us dividends. See "Item 5 — Operating and Financial Review and Prospects — Taxation."

The discontinuation of any of the preferential tax treatments available to us in the PRC or the rejection of our application for preferential tax treatments could adversely affect our business, operating results and financial condition.

The PRC national and local governments have provided various incentives to our subsidiaries and operating companies that are incorporated in the PRC, such as KongZhong Beijing, Beijing AirInbox, Tianjin Mammoth and BJXR due to their status as high technology enterprises. These subsidiaries and operating companies must continue to meet a number of criteria in order to continue to qualify for the preferential tax treatments currently available to them.

Moreover, the government could determine at any time to eliminate or reduce the scale of such preferential tax policies. Under the PRC enterprise income tax law that took effect on January 1, 2008 and its implementation regulation, KongZhong China, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong and Beijing Shiyuan Leya Culture Communication Co., Ltd., or Beijing Shiyuan Leya, were subject to a statutory income tax rate of 25% for 2008. Each of KongZhong China, Beijing WINT and Beijing Chengxitong is in the process of applying for the status of high technology enterprises. If the applications are approved, a preferential income tax rate of 15% would be applied to them in 2009. However, we are not certain that such application will be approved. See “Item 5 — Operating and Financial Review and Prospects — Taxation.” Any discontinuation, reduction or rejection of any of the preferential tax treatments could adversely affect our business, operating results and financial condition.

We were classified as a passive foreign investment company, or PFIC, for 2008, which resulted in adverse United States Federal income tax consequences to U.S. holders of our ADSs and may result in additional adverse United States Federal income tax consequences to such holders in subsequent years.

Based upon an analysis of the value of our assets as of December 31, 2008, we were a PFIC during 2008 for U.S. Federal income tax purposes. We have substantial passive assets in the form of cash and cash equivalents, and can provide no assurance that we will not continue to be classified as a PFIC in 2009 or future taxable years. The determination of whether we would continue to be a PFIC would be principally based upon:

- the composition of our assets, including goodwill, the amount of which will depend, in part, on our total net assets and the market value of our ordinary shares and ADSs, which is subject to change; and
- the amount and nature of our income from time to time.

We have limited control over these variables. Further, with regards to any additional capital markets or corporate finance transactions we might conduct in the future, we cannot, at this stage, specify the timing, amounts or the particular uses of the net proceeds. As a result, we cannot provide any assurance as to how the net proceeds of any such transactions would impact whether we are classified as a PFIC in any future periods.

In respect of any taxable year during which we are a PFIC, U.S. investors will be subject to adverse U.S. Federal income tax consequences (and may be subject to adverse U.S. Federal income tax consequences in subsequent years as well). For further discussion regarding our status as a PFIC, please see “Item 10 — Additional Information — Taxation — United States Taxation — PFIC Rules.” U.S. investors are urged to consult their own tax advisors regarding the application of the PFIC rules to their particular circumstances.

We have issued to Nokia Growth Partners II, L.P. a convertible senior note with an aggregate principal amount of \$6,775,400 and a warrant to purchase up to 80 million of our ordinary shares, and the conversion of the note and/or the exercise of the warrant could result in substantial dilution to the holders of our ordinary shares and ADSs and may depress the price of our ADSs.

In March 2009, we issued to Nokia Growth Partners II, L.P., or NGP, a convertible senior note due in 2014 with an aggregate principal amount of \$6,775,400, or the convertible senior note, and a warrant to purchase up to 80 million of our ordinary shares, exercisable within five years, or the warrant. The convertible senior note could be converted into up to 76 million of our ordinary shares based on the current conversion price, \$0.08915 per ordinary share, subject to possible adjustments. If the convertible senior note is converted and/or the warrant exercised, the holders of our ordinary shares and ADSs may experience substantial dilution and the market price of our ADSs could decline. The sale of the ordinary shares issued upon such conversion or exercise, or the perception that such convertible senior note might be converted, the warrant might be exercised or the ordinary shares issued upon such conversion or exercise might be sold, could also adversely affect the market price of our ADSs. Furthermore, we may issue additional securities in the future that may have a dilutive effect to the holders of our ordinary shares and ADSs.

We are subject to certain covenants in connection with the issuance of the convertible senior note and the warrant, and such covenants could have a material adverse effect on our business, financial condition and results of operations.

In connection with the issuance of the convertible senior note and the warrant to NGP, we have agreed on certain covenants. As long as NGP holds the convertible senior note or the warrant and maintains ownership of an aggregate amount of not less than 78 million of our ordinary shares comprised of the ordinary shares into which the convertible senior note is converted or convertible and for which the warrant is exercised or exercisable, we cannot, without the prior written consent of NGP, (i) authorize or issue any security senior to or pari passu with the convertible senior note or any security senior to our ordinary shares; (ii) enter into any agreement for indebtedness, including guarantees and like contingent obligations or (iii) authorize or issue any ordinary shares for an amount less than \$0.125 per ordinary share, or \$5.00 per ADS, such that the amounts of securities or obligations described in (i), (ii) and (iii) would exceed \$10,000,000, either individually or in the aggregate. Under the same conditions, we cannot, without the prior written consent of NGP, change the terms of the convertible senior note or warrant; engage in any related party transaction, other than those in the ordinary course of business, with any of our executive officers, Directors, any holder of 5% or more of our voting shares as reflected in our Register of Members or the Schedule 13D or 13E filed with the SEC, or any affiliate of our company, executive officers, Directors or such holders of our voting shares; or make any recommendation to holders of our ordinary shares or ADSs or take other actions by our Board of Directors that would materially and adversely affect NGP's rights under the convertible senior note or warrant or the ordinary shares issuable upon their respective conversion or exercise, subject to applicable laws, including laws governing the fiduciary duties of our Board of Directors, and our Amended and Restated Memorandum of Association as adopted on June 11, 2004, or Memorandum, and our Amended and Restated Articles of Association as adopted on September 6, 2005, or Articles of Association.

If we materially breach any of the above covenants and if such material breach continues for 30 days, NGP may declare the principal amount of the convertible senior note then outstanding plus any accrued but unpaid interest due and payable, and such action by NGP could have a material adverse effect on our business, financial condition and results of operations.

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

We believe the copyrights, service marks, trademarks, trade secrets and other intellectual property we use are important to our business, and any unauthorized use of such intellectual property by third parties may adversely affect our business and reputation. We rely on the intellectual property laws and contractual arrangements with our employees, clients, business partners and others to protect such intellectual property rights. Third parties may be able to obtain and use such intellectual property without authorization. Furthermore, the validity, enforceability and scope of protection of intellectual property in the WVAS, mobile games and wireless Internet industries in the PRC is uncertain and still evolving, and these laws may not protect intellectual property rights to the same extent as the laws of some other jurisdictions, such as the United States. Moreover, litigation may be necessary in the future to enforce 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.

Due to the manner in which we obtain, collect, produce and aggregate content and applications for our WVAS, mobile games and wireless Internet sites, and because our services may be used for the distribution of information, claims may be filed against us for defamation, negligence, copyright or trademark infringement or other violations. In addition, third parties could assert claims against us for losses in reliance on information distributed by us. When we license third-party content or other intellectual properties, we rely on the licensor's representations and warranties of its rights or titles to the content or intellectual properties. Although we perform reasonable due diligence, we cannot guarantee that such a licensor actually has the legal rights or titles to the content or intellectual properties that we distribute or use. We cannot guarantee that third parties will not assert claims against us or challenge the validity of

our license agreements. If we are found to have infringed any intellectual property rights of others, we may be enjoined from using such intellectual property, and we may incur licensing fees or be forced to develop alternative intellectual property. We may also incur significant costs in investigating and defending the claims even if they do not result in liability. We have not purchased liability insurance for these types of claims.

We are not able to register the Chinese name of our service mark “KongZhong Network” in the PRC, and we may not be able to effectively prevent its unauthorized use by third parties.

We are unable to register the Chinese name of “KongZhong Network” as our service mark because it is deemed a generic term under existing PRC trademark laws and regulations, which prohibit registration of generic terms as trademarks or service marks. As a result, we may not be able to effectively prevent the unauthorized use of the Chinese name of our service mark, “KongZhong Network,” and our brand name and reputation may be adversely affected by such unauthorized use.

Future acquisitions may have an adverse effect on our ability to manage our business.

Selective acquisitions form part of our strategy to further expand our business. We made three acquisitions in 2005, one in 2006, nil in 2007, nil in 2008 and two in 2009 to the date of March 31, 2009. If we are presented with appropriate opportunities, we may acquire additional businesses, technologies, services or products that are complementary to our business. Any acquisition and the subsequent integration of new companies into ours require significant attention from our management, in particular to ensure that the acquisition does not disrupt our relationships with the telecommunications operators or affect our users’ opinion of our services and customer support, and to ensure that the acquisition is effectively integrated with our existing operations. The diversion of our management’s attention and any difficulties encountered in any integration process could have an adverse effect on our ability to manage our business. Acquisitions may expose us to risks, including risks associated with the assimilation of new operations, services and personnel, unforeseen or hidden liabilities, the diversion of resources from our existing businesses and technologies, the inability to generate sufficient revenues to offset the costs and expenses of acquisitions and potential loss of, or harm to, relationships with employees and content providers. Given the sophisticated technologies used in the WVAS, mobile games and wireless Internet industries, the successful, cost-effective integration of other businesses’ technology platforms and services into our own will also be a critical and highly complicated aspect of any acquisition. Acquisitions may also result in potentially dilutive issuances of equity securities.

In addition, we are required under generally accepted accounting principles to review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is required to be tested for impairment at least annually. Factors that may be considered a change in circumstances indicating that the carrying value of our amortizable intangible assets may not be recoverable include a decline in stock price and market capitalization and slower growth rates in our industry. We may be required to record a charge to earnings in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined. For example, in the third quarter of 2008, we recorded a provision of \$21.62 million for impairment of goodwill associated with the WVAS segment. As of December 31, 2008, our goodwill and amortizable intangible assets arising from acquisitions were approximately \$16.36 million.

We have limited business insurance coverage.

The insurance industry in the PRC is still at an early stage of development. Insurance companies in the PRC offer limited business insurance products, and do not, to our knowledge, offer business liability insurance. As a result, we do not have any business liability insurance coverage for our operations. Moreover, while business disruption insurance is available, we have determined that the risks of disruption and cost of the insurance are such that we do not require it at this time. Any business disruption, litigation or natural disaster might result in substantial costs and diversion of resources.

We may incur significant costs and management time to avoid being considered an investment company under the Investment Company Act of 1940.

The United States Investment Company Act of 1940, or the 1940 Act, provides generally that a company is an investment company which must register as such under the 1940 Act and comply with its regulations if:

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- the company is or holds itself out as being engaged primarily in the business of investing, reinvesting or trading in securities; or
  - more than 40% of the value of the company's total assets is represented by investment securities.

The 1940 Act contains substantive regulations with respect to investment companies, including restrictions on their capital structure, operations, transactions with affiliates and other matters that would be incompatible with our operations. We may therefore have to incur significant costs and management time to avoid investment company status and may suffer other adverse consequences if we are deemed to be an investment company under the 1940 Act.

Based upon an analysis of the value of our assets as of December 31, 2008, we do not believe we will be considered an investment company during 2008. The determination of whether we will be an investment company will be based primarily upon the composition and value of our assets, which are subject to change, particularly when market conditions are volatile. As a result, we could inadvertently become an investment company. We can give no assurance as to our investment company status under the 1940 Act in the future.

We are controlled by a small group of our existing shareholders, whose interests may differ from other holders of our ordinary shares or ADSs.

Leilei Wang and Nick Yang, our senior officers, own 17.7% and 16.0% of our outstanding ordinary shares, respectively. Accordingly these shareholders acting together will have significant influence in determining the outcome of any corporate transaction or other matter submitted to the holders of our ordinary shares and ADSs for approval, including mergers, consolidations, the sale of all or substantially all of our assets, election of Directors and other significant corporate actions. They will also have significant influence in preventing or causing a change in control. In addition, without the consent of these shareholders, we may be prevented from entering into transactions that could be beneficial to us. The interests of these shareholders may differ from the interests of the other holders of our ordinary shares or ADSs.

Our Articles of Association contain anti-takeover provisions that could adversely affect the rights of holders of our ordinary shares and ADSs.

Our Articles of Association include certain provisions that could limit the ability of others or discourage a third party to acquire control of our company and thus deprive holders of our ordinary shares and ADSs of the opportunity to sell their ordinary shares or ADSs at a premium over the prevailing market price. Such provisions provide for, among others, the following:

- a classified board structure, with three classes of board members and each class having a three-year term;
- authority of our Board of Directors, or the Board, to issue up to a total of 1,000,000,000,000 ordinary shares, with or without preferred, deferred or other special rights or restrictions, whether with regard to dividend, voting, return of capital or otherwise and to such persons, at such time and on such other terms as the Directors think proper;
- power of our Board to elect Directors either as an addition to the existing Directors or to fill a vacancy resulting from death, resignation, retirement, disqualification, removal from office or any other reason; and
- the Directors' discretion to decline to register any transfer of ordinary shares without assigning any reason therefore.



## Risks Relating to Our Industry

Our ability to generate revenues could suffer if the PRC market for WVAS does not develop as anticipated.

The WVAS market in the PRC has evolved rapidly in recent years, with the introduction of new and advanced services, development of consumer preferences, changes in policies and guidelines initiated by the MII and the telecommunications operators, market entry by new competitors and adoption of new strategies by existing competitors. Accordingly, it is extremely difficult to accurately predict consumer acceptance and demand for various existing and potential new offerings and services, and the future size, as well as composition and growth, of these markets. Furthermore, given the limited history and rapidly evolving nature of our markets, we cannot predict the price that wireless users will be willing to pay for our services or whether users will have concerns about security, reliability, cost and quality of service associated with WVAS. If acceptance of our WVAS is different from what we anticipate, our ability to maintain or increase our revenues and net income could be materially and adversely affected.

The laws and regulations governing the WVAS, mobile games, Internet and wireless Internet industries in the PRC are developing and subject to future changes. Substantial uncertainties exist as to the interpretation and implementation of those laws and regulations.

Although WVAS and mobile games are subject to general regulation as telecommunication services, we believe that currently there are no PRC laws at the national level specifically governing WVAS and mobile games, such as our services related to SMS, MMS, WAP, Java™, IVR and color ring back tones, or CRBT.

Beijing AirInbox operates Internet websites and wireless Internet sites in the PRC. In recent years, the PRC government has begun to promulgate laws and regulations applicable to Internet-related services and activities, many of which are relatively new and untested and subject to future changes. In addition, various regulatory authorities of the central PRC government, such as the State Council, the MII, the State Administration of Industry and Commerce, or SAIC, the State Administration of Radio, Film and Television, or SARFT, and the Ministry of Public Security, are empowered to issue and implement rules to regulate certain aspects of Internet-related and wireless Internet-related services and activities. Furthermore, some local governments also have promulgated local rules applicable to Internet companies operating within their respective jurisdictions. As the Internet industry itself is at an early stage of development in the PRC, it is likely that new laws and regulations will be promulgated in the future to address issues that may arise from time to time. As a result, uncertainties exist regarding the interpretation and implementation of current and future PRC Internet laws and regulations. We cannot assure you that we will not be found in violation of any current or future PRC laws or regulations due to these uncertainties, in which case we could be subject to various penalties, including redressing the violations, confiscation of income, imposition of fines or even suspension of our operations.

In July 2006, the MII issued the Circular on Strengthening the Administration of Foreign Investment in the Operation of Value-added Telecommunications Business. In the circular, the MII reiterated the existing regulations regarding foreign investment in telecommunications business, which require foreign investors to set up foreign-invested enterprises and obtain a business operating license for Internet content provision, or ICP license, in order to conduct any value-added telecommunications business in the PRC. Under this circular, a domestic company that holds an ICP license is prohibited from leasing, transferring or selling the license to foreign investors in any form, and from providing resources, sites or facilities to foreign investors that conduct value-added telecommunications business illegally in the PRC. Furthermore, the relevant trademarks and domain names that are used in the value-added telecommunications business shall be owned by the local ICP license holder or its shareholders. This circular 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 telecommunications service providers are required to maintain network and information security in accordance with the standards set forth under relevant PRC regulations. Due to the lack of further interpretation from the regulator, it remains unclear what impact the above

circular will have on us or other PRC Internet companies that have adopted the same or similar corporate and contractual structures as ours.

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On December 20, 2007, the SARFT and the MII jointly promulgated the Regulations on Administration of Internet-based Audio-video Programming Service, or Internet-based Audio-video Regulations, which became effective as of January 31, 2008. The Internet-based Audio-video Regulations require providers of Internet-based audio-video programming services in the PRC to obtain the License for Disseminating Audio-video Programs over Information Networks, or the Internet-based Audio-video License, or complete registration procedures. To obtain such license or complete such registration, such provider must, among others, be a limited liability company that is either wholly-owned or controlled by the state. Pursuant to explanations of the Internet-based Audio-video Regulations provided by the responsible persons at the SARFT and the MII in a press conference, providers who engaged in Internet-based audio-video programming services before the promulgation of the Internet-based Audio-video Regulations and who have not violated any other laws or regulations shall be eligible to register their business and continue their operations. However, given the short history of the Internet-based Audio-video Regulations and the lack of interpretations and precedents, we cannot assure you that we will be qualified to apply for the Internet-based Audio-video License or complete the required registration, and we cannot assure you that we will be granted the Internet-based Audio-video License or be able to complete such registration.

In addition, each of Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, BJXR and Beijing Chengxitong has obtained a telecommunications and information services operating license for their Internet content businesses from the Beijing Telecommunications Administration Bureau. In addition, each of Beijing AirInbox, Beijing WINT, BJXR, Beijing Chengxitong and Mailifang has obtained a nationwide value-added telecommunications license from the MII in order to provide services in multiple provinces, autonomous regions and municipalities. If any of Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, BJXR, Beijing Chengxitong or Mailifang fails to obtain or maintain any required licenses or permits, it may be subject to various penalties, including redressing the violations, confiscation of income, imposition of fines or even suspension of its operations. Any of these measures could materially disrupt our operations and materially and adversely affect our financial condition and results of operations.

See “Item 4 — Information on the Company — Regulation.”

The PRC government or the telecommunications operators may prevent us from distributing, and we may be subject to sanctions for, content that any of them believes is inappropriate.

The PRC has promulgated regulations governing telecommunications service providers, Internet access and the distribution of news and other information. In the past, the PRC government has stopped the distribution of information over the Internet that it believes violates PRC law, including content that it deems to be obscene, to incite violence, to endanger national security, to be contrary to the national interest or to be defamatory.

The telecommunications operators also have their own policies that restrict the distribution by WVAS providers and wireless Internet sites of content they deem inappropriate. For instance, they have punished certain providers for distributing content deemed by them to be obscene. Such punishments have included censoring of content, delays in payments of fees by the telecommunications operators to the offending service provider, forfeiture of fees owed by the telecommunications operators to the offending service provider and suspension of the service on the telecommunications operators’ networks. Accordingly, even if we comply with PRC governmental regulations relating to licensing and foreign investment restrictions, if the PRC government or the telecommunications operators were to take any action to limit or prohibit the distribution of information we provide or to limit or regulate any current or future content or services available to our users, our revenues could be reduced, traffic to our wireless Internet sites decreased and our reputation harmed. For example, in August 2004, China Mobile notified us that one of our IVR services in early June 2004 had contained inappropriate content. For this infraction, China Mobile suspended until the end of 2004 approval of new applications from us for new products and services on all platforms and also suspended joint promotions with us. In addition, China Mobile suspended for one year, until June 30, 2005, approval of our applications to operate on new platforms. We cannot assure you that we will not be subject to sanctions in the future for violating content-related regulations of the PRC government or policies of any of the telecommunications

operators.

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

Any failure to maintain the satisfactory performance, reliability, security and availability of our network infrastructure may cause significant harm to our reputation and our ability to attract and maintain users. Major risks involved in such network infrastructure include, among others, any breakdowns or system failures resulting in a prolonged shutdown of all or a material portion of our servers, including failures which may be attributable to sustained power outages, or effort to gain unauthorized access to our systems causing loss or corruption of data or malfunctions of software or hardware.

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Our network systems are vulnerable to damage from fire, flood, power loss, telecommunications failures, computer viruses, hackings and other similar events. Any network interruption or inadequacy that causes interruptions in the availability of our services or deterioration in the quality of access to our services could reduce our user satisfaction and our competitiveness. In addition, any security breach caused by hacking, which involves effort to gain unauthorized access to information or systems, or to cause intentional malfunctions or loss or corruption of data, software, hardware or other computer equipment, and the inadvertent transmission of computer viruses could have a material adverse effect on our business, financial condition and results of operations. We do not maintain insurance policies covering losses relating to our systems and we do not have business interruption insurance.

The growth of our business may be adversely affected due to public concerns over the security and privacy of confidential user information.

The growth of our business may be inhibited if the public concern over the security and privacy of confidential user information transmitted over the Internet and wireless networks is not adequately addressed. Our services may decline and our business may be adversely affected if significant breaches of network security or user privacy occur.

If we are unable to respond successfully to technological or industry developments, our business may be materially adversely affected.

The WVAS, mobile games, wireless Internet, mobile advertising and telecommunications industries are characterized by rapid advances in technology, industry standards and customer demands. New technologies, industry standards or market demands may render our existing products, services or technologies less competitive or even obsolete. Telecommunications operators in the PRC are currently in the process of introducing 3G telecommunications services. Responding and adapting to 3G and other technological developments and standard changes in our industry may require substantial time, effort and capital investment. If we are unable to respond successfully to technology, industry and market developments, such developments may materially adversely affect our business, results of operations and competitiveness.

#### Risks Relating to the People's Republic of China

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

Changes in the PRC's economic, political and social conditions, as well as government policies, could affect our business. Although the PRC has been one of the world's fastest-growing economies in terms of GDP since 1978, we cannot assure you that such growth will be sustained in the future. Moreover, any negative development in the economies of the United States, the European Union and certain Asian countries may adversely affect economic growth in the PRC.

In addition, the PRC economy differs from the economies of most developed countries in many respects, including the amount of government involvement, level of development, growth rate, control of foreign exchange and allocation of resources. Although the PRC economy has experienced significant growth over the past decades, growth has been uneven, both geographically and among various sectors of the economy. The PRC government has implemented various measures to encourage economic growth and guide the allocation of resources. Some of these measures may benefit the overall PRC economy but have a negative effect on us. For example, our financial condition and results of operations may be adversely affected by government control over capital investments or changes in tax regulations that are applicable to us. The PRC government has implemented certain measures, including recent interest rate increases, to control the pace of economic growth. These measures may cause decreased economic activity in the PRC, including a slower growth or decline in demand in WVAS, mobile games, wireless Internet and mobile

advertising businesses, which in turn could adversely affect our operating results and financial conditions.

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Although the PRC government has implemented measures since the late 1970s emphasizing the use of market forces for economic reform, the reduction of state ownership of productive assets and the establishment of sound corporate governance in business enterprises, a substantial portion of productive assets in the PRC is still owned by the PRC government. In addition, the PRC government continues to play a significant role in regulating industry development by imposing industrial policies. It also exercises significant control over PRC economic growth through the allocation of resources, controlling payment of foreign currency-denominated obligations, setting monetary policy and providing preferential treatment to particular industries or companies. We cannot assure you that the PRC's economic, political or legal systems will not develop in a way that is detrimental to our business, results of operations and prospects.

Government control of currency conversion may adversely affect our financial condition and results of operations.

We receive substantially all of our revenues in Renminbi, which currently is not a freely convertible currency. A portion of these revenues must be converted into other currencies to meet our foreign currency obligations including, among others, payment of dividends declared, if any, in respect of our ordinary shares.

Under the PRC's existing foreign exchange regulations, our subsidiaries, KongZhong Beijing, Beijing Anjian Xingye, KongZhong China and Wukong Shentong Search Co., Ltd., or Wukong Shentong, are able to pay dividends in foreign currencies without prior approval from the State Administration of Foreign Exchange, or SAFE, by complying with certain procedural requirements. However, we cannot assure you that the PRC government will not take measures in the future to restrict access to foreign currencies for current account transactions.

Foreign exchange transactions under the capital accounts of our subsidiaries, KongZhong Beijing, Beijing Anjian Xingye, KongZhong China and Wukong Shentong, and of our operating companies, Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Tianjin Mammoth, Beijing Chengxitong, BJXR and Mailifang, continue to be subject to significant foreign exchange controls and require the approval of PRC governmental authorities, including the SAFE. In particular, if KongZhong Beijing, Beijing Anjian Xingye or KongZhong China borrow foreign currency loans from us or other foreign lenders, these loans must be registered with SAFE, and if we finance KongZhong Beijing, Beijing Anjian Xingye or KongZhong China by means of additional capital contributions, these capital contributions must be approved by certain government authorities including the Ministry of Commerce or its local counterparts. In addition, if we finance Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Tianjin Mammoth, Beijing Chengxitong, BJXR or Mailifang by loans, we must obtain approval from SAFE. These limitations could affect the ability of KongZhong Beijing, Beijing Anjian Xingye, KongZhong China, Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Tianjin Mammoth, Beijing Chengxitong, BJXR or Mailifang to obtain foreign exchange through debt or equity financing.

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

The SAFE has promulgated regulations that require PRC residents and PRC corporate entities to register with and obtain approvals from relevant PRC government authorities in connection with their direct or indirect offshore investment activities. These regulations may apply to holders of our ordinary shares and ADSs who are PRC residents in connection with our prior and any future offshore acquisitions.

The SAFE regulation required registration by March 31, 2006 of direct or indirect investments previously made by PRC residents in offshore companies prior to the implementation of the Notice on Issues Relating to the Administration of Foreign Exchange in Fund-Raising and Reverse Investment Activities of Domestic Residents Conducted via Offshore Special Purpose Companies on November 1, 2005. If a PRC holder of our ordinary shares or ADSs with a direct or indirect stake in an offshore parent company fails to make the required SAFE registration, the

PRC subsidiaries of such offshore parent company may be prohibited from making distributions of profit to the offshore parent and from paying the offshore parent proceeds from any reduction in capital, share transfer or liquidation in respect of the PRC subsidiaries. Furthermore, failure to comply with the various SAFE registration requirements described above could result in liability under PRC law for evasion of foreign exchange restrictions.



Those of our Directors and senior officers who are holders of our ordinary shares or ADSs and PRC residents have informed us that they have made the necessary applications and filings, as required under this regulation. However, as these regulations are still relatively new and there is uncertainty concerning the reconciliation of the new regulation with other approval requirements, it is unclear how the regulation, and any future regulation concerning offshore or cross-border transactions, will be interpreted, amended, implemented or enforced by the relevant government authorities. The failure or inability of the PRC resident holder of our ordinary shares or ADSs to obtain any required approvals or make any required registrations may subject us to fines and other legal sanctions, and prevent us from being able to make distributions or pay dividends, as a result of which our business operations and our ability to distribute profits to you could be materially adversely affected.

Fluctuation of the Renminbi could adversely affect the value of and dividends payable on our ADSs.

The value of the Renminbi fluctuates and is subject to changes in PRC political and economic conditions. On July 21, 2005, the PRC government changed its decade-old policy of pegging the value of the Renminbi to the U.S. dollar. Under the PRC government's new policy, the Renminbi is permitted to fluctuate within a managed band against a basket of certain foreign currencies. Although daily fluctuations of the Renminbi against the basket of currencies are currently limited to 0.5% per day, the Renminbi may appreciate or depreciate significantly in value against the U.S. dollar in the long term. We cannot guarantee that the Renminbi will not be permitted to enter into a full float, which also may result in a significant appreciation or depreciation of the Renminbi against the U.S. dollar. Because we receive substantially all of our revenues in Renminbi and a majority of our cash and cash equivalents are denominated in Renminbi, any fluctuation in the exchange rate against the U.S. dollar will affect our balance sheet and earnings per share in U.S. dollar terms and the value of dividends, if any, payable on, our ordinary shares in U.S. dollar terms and the value of any U.S. dollar-denominated investments we may make in the future. As of December 31, 2008, we had cash and cash equivalents in the amount of \$136.05 million. A 1.0% appreciation of the Renminbi against the U.S. dollar will result in an estimated increase of approximately \$1.05 million in our total amount of cash and cash equivalents, and a 1.0% appreciation of the U.S. dollar against the Renminbi will result in a decrease of approximately \$1.03 million in our total amount of cash and cash equivalents. To date, we have not entered into any hedging transactions in an effort to reduce our exposure to foreign currency exchange risk.

Uncertainties in the interpretation and enforcement of PRC laws and regulations could limit the legal protections available to you and us.

The PRC legal system is a civil law system based on written statutes. Unlike common law systems, it is a system in which decided legal cases have little precedential value. Although legislation in the PRC over the past 30 years has significantly improved the protection afforded to various forms of foreign investment and contractual arrangements in the PRC, these laws, regulations and legal requirements are relatively new and their interpretation and enforcement involve uncertainties, which could limit the legal protection available to us and foreign investors, including you. In addition, the PRC government may enact new laws or amend current laws that may be detrimental to our current contractual arrangements with Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong, BJXR and Mailifang, which may in turn have a material adverse effect on our business operations.

You may experience difficulties in effecting service of legal process and enforcing judgments against us and our management.

We are a company incorporated under the laws of the Cayman Islands, and our subsidiary and substantially all of our assets are located outside the United States. In addition, most of our Directors and officers and their assets are located outside the United States. As a result, it may not be possible to effect service of process within the United States upon our Directors or officers, including with respect to matters arising under U.S. Federal securities laws or applicable state securities laws.



Our PRC legal counsel, King & Wood, has advised us that the PRC does not have treaties providing for the reciprocal recognition and enforcement of judgments of courts with the United States, the United Kingdom or most other Western countries. As a result, recognition and enforcement in the PRC of judgments of a court obtained in those jurisdictions in relation to any matter not subject to a binding arbitration provision may be difficult or impossible.

We have been advised by Maples and Calder, our Cayman Islands legal advisers, that although there is no statutory enforcement in the Cayman Islands of judgments obtained in the United States, or any state thereof, a judgment obtained in the United States, or any state thereof, will be recognized and enforced in the courts of the Cayman Islands under common law, without any re-examination of the merits of the underlying dispute, by an action commenced on the foreign judgment debt in the Grand Court of the Cayman Islands, provided that such judgment (i) was given by a foreign court of competent jurisdiction; (ii) imposes on the debtor a liability to pay a liquidated sum for which the judgment has been given; (iii) is final; (iv) is not in respect of taxes, a fine or a penalty; and (v) was not obtained in a manner and is not of a kind of enforcement that is contrary to natural justice or the public policy of the Cayman Islands.

Any future outbreak of Severe Acute Respiratory Syndrome, avian influenza or any other epidemic in the PRC may have a material adverse effect on our business operations, financial condition and results of operations.

From December 2002 to June 2003, the PRC and certain other countries experienced an outbreak of a new and highly contagious form of atypical pneumonia that became known as severe acute respiratory syndrome, or SARS. On July 5, 2003, the World Health Organization declared that SARS had been contained. However, after this declaration, a number of isolated new cases of SARS have been reported, most recently in central PRC in April 2004. In addition, in recent years, a number of Asian and European countries, including the PRC, have reported cases of humans being infected with a strain of avian influenza or bird flu known as H5N1, which is often fatal to humans. Any outbreak of any of these diseases or other highly dangerous communicable diseases in the PRC in the future may disrupt our business operations and have a material adverse effect on our financial condition and results of operations. In addition, health or other government regulations may require temporary closure of our offices, or the offices of our advertisers, content providers or partners, which may severely disrupt our business operations and have a material adverse effect on our financial condition and results of operations. We have not adopted any written preventive measures or contingency plans to combat any future outbreak of SARS, bird flu or any other epidemic.

#### Item 4. Information on the Company

##### History and Development of the Company

We were incorporated on May 6, 2002 under the laws of the Cayman Islands as Communication Over The Air Inc., an exempted limited liability company. In March 2004, we changed our name to KongZhong Corporation. We are headquartered in Beijing, the PRC, and provide WVAS, mobile games and wireless Internet sites to mobile phone users throughout the PRC. In January 2007, we established a wholly-owned subsidiary, Monkey King Search Corporation, or Monkey King, under the laws of Cayman Islands in an effort to develop our wireless search business. Monkey King in turn established its own wholly-owned subsidiary, Wukong Shentong, under the laws of the PRC. After developing our wireless search business through Monkey King and Wukong Shentong for a period of time, in September 2008, we decided to terminate our project of developing wireless search business and liquidate Monkey King and Wukong Shentong. We are currently in the process of liquidating Wukong Shentong and plan to liquidate Monkey King in 2009. In July 2008, we liquidated Beijing Shuziyuansu Advertising Co., Ltd., a company formerly owned by two of our operating companies, Beijing Boya Wuji and Beijing WINT, because it had not had any operating activity since its incorporation in September 2005. In July 2008, BJXR, one of our operating companies, established its own subsidiary, Beijing Shiyuan Leya, which operates certain types of our WVAS business.

We conduct our business in the PRC solely through our wholly-owned subsidiaries, KongZhong Beijing, KongZhong China and Beijing Anjian Xingye. In order to meet domestic ownership requirements under PRC law, which restrict us and our subsidiaries, as foreign or foreign-invested companies, respectively, from operating certain value-added telecommunications and Internet services, we operate WVAS, mobile games and wireless Internet sites through Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong, BJXR and Mailifang, all of which are based in the PRC and are wholly-owned by PRC citizens. We do not have any equity interests in Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong, BJXR or Mailifang, but enjoy the economic benefits of these companies through a series of contractual arrangements as described below.

Our principal executive office is located at 35th Floor, Tengda Plaza, No. 168, Xizhimenwai Street, Beijing, 100044, the PRC. Our telephone number is (8610) 8857-6000. The address of our primary website is [www.KongZhong.com](http://www.KongZhong.com) and the address of our primary wireless Internet site is [Kong.net](http://Kong.net). Information contained on our website or our wireless Internet site does not constitute a part of this annual report.

In July 2004, we completed the initial public offering of our ADSs representing our ordinary shares and listed the ADSs on the Nasdaq Global Market, or Nasdaq. Effective January 1, 2008, our ADSs are listed on the Nasdaq Global Select Market.

#### Investments and Acquisitions

On May 12, 2005, our operating companies, Beijing AirInbox and Beijing WINT, signed an agreement with the original shareholders of Tianjin Mammoth to acquire 95% and 5%, respectively, of the equity interest in Tianjin Mammoth for an aggregate consideration of RMB6 million, or approximately \$724,944, of which \$675,379 was paid in 2005 and the remaining balance of \$49,565 was paid in June 2006. The acquisition was concluded on May 24, 2005. Tianjin Mammoth was founded in June 2002 and has become a well-known mobile game developer in the PRC. Since the acquisition, Tianjin Mammoth has primarily developed games for KongZhong affiliates.

In November 2005, we entered into a definitive agreement with Beijing Chengxitong, its original shareholders and our designees pursuant to which the original shareholders transferred 100% of the equity interest in Beijing Chengxitong, a WVAS provider in Hubei province, for a purchase price of RMB14.45 million (approximately \$1.79 million), consisting of RMB4.4 million (approximately \$0.54 million) in cash and RMB10.05 million (approximately \$1.24 million) satisfied by waiving receivables from former shareholders of Beijing Chengxitong. Of the \$0.54 million in cash, \$0.50 million was paid in 2005 and the remaining balance of \$0.04 million was paid in January 2006. In July 2006, we changed Beijing Chengxitong's registered address from Wuhan, Hubei province, to Beijing and consequently changed its name from Wuhan Chengxitong to Beijing Chengxitong.

In January 2006, we sold all of our 10% equity interest in eFriendsNet Entertainment Corp., or EFN, a leading social networking company in the PRC, for an immediate cash consideration of \$1.7 million. We received an additional payment of \$0.2 million in February 2007 pursuant to a payment mechanism in the sale agreement that provided for an additional payment if certain financial performance milestones are met by EFN after the completion of the sale of our equity interest.

In January 2006, we entered into a definitive agreement to acquire 100% of Sharp Edge, a company incorporated in the British Virgin Islands and based in Beijing, which provided WVAS on the SMS, IVR and CRBT technology platforms through its operating entity, BJXR. We waived \$0.83 million in receivables from former shareholders of Sharp Edge, and paid cash consideration of \$7 million, \$11 million and \$17 million during the first quarter of 2006, the third quarter of 2006 and the first quarter of 2007, respectively. Following our acquisition, we deregistered Sharp Edge and became the direct owner of its wholly-owned PRC subsidiary, Beijing Anjian Xingye.

In January 2008, we entered into a definitive agreement with HiU! Media, a company incorporated in the Cayman Islands and based in the PRC, which provides residential community direct marketing advertising network and residential community marketing solutions in the PRC, to acquire 9.87% of the total equity interest of HiU! Media for a consideration of \$1.5 million. We completed the investment in January 2008. We accounted for this investment using the cost method. For a further description of this transaction, see "Item 7 — Major Shareholders and Related Party Transactions — Related Party Transactions."

In May 2008, we entered into a definitive agreement with Beijing Xin Chuang Hang Yuan Technology Co., Ltd., or XCHY, a company that provides electronic coupons on mobile phones, to acquire 19.9% of the total equity interest of XCHY for a consideration of \$1.5 million. We completed the investment in July 2008.



In January 2009, we entered into a definitive agreement to acquire 100% of Sigma Interactive Inc., or Sigma, a company incorporated in the British Virgin Islands and based in Beijing, for a total consideration of \$1.0 million. Sigma is engaged in the business of developing technology solutions for mobile Internet, including the development of the on-device portal platform. The acquisition was completed in January 2009.

In March 2009, we issued to NGP a convertible senior note due in 2014 with an aggregate principal amount of \$6,775,400. The convertible senior note could be converted into our ordinary shares. The current conversion price is \$0.08915 per ordinary share, subject to possible adjustments. NGP also received a warrant to purchase up to 80 million of our ordinary shares at \$0.125 per ordinary share, exercisable within five years. The convertible senior note would initially pay an annual interest at a rate of 8%, subject to reduction to 6% based on our financial performance. The convertible senior note could be redeemed, by paying the principal amount then outstanding plus any accrued by unpaid interest, at our company's option after three years. We have agreed to certain covenants in connection with our issuance of the convertible senior note and warrant to NGP. See "Item 3 — Key Information — Risk Factors — Risks Relating to Our Business — We are subject to certain covenants in connection with the issuance of the convertible senior note and the warrant, and such covenants could have a material adverse effect on our business, financial condition and results of operations." The issuance of the convertible senior note and warrant was completed in March 2009.

In March 2009, we entered into a definitive agreement with Mailifang, its original shareholders and our designees pursuant to which the original shareholders would transfer 100% of the equity interest in Mailifang to us for a total consideration of RMB14.13 million (approximately \$2.07 million), consisting of RMB5.05 million (approximately \$0.74 million) in cash and RMB9.08 million (approximately \$1.33 million) satisfied by waiving receivables from the original shareholders of Mailifang. Mailifang is engaged in the business of developing mobile games. The acquisition was completed in April 2009.

#### Our Corporate Structure

The chart below sets forth our corporate and share ownership structure as of April 24, 2009.

- (1) We do not have any ownership interest in Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Tianjin Mammoth, BJXR, Beijing Chengxitong, Beijing Shiyuan Leya or Mailifang. Our wholly-owned subsidiaries have entered into a series of contractual arrangements with these companies and/or their respective shareholders.
- (2) We are currently in the process of liquidating Wukong Shentong.

PRC regulations currently restrict foreign ownership of companies that provide value-added telecommunications services, which include WVAS. See also “— Regulation.” To comply with PRC regulations, we conduct substantially all of our wireless value-added operations through Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong, BJXR, Beijing Shiyuan Leya and Mailifang, which are wholly-owned by PRC citizens or entities.

Beijing AirInbox was established in April 2002 with Yunfan Zhou, our former Chief Executive Officer, Songlin Yang, the uncle of Nick Yang, the Vice Chairman of our Board of Directors and the President and Chief Technology Officer of our company, and Leilei Wang, one of our initial investors, holding 35%, 35% and 30%, respectively, of the total equity interest of Beijing AirInbox. In September 2003, Leilei Wang transferred 15% of the equity interest in Beijing AirInbox to Yunfan Zhou and the other 15% he owned to Zhen Huang, the wife of Nick Yang. In April 2004, the registered capital of Beijing AirInbox was increased from RMB2.0 million (approximately \$0.3 million) to RMB10.0 million (approximately \$1.2 million). The increased registered capital was contributed from Songlin Yang and Yang Cha, one of our former employees, for RMB3.5 million (approximately \$0.4 million) and RMB4.5 million (approximately \$0.5 million), respectively. In October 2006, Yang Cha and Yunfan Zhou transferred their equity interests to our employees Linguang Wu and Guijun Wang, respectively, with the result that Linguang Wu holds 45% and Guijun Wang holds 10% of the total equity interest in Beijing AirInbox.



Beijing Boya Wuji was established in March 2004 with each of Yunfan Zhou and Zhen Huang holding 50% of its total equity interest. In January 2005, Beijing AirInbox acquired 40% of the total equity interest of Beijing Boya Wuji from Yunfan Zhou and 40% from Zhen Huang, with the result that Beijing AirInbox held 80% of Beijing Boya Wuji, and Yunfan Zhou and Zhen Huang each held 10%. In October 2006, Yunfan Zhou and Zhen Huang transferred each of their 10% equity interests to Beijing AirInbox, resulting in Beijing AirInbox holding 100% of the equity interest in Beijing Boya Wuji.

Beijing WINT was 40% owned by Yang Yang, one of our employees, and 60% owned by Hai Qi, our former Senior Vice President of Sales and Marketing who left our company on February 29, 2008. In September 2008, Hai Qi transferred his 60% equity interest to Jingye Sun, one of our employees, and Li Ai, one of our former employees, respectively, with the result that Yang Yang holds 40%, Jingye Sun holds 30% and Li Ai holds 30% of the total equity interest in Beijing WINT.

Tianjin Mammoth is 95% owned by Beijing AirInbox and 5% owned by Beijing WINT.

BJXR is 51% owned by Guijun Wang and 49% owned by Yang Li, both of whom are our employees.

Beijing Chengxitong is 90% owned by Yang Li and 10% owned by Xuelei Wu, both of whom are our employees.

Beijing Shiyuan Leya is 100% owned by BJXR.

Mailifang is 90% owned by Xu Guo and 10% owned by Yang Yang, both of whom are our employees.

We do not have any equity interests in Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Tianjin Mammoth, Beijing Chengxitong, BJXR, Beijing Shiyuan Leya or Mailifang but instead enjoy the economic benefits of these companies through a series of contractual arrangements, which we and our subsidiaries, KongZhong Beijing and Beijing Anjian Xingye, have entered into with these companies and/or their respective shareholders as described below. For a further description of each of these agreements, see “Item 7 — Major Shareholders and Related Party Transactions — Related Party Transactions.”

As part of these contractual arrangements, we have entered into loan agreements with each of the shareholders of Beijing AirInbox, pursuant to which long-term loans were provided to each of these shareholders to be invested exclusively in Beijing AirInbox. Each shareholder has also agreed to repay these loans only in the form of a transfer of all of his or her interest in Beijing AirInbox to either KongZhong Beijing or our designees to the extent allowed by PRC law under certain circumstances. We currently do not plan to extend any additional loans to the shareholders of Beijing AirInbox or to extend any loans to the shareholders of our other operating companies. See “Item 7 — Major Shareholders and Related Party Transactions — Related Party Transactions.”

Each of Beijing AirInbox, Beijing WINT, Beijing Chengxitong and Mailifang and their respective shareholders also has entered into an exclusive share option agreement with KongZhong Beijing. Pursuant to these agreements, each of the shareholders of Beijing AirInbox, Beijing WINT, Beijing Chengxitong and Mailifang has granted an exclusive option to KongZhong Beijing or our designees to purchase all or part of such shareholder’s equity interest in Beijing AirInbox, Beijing WINT, Beijing Chengxitong or Mailifang, as the case may be, in accordance with PRC law, and has covenanted not to encumber such equity interest in any manner other than as permitted by KongZhong Beijing.

KongZhong Beijing has entered into business operation agreements with each of Beijing AirInbox, Beijing WINT, Beijing Chengxitong, Mailifang and their respective shareholders. Pursuant to these agreements, Beijing AirInbox, Beijing WINT, Beijing Chengxitong, Mailifang and their respective shareholders agreed to appoint individuals designated by KongZhong Beijing to the management team of Beijing AirInbox, Beijing WINT, Beijing Chengxitong and Mailifang and to refrain from taking certain actions that may materially affect these companies’ operations. Each

of the shareholders of Beijing AirInbox, Beijing WINT, Beijing Chengxitong and Mailifang also has executed an irrevocable power of attorney in favor of individuals designated by KongZhong Beijing. Pursuant to these powers of attorney, those designated individuals have full power and authority to exercise all of such shareholders' rights with respect to their equity interests in Beijing AirInbox, Beijing WINT, Beijing Chengxitong or Mailifang.

KongZhong Beijing has entered into technical and consulting services agreements with each of Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong and Mailifang. Pursuant to these technical and consulting services agreements, KongZhong Beijing provides certain technical and consulting services to Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong and Mailifang in exchange for service fees. Each of the shareholders of Beijing AirInbox, Beijing WINT, Beijing Chengxitong and Mailifang has entered into an equity pledge agreement with KongZhong Beijing, pursuant to which these shareholders pledged their respective interests in Beijing AirInbox, Beijing WINT, Beijing Chengxitong or Mailifang, as the case may be, to guarantee the performance of such companies' payment obligations under the respective technical and consulting services agreements.

KongZhong China has entered into a technical and consulting services agreement with Beijing AirInbox, pursuant to which KongZhong China provides certain technical and consulting services to Beijing AirInbox in exchange for service fees.

BJXR and its shareholders have entered into exclusive share option agreements with our subsidiary, Beijing Anjian Xingye. Pursuant to these agreements, each of the shareholders of BJXR has granted an exclusive option to Beijing Anjian Xingye or our designees to purchase all or part of such shareholder's equity interest in BJXR in accordance with the PRC law, and has covenanted not to encumber such equity interest in any manner other than as permitted by Beijing Anjian Xingye.

Beijing Anjian Xingye has entered into a business operation agreement with BJXR and its shareholders. Pursuant to this agreement, BJXR and its shareholders agreed to appoint individuals designated by Beijing Anjian Xingye to the management team of BJXR, and to refrain from taking certain actions that may materially affect BJXR's operations. Each of the shareholders of BJXR also has executed an irrevocable power of attorney in favor of individuals designated by Beijing Anjian Xingye. Pursuant to these powers of attorney, those designated individuals have full power and authority to exercise all of such shareholders' rights with respect to their equity interests in BJXR.

Beijing Anjian Xingye has entered into an exclusive technical and consulting services agreement with BJXR. Pursuant to this agreement, Beijing Anjian Xingye provides technical and consulting services to BJXR in exchange for service fees. Each of the shareholders of BJXR has entered into an equity pledge agreement with Beijing Anjian Xingye, pursuant to which these shareholders pledged their respective interests in BJXR to guarantee the performance of BJXR's payment obligations under the exclusive technical and consulting services agreement.

In the opinion of our PRC legal counsel, King & Wood, the ownership structures of Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong, BJXR and Mailifang, our contractual arrangements with these companies and their respective shareholders and the businesses and operations of these companies as described in this annual report are in compliance with all existing PRC laws and regulations and are enforceable in accordance with their terms and conditions. In addition, our PRC legal counsel is of the opinion that, with respect to Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong, BJXR and Mailifang, no consent, approval or license, other than those already obtained, is required under any of the existing PRC laws and regulations for the effectiveness and enforceability of the ownership structures, contractual arrangements, businesses and operations of these companies, with the exception that Beijing AirInbox is required to obtain licenses pursuant to the Internet News Information Services Regulations and the Internet-based Audio-video Regulations for which Beijing AirInbox's applications are pending. However, there are substantial uncertainties regarding the interpretation and implementation of current PRC laws and regulations. See “— Regulation” and “Item 3 — Key Information — Risk Factors — Risks Relating to Our Business the PRC government finds that the agreements that establish the structure for operating our business do not comply with PRC government restrictions on foreign investment in the value-added telecommunications industry, we could be subject to severe penalties,” and “Item 3 — Key Information — Risk Factors — Risks Relating to Our Business — Our contractual arrangements with Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong, BJXR and Mailifang may not be as effective in providing operational control as direct ownership of these businesses and may be difficult to enforce.” As discussed in those risk factors, certain events may cause us to lose the benefits and control

intended to be created by these arrangements.

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## Capital Expenditures and Divestitures

See “Item 5 — Operating and Financial Review and Prospects — Capital Expenditures” for information concerning our principal capital expenditures since our inception and those planned for 2009. We have not undertaken any significant divestitures and do not have any significant divestitures currently in progress.

## Business Overview

We are one of the leading providers of WVAS and mobile games to mobile phone users and a wireless media company providing news, content, community and mobile advertising services through our wireless Internet sites in the PRC. We began providing WVAS on the networks of China Mobile in 2002. Since 2004 we have provided WVAS on the networks of China Unicom, China Telecom and China Netcom, the other major telecommunications operators in the PRC. Since 2004, we have started our wireless Internet sites to provide WIS. In 2008, we began reporting our mobile games business as a stand-alone operating segment, while it was previously reported as part of our WVAS business.

## Our Business

We provide interactive entertainment, media and community services to mobile phone users through 2G technology platforms, including SMS, IVR and CRBT, and through 2.5G technology and operating platforms, including WAP, MMS and Java™, which offer higher quality graphics, richer content and more interactivity than 2G wireless services. With the development of 3G services in the PRC, we plan to develop and offer services tailored to 3G technology platforms in the future.

We deliver a broad range of services that users can access directly from their mobile phones, by using our access code or by choosing an icon or a game pre-loaded in select models of handsets; from a telecommunications operator’s portal or website; and from our wireless Internet websites, including Kong.net and Ko.cn. Substantially all of our services are ordered or accessed by users directly through their mobile phones and all services are delivered through mobile phones. Our services are organized in three major categories, consisting of:

- Interactive entertainment. Our interactive entertainment services include mobile games, pictures, karaoke, electronic books and mobile phone personalization features, such as ringtones, wallpaper, clocks and calendars.
- Media. Our media services provide content such as domestic and international news, entertainment, sports, fashion, lifestyle and other special interest areas.
- Community. Our community services include interactive chat, message boards, dating and networking.

Although users can purchase our value-added services and downloadable mobile games on a single-transaction basis or on a monthly subscription basis, the majority of our services are offered on single-transaction basis in 2008. We provide our services mainly pursuant to our cooperation arrangements with the telecommunications operators and their provincial subsidiaries, the terms of which are generally for one year or less. We do not directly bill our users, and depend on the billing systems and records of the telecommunications operators to bill and collect all fees. We generally do not have the ability to independently verify the accuracy of the billing systems of the telecommunications operators. As the telecommunications operators do not provide us with a detailed revenue breakdown on a service-by-service basis, we depend on our internal data management system to monitor revenues derived from each of our services. We make our business decisions based on our internal data, taking into account our historical experience in reconciling our internal data to our actual results of operations and other factors including strategic considerations. See “Item 3 — Key Information — Risk Factors — Risks Relating to Our Business — Our dependence on the substance and timing of the billing systems of the telecommunications operators and their subsidiaries may require us

to estimate portions of our reported revenues and cost of revenues for WVAS and mobile games. As a result, subsequent adjustments may have to be made to our financial statements.”

The following diagram illustrates how our services are provided through technology platforms to users.

We continuously produce and source new content that appeals to our target consumers for value-added services. Utilizing software we have developed, our experienced editors and producers edit, redesign and repackage our content for our different services and technology platforms in a manner that appeals to consumers and ensures a consistent user experience across different mobile handset models. We obtain our content through in-house writers, freelance writers and third-party suppliers. Through contractual arrangements, we have exclusive rights over the content produced by our in-house writers, the content specifically produced for us by freelance writers and some of the content sourced from third-party suppliers.

#### Our WVAS Business

The following are the three major WVAS areas on which we focus:

- **Interactive Entertainment.** We offer a wide range of interactive entertainment products, including mobile games, karaoke, electronic books and mobile phone personalization features, such as ringtones, wallpaper, icons, clocks and calendars. We provide our interactive entertainment services through all of our technology platforms. Mobile phone users can download on demand or subscribe for regular downloads of our interactive entertainment services. Some of our most popular interactive entertainment products include:

**Pictures and Logos.** Mobile phone users can download pictures and logos to personalize the background of their mobile phone screens. Such pictures include cartoons, pets and scenic photos.

**Polyphonic Ringtones.** Our ringtones enable a mobile phone user to personalize their ringtones using the melodies of their favorite songs or special sound effects.

- **Media.** Users can download our media content on either a single-transaction basis or a monthly subscription basis. Media content covers international and domestic news, entertainment, sports, fashion, lifestyle and other special interest areas. Some of our most popular media services include:

**News.** We offer international and domestic news, delivered in a format easy for the reader to peruse. Our WAP version enables users to easily search for news that interests them.

Entertainment. Our entertainment magazine focuses on high-profile celebrities and includes star biographies, interviews and photos.

– Sports. Our sports magazine features sports news, game scores and information about sports stars.

•Community. Users can engage in community-oriented activities such as interactive chatting, message boards, dating and networking. Users may access our community services on a monthly subscription basis or single-transaction basis. Some of our most popular community services include:

•Chat. We offer a variety of chat services. For instance, we have a virtual reality game that allows mobile phone users to choose the lifestyle they dream of and interact with the city's other inhabitants/players.

•Photo Albums. Our photo albums allow mobile users to post and arrange their photos taken with their mobile handsets into albums accessible via their handsets. Utilizing the WAP technology platform, mobile users can access photo albums in a manner similar to accessing photo albums on the Internet.

#### Our Mobile Games Business

We offer mobile games based on 2.5G platforms, including WAP and Java™. In 2005, we established a dedicated mobile games product development team to develop and publish 2.5G mobile games and also acquired Tianjin Mammoth, a mobile games developer. Our mobile games include both downloadable and online mobile games. As of December 31, 2008, we had a library of over 40 internally developed mobile games.

We began developing online mobile games in 2006 and 2007. Our online mobile games are generally offered free of charge for mobile phone users. We derive revenues from users who desire to purchase merchandise or premium features embedded in the games to enhance their gaming experience. Our internally developed mobile on-line games, e 3-Kingdom and Tian Jie (Reincarnation) On-line, were named “Most Popular Mobile Networking Game” at the 2006 and 2007 China Joy Best Games Contests, respectively. Tian Jie (Reincarnation) On-line was awarded as one of the “Best Ten Self-Developed Mobile Games in China” at the China Game Industry Annual Forum in January 2008. Tian Jie (Reincarnation) On-line was launched on China Mobile's Mobile Online Game Platform on September 10, 2008. In addition, Tianjin Mammoth received the “Best Mobile Game Developer” award at the 2007 China Joy Best Games Contests.

Our mobile games business was previously reported as part of our WVAS business. We have treated our mobile games business as a stand-alone operating segment since 2008 as we expect to expend more effort to develop our mobile games business and anticipate our mobile games business to make a more significant contribution to our total revenues. Our mobile games business has achieved continuous growth and we believe it is an important part of our effort to grow our business over the long term. We intend to develop internally the majority of our mobile games. However, in order to expand our mobile games business and increase our market share, we also plan to actively identify quality mobile games to be purchased or licensed from third parties and cooperate with third parties to jointly develop mobile games.

#### Our WIS Business

In 2004, we launched a wireless Internet site that customers can visit from their mobile phones through their browsers while using 2.5G mobile networks. Our original wireless Internet domain name, or URL, was cota.cn before the URL was changed to Kong.net in 2006. Kong.net is independent of the telecommunications operators' portals, including China Mobile's Monternet™ portal. Through Kong.net, we offer news, community services, games and other interactive media and entertainment services to our customers free of charge. We also sell advertising space on Kong.net in the form of text-link, banner and button advertisements. We conducted major advertising campaigns in each of 2006,



2007 and 2008 to drive traffic to Kong.net and promote recognition of Kong.net and our corporate brand.

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In March 2007, we launched the new wireless Internet community site Ko.cn. Users can register at Ko.cn to access their own virtual space with features such as personalized domain names, friend networks, chat rooms, photo albums and blogs.

In September 2007, we entered into a cooperation agreement with the National Basketball Association of the United States, or the NBA, and launched the official Chinese NBA mobile website, cn.NBA.com, the first official NBA site on mobile phones in the PRC.

In January 2008, we entered into a strategic alliance agreement with China Sports Industry Group Co., Ltd. to jointly explore business opportunities for developing sports-related content for mobile phones, including WVAS and wireless Internet sites.

In 2008, we also entered into cooperation agreements with Infront Sports & Media (China) Co., Ltd. to operate the official mobile websites for the Men's Professional League of the Chinese Basketball Association, China's National Basketball Teams and China's National Football Teams.

In 2008, we had cooperation arrangements with over 70 content providers, including the NBA, China Interactive Sports, the operator of www.Sports.cn, www.Olympic.cn, 51job, Inc., the PRC's largest recruitment services provider, Xinhua News Agency, Beijing Mapabc, a digital map provider, SouFun.com, a real estate portal and Hexun.com, an on-line financial news provider, to include selected content from these providers on Kong.net.

Our wireless Internet business is a new business and strategic initiative that we are undertaking with the aim of further expanding our product offerings, strengthening our competitive advantages, increasing corporate brand awareness and preparing ourselves for the development of 3G services in the PRC. We believe that mobile phone users demand increasing amounts of information and entertainment and that wireless Internet sites offer the most convenient means to satisfy this demand. Although the traffic from the users' mobile phones to the wireless Internet sites is still carried by telecommunications operators, our wireless Internet business does not rely on the telecommunications operators for billing and collection, and is not as heavily affected by the policies or guidelines of telecommunications operators as our WVAS business. We believe this strategic initiative will continue to be a key focus of our effort in 2009.

We began to generate advertising revenues in 2006 and achieved continuous growth in 2007 and 2008. Although we do not expect that mobile advertising on our wireless Internet sites would make a significant contribution to our total revenues in the short term, we believe that they would eventually become a more significant revenue source if the volume of traffic to our wireless Internet sites becomes sufficiently large and the mobile advertising market grows steadily. In 2009, we plan to complement our mobile advertising business by offering paid services such as mobile games and virtual items to Kong.net users, leveraging our existing payment platforms and customer base of our WVAS and mobile games businesses.

#### Our Technology Platforms for WVAS and Mobile Games

##### 2G Wireless Standard Services

We deliver our 2G services primarily through the SMS, IVR and CRBT technology platforms.

- Short Messaging Services (SMS). SMS is the basic form of mobile messaging service, and is supported by substantially all mobile phone models currently sold. Users can receive our products and services, which include news, jokes, weather forecasts and short stories, through their mobile phones on a single-transaction or a monthly subscription basis. We launched and began receiving revenues from SMS in July 2002.

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Interactive Voice Response (IVR). IVR services allow users to access voice content from their mobile phones, including music, chat, foreign-language instruction and novels. We launched and began receiving revenues from IVR services in December 2003.

- Color Ring Back Tones (CRBT). CRBT allow a mobile phone user to customize the sound that callers hear when calling the user's mobile phone. We offer a variety of entertaining content, including pre-recorded messages, movie dialogues and soundtracks and a wide range of classical and popular music. We launched and began receiving revenues from our CRBT services in October 2003.

## 2.5G Wireless Standard Services

We deliver our 2.5G services primarily to users of mobile phones that either are based on the global system for mobile communication, or GSM, standard and utilize GPRS, technology or are based on the CDMA standard and utilize CDMA 1x technology, in both cases through the WAP, MMS and Java™ technology platforms.

- Wireless Application Protocol (WAP). WAP allows users to browse content on their mobile phones so that users can request and receive information in a manner similar to accessing information on Internet websites using personal computers. We provide our WAP services primarily over China Mobile's GPRS networks. Our WAP services allow users to download color and animated pictures, logos and wallpaper, interactive mobile games, customized ringtones and other Internet content. We launched WAP services in May 2002, but did not begin to receive revenues for such services until September 2002, when China Mobile began to allow service providers to charge fees for WAP services.
- Multimedia Messaging Services (MMS). MMS is a messaging service that we deliver over GPRS networks and that, in the PRC, allows up to 50 kilobytes of data to be transmitted in a single message, compared to 140 bytes of data via SMS. As a result, MMS enables users to download colorful pictures and advanced ringtones. We launched MMS services in October 2002, but did not begin to receive revenues for such services until April 2003, when China Mobile started to allow service providers to charge fees for MMS. Our monthly subscription services automatically send information to users' mobile phones, and include news, beauty, celebrity photographs and special collectible items. Our services that can be downloaded on a single-transaction basis include pictures, screensavers, ringtones and special sound effects.
- Java™. Java™ technology allows mobile phone users to play interactive and networked mobile games, perform karaoke and download applications, such as screensavers and clocks, to customize their mobile phone settings. We launched services based on the Java™ programming language in September 2003, but did not begin to receive revenues for such services until November 2003, when China Mobile started to allow service providers to charge fees for Java™ services.

Since 2005, we have pursued a diversified growth strategy and our objective has been and remains providing services based on both the 2G and 2.5G technology platforms. As a result of our continuous effort in developing and promoting 2G services, and also due to our acquisition of Sharp Edge, which derives most of its revenues from the provision of 2G services, the portion of our total revenues from 2G services grew from 27.3% in 2005 to 51.2% in 2006, 62.7% in 2007 and 63.4% in 2008.

## Strategic Relationships

We have established cooperation arrangements with telecommunications operators, mobile handset manufacturers, content providers and other business partners to produce, promote and market our services. We provide our WVAS mainly pursuant to cooperation agreements with China Mobile. Since 2004, we also have provided our WVAS through China Unicom's mobile network and each of China Netcom's and China Telecom's Personal Handyphone Systems, or PHS systems, which are based on fixed-line networks. In addition, we cooperate with several PRC leading mobile handset manufacturers, which make select handset models with a WVAS icon in the handset's menu that enables users to access our services directly. We pay service fees to the telecommunications operators, mobile handset manufacturers, mobile handset distributors, content providers and other partners, where relevant.



## Telecommunications Operators

China Mobile is the world's largest mobile telecommunications network operator in terms of subscribers, with 457 million subscribers as of December 31, 2008, according to China Mobile's public filings with the SEC. Our working relationship with China Mobile is critical to the operation and continued development of our business. See "Item 3 — Key Information — Risk Factors — Risks Relating to Our Business — We depend on China Mobile and other PRC telecommunications operators for the majority of our revenues, and any loss or deterioration of our relationship with these telecommunications operators may result in severe disruptions to our business operations and the loss of the majority of our revenues." We provide WVAS in 31 Chinese provinces or provincial-level municipalities pursuant to cooperation agreements with China Mobile and its provincial subsidiaries. Generally, these agreements have terms of one year or shorter, but renew automatically unless either party objects. We were one of the first wireless service providers to work with China Mobile to develop and offer WAP, MMS and Java™. We continue to jointly develop and promote WVAS with China Mobile and its provincial subsidiaries, which is generally more cost-effective and far-reaching than if we were to promote these services through traditional advertising.

In addition to our cooperation agreements with China Mobile and its provincial subsidiaries, we have entered into cooperation agreements pursuant to which we provide 2G and 2.5G services on the networks of China Unicom and 2G services on the networks of China Netcom and China Telecom. Aggregate revenues from the cooperation agreements with these three telecommunications operators amounted to 24%, 25% and 23% of our total revenues during the years ended December 31, 2006, 2007 and 2008, respectively.

We charge our customers content fees, which vary among our different services, on either a single-transaction or a monthly subscription basis. We establish the fees paid by our customers in consultation with the telecommunications operators and, in turn, pay a portion of these fees to the telecommunications operators through which our services are provided.

Pursuant to our agreements with the subsidiaries of China Mobile, we generally pay to China Mobile subsidiaries 15% of the fees we generate from providing our services to customers through such subsidiaries' networks, with the exception of IVR services, with respect to which we pay to China Mobile subsidiaries 30% of the fees we generate. China Mobile subsidiaries also offer to provide us with customer services or customer services packaged with marketing and promotional services in return for an additional 15% or 35%, respectively, of the fees we generate from providing our services through such subsidiaries' networks. However, because we maintain our own customer service and sales and marketing capabilities, we generally do not contract with China Mobile subsidiaries for such services. In addition, China Mobile subsidiaries deduct a net transmission charge from our portion of the fees for services provided on the MMS and SMS platforms. Such transmission charge is equivalent to the transmission fee set forth in the table below multiplied by the number of messages we send through the telecommunications operator's network minus the number of messages we receive from users requesting our services.

Pursuant to our agreements with China Unicom and its subsidiaries, we generally pay each China Unicom subsidiary 15% to 52% of the fees we generate from providing our services to customers through such subsidiary's network, with the exception of IVR services, with respect to which we pay 52%.

Pursuant to our agreements with China Telecom and China Netcom and their respective subsidiaries, we generally pay each China Telecom and China Netcom subsidiary 15% to 50% of the fees we generate from providing our services to customers through such subsidiary's network, with the exception of IVR services, with respect to which we pay 50%.

The following table sets forth the principal fees that we charged our customers for our services and the service and transmission fees that we paid to the telecommunications operators as of December 31, 2008:



	Fees we charged customers		Fees we paid telecommunication operators	
	Transaction fee per unit (1)	Monthly subscription fee (in RMB (3), except percentages)	Service fees	Transmission fee (2)
WAP	1.00-3.00	1.00-8.00	15%-50%	N/A
MMS	0.50-3.00	5.00-30.00	15%	0.15-0.20
Java™	1.00-15.00	1.00-15.00	15%	N/A
SMS	0.10-3.00	2.00-20.00	15%-50%	0.02-0.08
IVR	0.10-3.00	10.00	20%-54%	N/A
CRBT	0.10-4.00	0.10-10.00	15%-50%	N/A

(1) Transaction fees are per download for WAP, MMS, Java™, SMS and CRBT services and per minute for IVR service.

(2) A transmission fee is assessed for each message we send in excess of the number of messages we receive. The amount of the transmission fees for each month depends on the volume of messages sent in that month. No transmission fees are assessed for WAP, JAVA™, IVR or CRBT services.

(3) Our fees are charged in Renminbi. The noon buying rate certified by the Federal Reserve Bank of New York was RMB6.8225 = \$1.00 on December 31, 2008.

In May 2008, the PRC government announced its policy initiative to restructure the PRC telecommunications industry, and a series of related transactions were completed in 2008. In addition, a 3G license was issued to each of China Mobile, China Unicom and China Telecom. While we are currently assessing the impact that this restructuring may have on us, potential changes in the telecommunications industry in the PRC could impact our relationship with telecommunications operators and thus have a material adverse effect on our business and results of operations. See “Item 3 — Key Information — Risk Factors — Risks Relating to Our Business — We depend on China Mobile and other PRC telecommunications operators for the majority of our revenues, and any loss or deterioration of our relationship with these telecommunications operators may result in severe disruptions to our business operations and the loss of the majority of our revenues.”

We rely primarily on the telecommunications operators to provide billing and collection services for us. Each telecommunications operator incorporates the fees for our services into the invoices that such operator sends to its customers on a monthly basis. We receive monthly statements from each of the telecommunications operators, which indicate the aggregate amount of fees that were charged to customers for services that we provided. For a description of our revenue recognition policy, see “Item 5 — Operating and Financial Review and Prospects — Critical Accounting Policies — Revenue Recognition.” Also see “Item 3 — Key Information — Risk Factors — Risks Relating to Our Business — We depend on China Mobile and other PRC telecommunications operators for the majority of our revenues, and any loss or deterioration of our relationship with these telecommunications operators may result in severe disruptions to our business operations and the loss of the majority of our revenues.”

#### Material Contracts with Telecommunications Operators

The term of our contracts with the telecommunications operators is generally one year or shorter. When such contracts expire, we rely on the automatic renewal clauses contained in such contracts, execute an extension or enter into new contracts. On occasion, the renewal or the execution of new contracts can be delayed by several months. Based on our experience, in the event that a contract expires and is not promptly renewed, the telecommunications operator typically continues to honor the expired contract until such time that an extension is executed or a new contract is signed. We cannot assure you that any telecommunications operator will in fact continue to honor an expired contract. The specific termination and other material provisions of our more significant contracts with the telecommunications operators are set forth below.



Beijing AirInbox has entered into a cooperation agreement with China Mobile to provide WAP services to customers nationwide on the Monternet™ portal during the period from January 1, 2008 through December 31, 2008. We are in the process of renewing such agreement. Pursuant to this agreement, Beijing AirInbox pays China Mobile a service fee of 15% of the revenues generated from providing WAP services to customers. Beijing AirInbox may not provide the same content that it provides to China Mobile under this agreement to other operators or WAP sites. Any violation of such provision entitles China Mobile to terminate this agreement. Beijing AirInbox also has entered into contracts with certain provincial subsidiaries of China Mobile that provide access to Beijing AirInbox's WAP services through the provincial subsidiaries' WAP portals.

Beijing AirInbox has entered into a cooperation agreement with China Mobile to provide MMS services on China Mobile's nationwide network during the period from June 18, 2008 through December 31, 2008. The cooperation agreement was automatically renewed for one more year upon expiration. Pursuant to this agreement, Beijing AirInbox pays China Mobile a service fee of 15% of the revenues generated from providing MMS services to customers, plus net transmission charges. Beijing AirInbox may not provide the same content that it provides to China Mobile under this agreement to other telecommunications operators. Any violation of such provision entitles China Mobile to terminate this agreement.

Beijing AirInbox has entered into a cooperation agreement with China Mobile to provide IVR services on China Mobile's nationwide network during the period from November 1, 2008 through November 1, 2009. The cooperation agreement can be automatically renewed for six months upon expiration. Pursuant to this agreement, Beijing AirInbox pays China Mobile a service fee of 30% of the revenues generated from providing IVR services to customers.

Beijing AirInbox has entered into a cooperation agreement with China Mobile to provide SMS services on China Mobile's nationwide network during the period from May 1, 2008 through April 30, 2009. The cooperation agreement can be automatically renewed for six months upon expiration. Pursuant to this agreement, Beijing AirInbox pays China Mobile a service fee of 15% of the revenues generated from providing SMS services to customers.

In September 2007, Beijing AirInbox entered into a cooperation agreement with China Unicom to provide WVAS to its customers on China Unicom's mobile communication network and data service platform. The service fees payable by Beijing AirInbox to China Unicom vary with the type of WVAS that are provided. This cooperation agreement was initially effective from September 1, 2007 to June 30, 2008 and was automatically renewed for one year.

In June 2007, Beijing AirInbox entered into a cooperation agreement with China Telecom to provide SMS services on China Telecom's nationwide network and SMS service platform. The service fees payable by Beijing AirInbox to China Telecom vary with the contents of SMS service that are provided. This cooperation agreement was initially effective from June 5, 2007 to June 5, 2008 and was automatically renewed for one year.

#### Mobile Handset Manufacturers

We have established distribution arrangements with mobile handset manufacturers, including Nokia, Motorola, Samsung, Lenovo, Sony Ericsson, Jin Tongxin, Guangli Technical, Shenzhen Taisida, Youxinda, Amoi and other major international and domestic handset manufacturers. Pursuant to these distribution arrangements, we pre-load into the menu of certain mobile handsets our mobile games, WAP icons and MMS, SMS, JAVA™ and IVR short codes, which enable customers to access our WVAS quickly and easily. We pay the mobile handset manufacturers 35% to 70% of the net revenues that we receive from the telecommunications operators, generally after deducting the telecommunications operators' service fees, with respect to our mobile games and WVAS that are accessed by means of the pre-loaded icons and short codes. The terms of these agreements are generally for one year, and pertain to specific mobile handset models. In addition, we also leverage our relationships with the mobile handset manufacturers to enter into joint marketing programs.

In addition to pre-loading our mobile games, icons and short codes into selected mobile handsets, until recently we also embedded our icons and codes in selected handsets. On April 11, 2007, the MII issued a notice barring the production of mobile handsets with embedded icons and codes that cannot be changed or deleted by customers. We have altered our arrangements with mobile handset manufacturers to comply with the notice, which took effect on June 1, 2007. See "Item 3 — Key Information — Risk Factors — Risks Relating to Our Business — Our effort to develop additional distribution channels for our WVAS and mobile games may not succeed or may be halted by the MII or the telecommunications operators."



## Content Providers

We have entered into licensing agreements with content providers. Pursuant to these agreements, we contract with our content providers to use their content for a fixed licensing fee or for a certain percentage, generally 10% to 80%, of the net cash we receive from telecommunications operators with respect to products and services that contain the licensed content, generally after deducting the fees paid to our distribution partners. These arrangements are typically for one or two years and are not exclusive, except for the content specifically produced for us by our freelance writers and certain content from our third-party content providers. We currently license news content from the Xinhua News Agency, [www.qianlong.com](http://www.qianlong.com) and China Foto Press, among others, and license music content from EMI, Music Publishing China, HBstars and Avex Asia Limited. We use the music that we license in our CRBT, song dedication, song listening, mobile karaoke, true ringtone and music video streaming and download services. We also have signed agreements giving us exclusive rights in the PRC to develop wireless value-added products and services based on the voice of the Chinese actor Ge You and the content of the movies "Painted Skin" and "If You Are The One." In addition, we have entered into licensing agreements with Gameloft, IN-FUSIO and Tianjin Yaxun to provide their games to mobile phone users in the PRC.

We have also entered into agreements with content providers to obtain premium contents for our wireless Internet sites. Pursuant to these agreements, we use the contents for a fixed license fee or for a certain percentage, generally 30% to 70%, of the net revenues we receive from the mobile advertising that contains the licensed contents, or sometimes both. We currently license contents from the NBA, China Sports Industry Group Co., Ltd., Infront Sports & Media (China) Co., Ltd., Xinhua PR Newswire, Dow Jones & Company, Finet Group Limited and other content providers.

## Product Development

Our product development team focuses on constantly creating innovative products that use the latest standards and technologies with respect to our WVAS, mobile games and wireless Internet sites. China Mobile started operating its 2.5G network in May 2002. The 2.5G standard enables WVAS providers to send more data in a shorter period of time, thereby facilitating the transmission of more advanced data services. We were one of the first WVAS providers to work with China Mobile to develop and offer MMS and WAP services and have continued to be a leading developer of innovative services compatible with these technology platforms. We have a dedicated mobile games development team that develops games for Java™ and other mobile games platforms. At the same time, we have increased our product development team's emphasis on developing and supporting our 2G products, including IVR and CRBT, which we distribute on the networks of China Mobile, China Unicom and China Telecom. In addition, a portion of our product development team focuses on products and services for the wireless Internet sites we are operating, including [Kong.net](http://Kong.net), [Ko.cn](http://Ko.cn) and [cn.NBA.com](http://cn.NBA.com). We believe that our timely delivery of new services that meet telecommunications operators' specifications demonstrates our technical capabilities and strengthens our cooperation relationship with the telecommunications operators.

In addition to developing a range of innovative services, we also have developed a variety of programming tools that allow us to enhance customers' enjoyment of our services. For instance, in response to the current lack of a standard operating system among mobile phones produced by different manufacturers in the PRC, which may result in inconsistent experiences for customers accessing our services through different handset models, we have developed software tools that allow our services to be readily adapted for use on most mobile phones on the market. Such tools reduce the cost of adapting our services to new models of mobile phones and optimize the user experience in terms of format and presentation of our services.

The number of our product development employees increased to 477 as of December 31, 2008 from 444 as of December 31, 2007.

Sales, Marketing and Customer Service

We are committed to establishing our KongZhong name as a well-recognized and reputable brand not only among our customers and users, but also among telecommunications operators, key industry players and owners of brand names. We sell our WVAS and mobile games principally through the telecommunication operators, as well as other distribution partners. We market through our website, promotional events, direct marketing and media advertising. We provide support and technical services to China Mobile, China Unicom and China Telecom and to our customers and users.

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## Sales and Marketing

We focus on marketing our KongZhong brand name, as we believe branding is important in the wireless Internet business. In 2007, we increased our effort on advertising in traditional media such as television, billboards, newspapers and magazines as well as through the Internet to promote the wireless Internet sites we are operating, including Kong.net, Ko.cn and cn.NBA.com, and our corporate brand name, KongZhong. We conducted a major advertising campaign in the first half of 2007 and have started to cooperate with the NBA to promote cn.NBA.com since the second half of 2007. In 2008, we increased our effort in joint activities to promote our brand and business conducted in cooperation with the telecommunications operators.

We utilize our leading position among providers of WVAS and our knowledge of our customers to attract joint promotion arrangements with brand owners seeking effective channels of publicity among trend-conscious consumers. Through select distribution channels, we target young and fashion-driven consumers who we believe set trends for consumer products and services in the PRC. For example, we promoted the movie “The Promise” pursuant to a joint promotional arrangement under which we offered exclusive WVAS containing pictures and other content relating to the movie. In addition, we market through traditional offline media venues, such as through newspapers, magazines and flyers.

A majority of our revenues are derived from services provided through the networks of China Mobile. Accordingly, we devote significant resources to maintaining, expanding and strengthening our relationship with China Mobile and its subsidiaries. In addition, we have strengthened our sales and marketing of 2G services, which we provide through the networks of China Mobile as well as other telecommunications operators. As of December 31, 2008, our sales and marketing department consisted of 152 persons strategically located in 27 provinces across the PRC to work closely with the telecommunications operators at the provincial and local levels, where pricing and other important decisions on marketing and operations are made. Our localized sales team helps us gain insight into developments in the local markets and the competitive landscape, as well as new market opportunities.

We also continuously seek alternative distribution channels, such as mobile handset manufacturers and mobile handset distributors. Our sales force also works with other distribution partners to promote our services.

To motivate our sales professionals, a portion of their compensation is based on the usage of our services in their respective regions. Sales quotas are assigned to all sales personnel according to quarterly sales plans. We also continuously explore other joint marketing strategies in order to maximize our cooperation arrangements and resources.

In addition, we have created an advertising sales team in our sales and marketing department that focuses on selling advertising at Kong.net, Ko.cn and cn.NBA.com. Beginning in 2007, members of this team have received sales commissions instead of the performance-based bonuses paid to other members of the sales and marketing department.

## Customer Service

We view both the telecommunications operators and end users of our services as customers. Customer service is key to building our brand and our relationships with the telecommunications operators. We train our customer service representatives with an emphasis on customer satisfaction. Our customer service center handles calls, faxes and e-mails from our end users, as well as inquiries forwarded from the telecommunications operators. Our customer service representatives interact on a regular basis with, and provide training materials to, customer service representatives of telecommunications operators to enhance our customers’ experience with our services. As of December 31, 2008, our customer service department consisted of 65 persons strategically located in 9 provinces across the PRC.



## Competition

We face significant competition in the WVAS, mobile games, wireless Internet and mobile advertising markets in the PRC. The MII has reported on its website that, as of April 8, 2009, more than 1,700 service providers held nationwide licenses to supply content and services on the PRC telecommunications operators' networks. China Mobile has begun to develop and market its own MMS and WAP products that compete with ours. Other PRC telecommunications operators may decide to do the same. We compete with these companies primarily on the basis of brand, the type and timing of service offerings, content and business partner and channel relationships. The telecommunications operators may also decide to enter the mobile games market in the future. Other potential competitors in this market include developers of personal-computer-based online games, major media companies, traditional video game developers, content aggregators, mobile software providers and independent mobile games developers. In addition to competition for products, services and distribution channels, we also compete for experienced and talented employees.

Some of our competitors may have more human and financial resources and a longer operating history than us. For example, Internet portals providing WVAS may have an advantage over us with their longer operating history, more established brand name, larger user base and Internet distribution channels. Furthermore, some competitors may be able to develop or exploit new technologies faster than us, or offer a broader range of products and services than we are presently able to offer.

In addition, barriers to entry of wireless Internet services are relatively low and current and new competitors can launch new wireless Internet sites at a relatively low cost. The PRC telecommunications operators also operate their own wireless Internet sites. We compete with the operators of other wireless Internet sites for visitors, employees and advertisers, and also compete with traditional media companies such as newspapers, television networks and radio stations for advertisers.

See "Item 3 — Key Information — Risk Factors — Risks Relating to Our Business — We face increasing competition in the PRC from providers of WVAS, mobile games and wireless Internet services, which could reduce our market share and materially adversely affect our financial condition and results of operations."

### 2G Wireless Standard Services

Competition is particularly intense in the 2G-based WVAS market in the PRC as the barriers to entry are relatively low compared to the 2.5G market. Our primary competitors in this market include Internet portals, such as Sina Corporation, Sohu.com Inc. and TOM Online Inc., or TOM Online, and providers focused on WVAS, such as Tencent Technology Limited and Linktone Limited.

### 2.5G Wireless Standard Services

Our primary competitors in the 2.5G WVAS and mobile games market in the PRC include Internet portals, such as Sina Corporation and TOM Online, as well as providers focused on WVAS and mobile games, such as Tencent Technology Limited and Glu Mobile Inc. We also face increasing competition from China Mobile in the 2.5G WVAS market.

### 3G Wireless Standard Services

3G wireless services are still at an early stage of development in the PRC, but future competitors in the 3G market could include existing competitors in 2G and 2.5G services, as well as established fixed-line Internet companies that may not currently have any 2G or 2.5G service offering.

### Wireless Internet Business



Our primary competitors in the wireless Internet market in the PRC include Internet portals, such as Sina Corporation and Tencent Technology Limited, as well as independent operators of wireless Internet sites and PRC telecommunications operators who operate their own wireless Internet portals, such as China Mobile. Since there is currently no reliable and accurate third-party monitoring of wireless Internet traffic in the PRC, detailed data of traffic on the major wireless Internet sites are not available.

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## Intellectual Property and Proprietary Rights

We regard our copyrights, trademarks, trade secrets and other intellectual property rights as critical to our business. We rely on trademark and copyright law, trade secret protection, non-competition, confidentiality and licensing agreements with our senior officers, clients, partners and others to protect our intellectual property rights. Despite our effort to protect our proprietary rights, we cannot be certain that the steps we have taken will prevent misappropriation of our content or technology, particularly in foreign countries where the relevant laws may not protect our proprietary rights as fully as in the United States. For a description of the regulations applicable to our industry in the PRC, see “— Regulation.”

We have registered KongZhong Network as a commercial website with the SAIC. As a result, no one else may operate a website, whether commercial or otherwise, using the name of KongZhong Network. We also have registered our logo, the KongZhong thumb, and certain of our product names as trademarks in the PRC, and have applied to register our wireless Internet portal logo, the K palm, as a trademark in the PRC. Our trademarks are registered in the name of Beijing AirInbox. In addition, Beijing AirInbox is the registered owner of a number of domain names, the principal ones of which are [www.kongzhong.com](http://www.kongzhong.com), [www.kongzhong.com.cn](http://www.kongzhong.com.cn), [www.kongzhong.net](http://www.kongzhong.net), [www.kongzhong.net.cn](http://www.kongzhong.net.cn), [www.cota.com.cn](http://www.cota.com.cn), [www.cota.cn](http://www.cota.cn), [ko.cn](http://ko.cn) and [Kong.net](http://Kong.net).

We are unable to register the Chinese name of “KongZhong Network” as our service mark in the PRC because it is deemed a generic term under existing PRC trademark laws and regulations, which prohibit registration of generic terms as trademarks or service marks. However, we do not expect to face a proliferation of counterfeit services or products without any legal remedy as we may seek a remedy for piracy under the PRC’s Anti-Unfair Competition Law, by bringing a suit against a third party that uses the Chinese name of “KongZhong Network” if the overall design or appearance of that third party’s services is substantially the same as that of the well-known or established services provided by us. See “Item 3 — Key Information — Risk Factors — Risks Relating to Our Business — We may not be able to adequately protect our intellectual property, and we may be exposed to infringement claims by third parties.”

## Information Technology Systems and Infrastructure

We maintain most of our servers at the premises of Beijing Telecommunication Corporation, which is the administrator of the central hub of the ChinaNet backbone. We also maintain servers at other Internet data centers, including Beijing Mobile Communication Company Limited, Chongqing Mobile Communication Company Limited and Hangzhou Mobile Communication Company Limited. We believe that utilizing these hosting partners provides significant operating benefits, such as protecting our systems from power loss, break-ins and other potential external causes of service interruption. In addition, we back up all of our data. We believe we will be able to increase our server capacity as needed to accommodate future growth.

## Employees

### General

Our senior management and many of our employees have had prior experience in the Internet portal or telecommunications-related industries. Our employees receive a base salary and a performance-based bonus. Our bonuses are available to all employees and the amounts of such bonuses are calculated based on the performance ranking of the employee. We have a broad-based equity incentive plan pursuant to which we grant stock options and restricted share units, or nonvested shares, from time to time to employees who have passed their initial probation period. We also offer internal training programs tailored to different job requirements to help enhance our employees’ talents and skills. We believe that these initiatives have contributed to the growth of our business.



In July 2006, we announced plans to reduce our workforce by approximately 15% as a result of the anticipated negative impact of China Mobile's announcement of its new billing measures. Such plans were completed by September 30, 2006. As of December 31, 2008, we had 772 employees, all in the PRC. The table below sets forth the number of our employees by function as of the end of the periods indicated:

	2006		As of December 31, 2007		2008	
	Number	% of Total	Number	% of Total	Number	% of Total
Sales, marketing and business development	276	34.6%	212	26.4%	152	20%
Customer service	77	9.7%	69	8.6%	65	8%
Product development	371	46.5%	444	55.2%	477	62%
Networking operation	25	3.1%	26	3.2%	26	3%
General and administrative	49	6.1%	53	6.6%	52	7%
Total	798	100.0%	804	100.0%	772	100%

We believe that we maintain a good working relationship with our employees and we have not experienced any significant labor disputes or any difficulty in recruiting staff for our operations. Our employees are not represented through any collective bargaining agreements or by labor unions.

#### Employee Benefits Plan

Our full-time employees in the PRC participate in a government-mandated multi-employer defined contribution plan pursuant to which certain pension benefits, medical care, unemployment insurance, employee housing fund and other welfare benefits are provided to employees. The PRC labor regulations require us to accrue for these benefits based on certain percentages of the employees' salaries. The total provisions for such employee benefits were \$2,583,427, \$646,515 and \$404,074 for the years ended December 31, 2006, 2007 and 2008, respectively. The decreases in 2007 and 2008 mainly resulted from the reduction of certain welfare benefits in response to the adverse impacts on our business and financial condition of the new policies adopted by the telecommunications operators since the second half of 2006.

We have granted stock options to our employees pursuant to our KongZhong Corporation 2002 Equity Incentive Plan, or the 2002 Plan, and our KongZhong Corporation 2006 Equity Incentive Plan, or the 2006 Plan, as described in "Item 6 — Directors, Senior Management and Employees — Stock Options."

#### Properties

Our principal executive office currently occupies approximately 6,807 square meters of office space in Beijing, the PRC, primarily under leases that will expire in August 2009. In addition, we lease sales offices in 11 provinces throughout the PRC.

#### Legal Proceedings

We and certain of our Directors, officers and shareholders were named as defendants in six related securities class action lawsuits filed in the United States District Court for the Southern District of New York. These lawsuits were brought on behalf of a putative class of shareholders who purchased or otherwise acquired our ADSs pursuant to our initial public offering between July 9, 2004 and August 17, 2004. The complaints asserted that our prospectus filed with the United States SEC was false and misleading because it failed to disclose certain adverse facts related to sanctions subsequently imposed by China Mobile on us. The complaints alleged violations of Sections 11, 12(a) and 15 of the Securities Act. The court selected the lead plaintiff in these actions, and a consolidated amended complaint was filed with the United States District Court for the Southern District of New York on April 14, 2005. On

September 13, 2005, we reached an agreement in principle to settle the action. On November 9, 2005, we entered into a stipulation of settlement pursuant to which the plaintiffs agreed to dismiss with prejudice the class action claims and we agreed to pay \$3.5 million into a settlement fund for persons who purchased or sold our ADSs between July 9, 2004 and August 17, 2004. The court approved the settlement at a fairness hearing on April 14, 2006. In the first quarter of 2006, we paid the \$3.5 million settlement payment into an escrow account. We believe that we have been in compliance with securities laws and made appropriate and necessary disclosures in our prospectus dated July 9, 2004 at the time of the initial public offering. We agreed to this settlement solely to avoid the expense, distraction and uncertainty associated with continued litigation without admitting any fault, liability or wrongdoing.

Despite our effort to comply with the intellectual property rights of third parties, we cannot be certain that we have not, and will not, infringe on the intellectual property rights of others, which may subject us to legal proceedings and claims in the ordinary course of our business from time to time. Such legal proceedings or claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources. In addition, we may also initiate litigation to protect our intellectual property rights. See “Item 3 — Key Information — Risk Factors — Risks Relating to Our Business — We may not be able to adequately protect our intellectual property, and we may be exposed to infringement claims by third parties.”

## Regulation

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

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

- formulating and enforcing telecommunications industry policy, standards and regulations;
- granting licenses to provide telecommunications and Internet services;
- formulating tariff and service charge policies for telecommunications and Internet services;
- supervising the operations of telecommunications and Internet service providers; and
- maintaining fair and orderly market competition among operators.

In September 2000, the State Council promulgated the Telecommunications Regulations, or the Telecom Regulations. The Telecom Regulations categorize all telecommunications businesses in the PRC as either infrastructure telecommunications businesses or value-added telecommunications businesses, with WVAS classified as value-added telecommunications businesses. The Telecom Regulations also set forth extensive guidelines with respect to different aspects of telecommunications operations in the PRC.

In December 2001, in order to comply with the PRC’s commitments with respect to its entry into the WTO, the State Council promulgated the 2001 Telecom FIE Rules. In September 2008, the State Council promulgated the Decree of the State Council No. 534 to amend certain provisions of the 2001 Telecom FIE Rules. The Telecom FIE Rules set forth detailed requirements with respect to capitalization, investor qualifications and application procedures in connection with the establishment of a foreign-invested telecommunications enterprise. Pursuant to the Telecom FIE Rules, the ultimate capital contribution ratio of the foreign investor(s) in a foreign-funded telecommunications enterprise that provides value-added telecommunications services shall not exceed 50%. In addition, all principal investors in such an enterprise must themselves be telecommunications operators. Pursuant to the Foreign Investment Industrial Guidance Catalogue, as of October 31, 2007, the permitted foreign investment ratio of value-added telecommunications services is no more than 50%. To comply with these PRC regulations, we conduct substantially all of our operations through Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong, BJXR and Mailifang, which are wholly-owned by PRC citizens or entities and incorporated in the PRC. We do not have any equity interests in these operating companies, but instead enjoy the economic benefits of these operating companies through a series of contractual arrangements, which we and our wholly-owned subsidiaries, KongZhong Beijing and Beijing Anjian Xingye, have entered into with Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Beijing Chengxitong, BJXR and Mailifang and their respective shareholders as described in “— Our Corporate Structure” and

“Item 7 — Major Shareholders and Related Party Transactions — Related Party Transactions.” In the opinion of King & Wood, our PRC legal counsel, the ownership structures of, and each of our contractual agreements with, these operating companies comply with all existing PRC laws and regulations, including the Telecom FIE Rules.

In July 2006, the MII issued the Circular on Strengthening the Administration of Foreign Investment in and Operation of Value-added Telecommunications Business. In the circular, the MII reiterated the existing regulations regarding foreign investment in telecommunications business, which require foreign investors to set up foreign-invested enterprises and obtain an ICP license in order to conduct any value-added telecommunications business in the PRC. Under this circular, a domestic company that holds an ICP license is prohibited from leasing, transferring or selling the license to foreign investors in any form, and from providing resources, sites or facilities to foreign investors that conduct value-added telecommunications business illegally in the PRC. Furthermore, the relevant trademarks and domain names that are used in the value-added telecommunications business shall be owned by the local ICP license holder or its shareholders. This circular 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 telecommunications service providers are required to maintain network and information security in accordance with the standards set forth under relevant PRC regulations. Due to the lack of further necessary interpretation from the regulator, it remains unclear what impact the above circular will have on us or other PRC Internet companies that have adopted the same or similar corporate and contractual structures as ours.

In addition to the regulations promulgated by the central PRC government, some local governments have also promulgated local rules applicable to Internet or other value-added telecommunications companies operating within their respective jurisdictions. In Beijing, the Beijing Municipal Administrative Bureau of Industry and Commerce, or the Beijing AIC, has promulgated a number of Internet-related rules. In 2000, the Beijing AIC adopted the Administrative Rules on Filing Commercial Websites, which require owners of the domain names of commercial websites located within Beijing to file their website names and commercial websites with the Beijing AIC.

#### Regulation of Internet Content Services

Subsequent to the State Council's promulgation of the Telecom Regulations and the Internet Information Services Administrative Measures, or the Internet Information Measures, in September 2000, the MII and other regulatory authorities formulated and implemented a number of Internet-related regulations, including but not limited to the Internet Electronic Bulletin Board Service Administrative Measures, or the BBS Measures. The Internet Information Measures require that commercial Internet content providers must obtain an Internet information license from the appropriate telecommunications authorities in order to carry on any commercial Internet content operations within the PRC. Internet content operators must display their operating license numbers in a conspicuous location on their home page. Internet content operators are obliged to police their websites in order to remove categories of harmful content that are broadly defined. This obligation reiterates Internet content restrictions that have been promulgated by other ministries over the past few years. In addition, the Internet Information Measures also provide that Internet content operators which operate in sensitive and strategic sectors, including news, publishing, education, health care, medicine and medical devices, must obtain additional approvals from the relevant authorities in charge of those sectors as well. Of particular note to foreign investors, the Internet Information Measures stipulate that Internet content operators must obtain the consent of the MII prior to establishing an equity or cooperative joint venture with a foreign partner. The BBS Measures provide that any Internet content operator engaged in providing online BBS is subject to a special approval and filing process with the relevant governmental telecommunications authorities.

Certain local governments have promulgated local rules applicable to Internet companies operating within their respective jurisdictions. In Beijing, the Beijing AIC has promulgated a number of Internet-related rules. In 2004, the Beijing AIC adopted the Administrative Rules on Filing Commercial Websites, which require owners of the domain names of commercial websites located within Beijing to file their website names and commercial websites with the Beijing AIC.

Each of Beijing AirInbox, Beijing Boya Wuji, Beijing WINT and BJXR has a telecommunications and information services operating license for their Internet content businesses from the Beijing Telecommunications Administration Bureau. These licenses are subject to standard annual reviews.





## Regulation of WVAS

Pursuant to the Telecom Regulations, a commercial operator of Internet content services must obtain an operating license. Other than this requirement, PRC legislation on wireless telecommunications is generally aimed at regulating equipment and infrastructure rather than applications and value-added service providers.

The Administrative Measures for Telecommunications Business Operating Licenses, or Telecom License Measures, were promulgated by the MII on December 26, 2001. The Telecom License Measures confirm that there are two types of telecommunications operations licenses for operators in the PRC (including foreign-invested telecommunications enterprises), namely, licenses for infrastructure services and licenses for value-added services, for which a distinction is made as to whether a license is granted for intra-provincial or nationwide activities. An appendix to the license details the permitted activities of the enterprise to which it was granted. An approved telecommunications service operator must conduct its business, for both infrastructure and value-added services types of businesses, according to the specifications recorded on its Telecom Business Operating License. The MII is the competent approval authority for foreign-invested telecommunications enterprises and for granting nationwide licenses to value-added telecommunications enterprises.

Other than a general classification of wireless information services as value-added telecommunications services by an appendix to the Telecom Regulations, as amended, there is currently no nationwide legislation that specifically addresses the provision of WVAS, such as SMS, MMS, WAP, Java™, IVR or CRBT services. At this time, it is uncertain when national legislation might be enacted to regulate this business.

Each of Beijing AirInbox and Beijing Boya Wuji has obtained a value-added telecommunications business operation permit in order to operate wireless value-added businesses in Beijing. Each of Beijing AirInbox, Beijing WINT, Beijing Chengxitong, BJXR and Mailifang has obtained a nationwide value-added telecommunications license from the MII in order to provide services in multiple provinces, autonomous regions and municipalities. These licenses are subject to standard annual review.

## Regulation of Internet Culture Activities

On May 10, 2003, the Ministry of Culture of the PRC promulgated the Interim Provisions on the Administration of Internet Culture, or the Internet Culture Measures, which became effective as of July 1, 2003. On July 1, 2004, the Ministry of Culture promulgated the Decision of the Ministry of Culture on Amending the Interim Provisions on the Administration of Internet Culture, or the Amendment Decision. The Internet Culture Measures and the Amendment Decision require Internet content providers that engage in Internet culture activities to obtain an Internet culture business operations license from the Ministry of Culture in accordance with the Internet Culture Measures and the Amendment Decision. The term "Internet culture activities" is defined in the Internet Culture Measures and the Amendment Decision as activities in connection with the provision of Internet cultural products and services, which mainly include: (1) producing, reproducing, importing, selling (either on a wholesale or retail basis), leasing or broadcasting Internet cultural products; (2) publishing cultural products on the Internet or distributing cultural products through the Internet to such consumer electronics as computers, fixed telephones, mobile phones, radios, television sets and video game machines for consumption by Internet users; and (3) holding exhibitions of and competitions involving Internet cultural products.

Beijing AirInbox has obtained an Internet culture business operations license from the Ministry of Culture.

## Regulation of Information Security and Censorship

PRC legislation concerning information security and censorship specifically prohibits the use of Internet infrastructure where it results in a breach of public security, the provision of socially destabilizing content or the divulgence of state

secrets.

- “A breach of public security” includes a breach of national security or disclosure of state secrets; infringement on state, social or collective interests or the legal rights and interests of citizens; or illegal or criminal activities.

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- “Socially destabilizing content” includes any action that incites defiance or violation of PRC laws; incites subversion of state power and the overturning of the socialist system; fabricates or distorts the truth, spreads rumors or disrupts social order; advocates cult activities; or spreads feudal superstition, involves obscenities, pornography, gambling, violence, murder, or horrific acts or instigates criminal acts.
- “State secrets” are defined as “matters that affect the security and interest of the state.” The term covers such broad areas as national defense, diplomatic affairs, policy decisions on state affairs, national economic and social development, political parties and “other state secrets that the State Secrecy Bureau has determined should be safeguarded.”

According to the aforementioned legislation, it is mandatory for Internet companies in the PRC to complete security filing procedures with the local public security bureau and for them to update their filings regularly with the local public security bureau regarding information security and censorship systems for their websites. In this regard, the Measures for the Administration of Commercial Website Filing, promulgated in October 2004 by the Beijing AIC, state that websites must comply with the following requirements:

- they must file with the Beijing AIC and obtain electronic filing marks;
- they must place the filing marks on their websites’ homepages; and
- they must register their website names with the Beijing AIC.

We have successfully filed our websites and website names with the Beijing AIC. Accordingly, we have obtained an electronic registration mark.

#### Regulation of Advertisements

The principle regulations governing advertisements in the PRC are the Advertising Law (1996) and the Administrative Regulations of Advertisements (1987), pursuant to which an entity conducting advertising activities as a supplementary business must obtain a permit from the local AIC and specifically mention advertising activities as a permitted business activity in such entity’s business license. The SAIC is the government agency responsible for regulating advertising activities in the PRC. The Advertising Law (1996) and the Administrative Regulations of Advertisements (1987) do not contain, and the SAIC has not promulgated, regulations specifically aimed at mobile advertising through SMS or MMS services.

As part of our non-telecommunications operator marketing activities, we have developed integrated marketing campaigns with traditional media companies and multinational corporations through certain cross-selling effort with these companies. Beijing AirInbox has applied to the Beijing AIC to amend its business license to specify that the mobile advertising business is a permitted business activity and Beijing AIC has informed Beijing AirInbox that this is not necessary because Beijing AirInbox’s business license already permits it to undertake the mobile advertising activities that it presently conducts. We cannot assure you that the SAIC or Beijing AIC will not require Beijing AirInbox to obtain an advertising permit from the Beijing AIC and specifically mention advertising activities as a permitted business in its business license in the future. In such an event, failure to comply could result in penalties including being banned from engaging in online advertising activities, confiscation of illegal earnings and fines.

#### Regulation of News Dissemination

On November 17, 2000, the Internet News Measures were promulgated by the State Council News Office and the MII. These measures stipulate that general websites established by non-news organizations may publish news released by certain official news agencies if such websites satisfy the requirements set forth in Article 9 of the measures and have acquired the requisite approval, but may not publish news items produced by themselves or news sources from

elsewhere. All the news that we publish and disseminate originates from official news agencies approved by the PRC government.

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On September 25, 2005, the State Council News Office and the MII jointly promulgated the Administrative Regulations for Internet News Information Services, or Internet News Information Services Regulations. According to the Internet News Information Services Regulations, the term “news information” means current affairs and political types of news information, including reports or comments on politics, economy, military affairs, diplomacy and other social and public affairs, as well as reports or comments related to unexpected social events, and the term “Internet news information services” includes publication of news information, provision of current affairs and political types of electronic messaging services and release of current affairs and political types of communication information to the public through the Internet. The Internet News Information Services Regulations specify that Internet news information service providers established by non-news organizations must apply for approval from the State Council News Office, through its provincial offices, to be allowed to engage in providing Internet news information service in relation to the news information released by official news agencies. Such Internet news information providers shall also enter into cooperation agreements with those official news agencies pursuant to which the general websites will publish news information provided by the official news agencies, and such cooperation agreements shall be submitted to the local provincial offices of the State Council News Office for record. Beijing AirInbox has submitted an application for a license pursuant to the Internet News Information Services Regulations and is awaiting a reply.

#### Regulation of Online Publications

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

GAPP and the MII have not specified whether the aforementioned approval in the Internet Publishing Measures is applicable to dissemination of works through SMS, MMS, WAP, Java™, IVR, CRBT or other wireless technologies. If, in the future, GAPP and the MII clarify that the Internet Publishing Measures are applicable to wireless value-added telecommunications services operators or issue new regulations or rules regulating wireless publishing, we may need to apply for a license or permit from governmental agencies in charge of publishing. We cannot assure you that such application would be approved by the relevant governmental agencies.

#### Regulation of Internet-Based Audio-Video Programming Services

On December 20, 2007, the SARFT and the MII jointly promulgated the Internet-based Audio-video Regulations, which became effective as of January 31, 2008. The Internet-based Audio-video Regulations are applicable to the public dissemination of Internet-based, including wireless Internet-based, audio-video programming services within the territory of the PRC. Activities covered by the Internet-based Audio-video Regulations include producing, compiling, integrating and public dissemination over the Internet of audio or video programs, as well as aiding others to upload and disseminate such programs.

Providers of Internet-based Audio-video programming services are required to obtain the Internet-based Audio-video License or complete registration procedures as required in the Internet-based Audio-video Regulations.

Pursuant to the Internet-based audio-video Regulations, such provider must:

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be a limited liability company that is either wholly-owned or majority-controlled by the state, without any violation of law or regulation within three years before the application date;

- have measures that ensure the safe dissemination of audio-video programs and protect against security breaches;

- have audio-video programming resources that are appropriate for their businesses and in compliance with laws and regulations;
  - possess technical competence, network resources and lawful funds that are appropriate for their businesses;
- retain professionals who are appropriate for their businesses, and its major investors and operators did not violate any law or regulation within three years before the application date;
  - have network technical designs that comply with laws and regulations and industry standards and guidance;
- be in compliance with plans, layouts and business guidelines issued by the departments in charge of radio, film and television operations under the State Council; and
  - be in compliance with laws and administrative regulations.

Pursuant to explanations of the Internet-based Audio-video Regulations provided by the responsible persons at the SARFT and the MII in a press conference, providers who engaged in Internet-based audio-video programming services before the promulgation of the Internet-based Audio-video Regulations and who have not violated any other laws or regulations shall be eligible to register their business and continue their operations. However, given the short history of the Internet-based Audio-video Regulations and the lack of interpretations and precedents, we cannot assure you that we will be qualified to apply for the Internet-based Audio-video License, or complete the required registration and we can not assure you that we will be granted the Internet-based Audio-video License.

#### Regulation of Foreign Exchange Control

The principal regulations governing foreign exchange in the PRC are the Foreign Exchange Control Regulations (Amended in 2008) and the Administration of Settlement, Sale and Payment of Foreign Exchange Regulations (1996), or together, the Exchange Regulations. Under the Exchange Regulations, the Renminbi is freely convertible into foreign exchange for current account items, including the distribution of dividends. Conversion of Renminbi for capital account items, such as direct investment, loans, security investment and repatriation of investment, however, is still subject to the approval of SAFE.

Under the Exchange Regulations, foreign-invested enterprises are required to open and maintain separate foreign exchange accounts for capital account items (but not for other items). In addition, foreign-invested enterprises may buy, sell or remit foreign currencies only at those banks authorized to conduct foreign exchange business after providing valid commercial documents and, in the case of capital account item transactions, obtaining approval from SAFE.

In October 2005, SAFE issued the Notice on Issues Relating to the Administration of Foreign Exchange in Fund-raising and Return Investment Activities of Domestic Residents Conducted via Offshore Special Purpose Companies, or Notice 75, which took effect on November 1, 2005. Notice 75 supersedes prior SAFE regulations promulgated in January and April of 2005. In May 2007, SAFE issued the Notice of the State Administration of Foreign Exchange on Operating Procedures Concerning Notice on Issues Relating to the Administration of Foreign Exchange in Fund-raising and Return Investment Activities of Domestic Residents Conducted via Offshore Special Purpose Companies, or Notice 106. Notices 75 and 106 require PRC residents to register with the relevant local SAFE branch in connection with their establishment or control of an offshore entity established for the purpose of overseas equity financing involving onshore assets or equity interests held by them and direct investment through such an offshore entity in the PRC. The term “PRC residents,” as used in Notice 75, includes not only PRC citizens but also other persons who habitually reside in the PRC for economic benefit. Such PRC residents are required to register with the relevant SAFE branch before establishing or taking control of such an offshore entity and complete amended



registrations with the relevant SAFE branch upon (i) injection of equity interests or assets of an onshore enterprise into the offshore entity, (ii) subsequent overseas equity financing by such offshore entity, or (iii) any material change in the shareholding or capital of the offshore entity, such as changes in share capital, share transfers and long-term equity or debt investments, and providing security. The PRC residents who have already incorporated or gained control of offshore entities that had completed onshore investments in the PRC before Notice 75 took effect must register with the relevant local SAFE branch on or before March 31, 2006. In addition, such PRC residents are required to repatriate into the PRC all of their dividend profits or capital gains from their shareholdings in the offshore entity within 180 days of their receipt of such profits or gains.

The registration and amendment procedures set forth by Notices 75 and 106 are prerequisites for other approval and registration procedures necessary for capital inflow from the offshore entity, such as inbound investment or shareholders loans, or capital outflow to the offshore entity, such as the payment of profits or dividends, liquidating distributions, equity sale proceeds or the return of funds upon a capital reduction.

A number of terms and provisions in Notices 75 and 106 remain unclear. Because of uncertainty over how Notices 75 and 106 will be interpreted and implemented, we cannot predict how they will affect our business operations or future strategies. For example, our present and prospective PRC subsidiaries' ability to conduct foreign exchange activities, such as remitting dividends and foreign currency-denominated borrowings, may be subject to compliance with requirements of Notices 75 and 106 by the PRC resident holders of our ordinary shares and ADSs. Despite our effort to fully comply with the SAFE regulations, we cannot assure you that we will obtain, or receive waivers from, any necessary approvals or not be found in violation of the SAFE regulations or any other related foreign exchange regulations. In particular, we cannot assure you that we will be able to cause all the present or prospective PRC resident holders of our ordinary shares or ADSs to comply with all SAFE regulations. A failure by the PRC resident holders of our ordinary shares or ADSs to comply with Notices 75 and 106 or our inability to secure required approvals or registrations may subject us to fines or legal sanctions, limit our subsidiaries' ability to make distributions or pay dividends, restrict our overseas or cross-border investment activities or affect our ownership structure, any of which could affect our business and prospects.

#### Item 4A. Unresolved Staff Comments

Not applicable.

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

The following discussion and analysis should be read in conjunction with our audited consolidated financial statements and the related notes thereto included elsewhere in this annual report. Our audited consolidated financial statements have been prepared in accordance with U.S. GAAP. Actual results could differ materially from those projected in the forward-looking statements. In evaluating our business, you should carefully consider the information provided in "Item 3 — Key Information — Risk Factors."

##### Overview

We are one of the leading providers of WVAS and mobile games to mobile phone users and a wireless media company providing news, content, community and mobile advertising services through our wireless Internet sites in the PRC. We provide interactive entertainment, media and community services through multiple technology platforms to mobile phone users. We offer a range of data and voice services through 2G technology platforms, including SMS, IVR and CRBT. We also provide a range of our services through 2.5G technology and operating platforms, including WAP, MMS and Java™, which offer higher quality graphics, richer content and interactivity compared to 2G wireless services. With the development of 3G services in the PRC, we plan to offer services tailored to 3G technology platforms in the future.

In addition, we maintain wireless Internet sites, including Kong.net, which we launched in 2004, Ko.cn, which we launched in 2007, and cn.NBA.com, which we launched in 2007 with the NBA and have operated for the NBA. Through our wireless Internet sites, we offer news, community, games and other interactive media and entertainment services to our customers free of charge. Our mobile advertising product offerings primarily consist of text-link, banner and button advertisements that appear on the pages of Kong.net, Ko.cn and cn.NBA.com.

We were incorporated under the laws of the Cayman Islands on May 6, 2002. Our revenues for the year ended December 31, 2008 were \$96.7 million, whereas our revenues for the year ended December 31, 2007 were \$74.0 million. Our net loss for the year ended December 31, 2008 was \$20.7 million, compared to a net income of \$2.8 million for the year ended December 31, 2007.

We have devoted significant resources to product development in order to analyze consumer demands and to expand the range of our service offerings to attract new customers and increase usage among our existing customers. Although we reduced the size of our product development team in 2006 in response to a decline in our revenues following China Mobile's change in customer billing policies, we expanded our product development team in 2007 and continued to do so in 2008. In addition, we have endeavored to increase our product development efficiency by coordinating it more closely with sales and marketing. In this way, our product developers can align their effort more closely with market trends.

We have also committed significant resources since our founding to building our sales and marketing team, which we believe has been crucial in promoting our brand and placing our services in the hands of users by building our relationships with telecommunications operators and other distribution channels. Our sales and marketing team consisted of 155 persons in 26 provinces as of December 31, 2005, increased to 276 persons in 27 provinces as of December 31, 2006, primarily as the result of our acquisition of Sharp Edge, and consisted of 212 persons in 27 provinces as of December 31, 2007. In 2008, we focused on enhancing the efficiency and productivity of our sales and marketing team by recruiting more experienced staff, while reducing the headcount to 152 persons in 27 provinces as of December 31, 2008.

We have a limited operating history on which to base an evaluation of our business and prospects. Our prospects should be considered in light of the risks, uncertainties, expenses and difficulties frequently encountered by companies in the early stages of their development, particularly in new and rapidly evolving markets such as the WVAS, mobile games, wireless Internet and mobile advertising markets.

The major factors affecting our results of operations and financial condition include:

- growth of the WVAS, mobile games, wireless Internet and mobile advertising markets in the PRC;
- change in the number, scope and terms of our cooperation arrangements with the telecommunications operators, content providers, mobile handset manufacturers, mobile handset distributors and other key players in the PRC's mobile telecommunications industry;
  - changes in government or telecommunications operator regulatory policies;
- development of competing services from China Mobile, other PRC telecommunications operators and other enterprises in the PRC WVAS, mobile games, wireless Internet market and mobile advertising markets;
- technological advancement of the mobile telecommunications market, including the adoption of 2.5G, 3G and subsequent standards of mobile handsets and networks, in the PRC;
  - attractiveness and variety of our products and services;
  - our product development effort to capitalize on market opportunities; and
  - effectiveness of our marketing and promotional activities.

In order to reduce the risk that our results of operations and financial conditions will be overly dependent upon, and disproportionately impacted by, any particular service offering, technology platform or telecommunications operator, we have sought to broaden the range of our services, expand our distribution channels, cultivate new relationships with telecommunications operators, and develop our wireless Internet sites, including Kong.net and Ko.cn, which are less dependent on the telecommunications operators. Meanwhile, we are also building our relationships with China Unicom and China Telecom in order to broaden the base of our operations.

In May 2008, the PRC government announced its policy initiative to restructure the PRC telecommunications industry, and a series of related transactions were completed in 2008. In addition, a 3G license was issued to each of China Mobile, China Unicom and China Telecom. While we are currently assessing the impact that this restructuring may have on us, potential changes in the telecommunications industry in the PRC could impact our relationship with telecommunications operators and thus have a material adverse effect on our business and results of operations. See “Item 3 — Key Information — Risk Factors — Risks Relating to Our Business — We depend on China Mobile and other PRC telecommunications operators for the majority of our revenues, and any loss or deterioration of our relationship with these telecommunications operators may result in severe disruptions to our business operations and the loss of the majority of our revenues.”

Prior to 2008, we operated in two segments, WVAS and WIS. As our mobile games business grows, it has required separate management in respect of decision making, allocation of resources and assessment of performance. We anticipate that mobile games could provide significant contributions to our future revenues. As a result, we started to have three operating segments in 2008, WVAS, mobile games and WIS. The segment reports for 2006 and 2007 have been restated.

### Revenues

The following table sets forth the historical consolidated revenues attributable to services derived from the WVAS, mobile games and WIS segments in terms of amount and as a percentage of our total revenues for the periods indicated:

	For the year ended December 31,					
	2006		2007		2008	
	Amount	Percentage of revenues	Amount	Percentage of revenues	Amount	Percentage of revenues
(in thousands of U.S. dollars, except percentages)						
WVAS	\$ 103,974.2	97.4%	\$ 70,178.8	94.8%	\$ 86,911.7	89.9%
Mobile games	2,506.0	2.3%	2,835.9	3.8%	7,743.3	8.0%
WIS	289.0	0.3%	1,002.2	1.4%	2,034.7	2.1%
Total	\$ 106,769.2	100.0%	\$ 74,016.9	100.0%	\$ 96,689.7	100.0%

The following table sets forth the historical consolidated revenues attributable to services derived from each of our 2G and 2.5G technology platforms in terms of amount and as a percentage of our total revenues for the periods indicated:

	For the year ended December 31,					
	2006		2007		2008	
	Amount	Percentage of revenues	Amount	Percentage of revenues	Amount	Percentage of revenues
(in thousands of U.S. dollars, except percentages)						
<b>2G services</b>						
SMS	\$ 43,308.8	40.6%	\$ 31,339.9	42.3%	\$ 42,228.8	43.7%
IVR	6,443.5	6.0%	10,047.9	13.6%	10,312.7	10.7%
CRBT and others	4,933.0	4.6%	4,983.8	6.7%	8,711.7	9.0%
Total	54,685.3	51.2%	46,371.6	62.6%	61,253.2	63.4%
<b>2.5G services</b>						
WAP	\$ 26,154.2	24.5%	\$ 10,554.2	14.3%	\$ 8,994.1	9.3%
MMS	23,134.7	21.7%	13,253.0	17.9%	16,664.4	17.2%
Total	\$ 49,288.9	46.2%	\$ 23,807.2	32.2%	\$ 25,658.5	26.5%

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Total WVAS revenues	\$ 103,974.2	97.4%	\$ 70,178.8	94.8%	\$ 86,911.7	89.9%
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## WVAS Revenues

Prior to 2004, we generated all of our revenues from fees paid by mobile phone users who use our services through China Mobile's network. Starting from 2004, we began to cooperate with China Unicom, China Netcom and China Telecom and receive revenues from services provided on their networks. In January 2006, we acquired Sharp Edge, which derived most of its revenues from China Unicom, China Netcom and China Telecom. The revenues we derived from these three telecommunications operators amounted to 23%, 25% and 24% of our total revenues during each of the years ended December 31, 2008, 2007 and 2006, respectively, compared to 5% of our total revenues during the year ended December 31, 2005. Some of our contracts are with the telecommunications operator parent companies and are nationwide, while other contracts are with the respective operators' provincial subsidiaries. Users in the coastal provinces of the PRC constitute the most significant portion of our customer base. As a result, we allocate additional resources to these provinces, including maintaining sales offices in most of these provinces.

We recognize revenues derived from our services before deducting the service fees and the net transmission charges that we pay to the telecommunications operators. Fees for our services are charged on either a single-transaction or monthly subscription basis and vary according to the type of services delivered. For a description of our fees and arrangements with the telecommunications operators, see "Item 4 — Information on the Company — Our Business — Strategic Relationships — Telecommunications Operators." We recognize all revenues in the period in which the services are performed. For a description of our revenue recognition policy, see "— Critical Accounting Policies."

As telecommunications operators do not provide us with a detailed revenue breakdown on a service-by-service basis, we depend on our internal data management system to monitor revenues derived from each of our services. We make our business decisions including research and development of new services and reallocation of resources to popular services based on our internal data, taking into account other factors including strategic considerations.

Since the second half of 2004, China Mobile and its provincial subsidiaries have been gradually implementing a series of policies designed to improve customer service and satisfaction. These policies include:

- not recognizing revenues to us and other service providers for MMS messages that cannot be delivered because of network or handset problems,
- canceling monthly subscriptions of customers who have not accessed their WVAS subscriptions for a certain period of time,
- implementing more complicated procedures for customers to confirm new subscriptions to certain WVAS, and
- removing from subscriber lists those customers who fail to pay China Mobile or the provincial subsidiaries, or who cannot be billed because they use pre-paid telecommunications service cards.

On July 6, 2006, China Mobile announced a series of additional measures with respect to the billing of customers of WVAS on its network, with focus on customers' monthly subscriptions to WVAS. Among the measures announced by China Mobile, those which have had a significant impact on our results of operations and financial condition are summarized as follows:

- beginning July 10, 2006, for any new monthly subscriptions to WVAS, China Mobile sends customers two reminder notices prior to charging monthly subscription fees in the customers' monthly mobile phone bills, and customers must confirm twice, once in response to each reminder, that they wish to subscribe to those services on a monthly basis. Previously, China Mobile sent one reminder notice immediately after a monthly subscription order was placed, and customers needed to confirm only once;





- customers enjoy a free trial period of 11 to 41 days, depending on the day of the month on which they place their monthly subscriptions. Previously, customers enjoyed a free trial period of three to 11 days; and
- China Mobile cancels WAP monthly subscriptions that have not been active for more than four months.

During the fourth quarter of 2006, other PRC telecommunications operators also began implementing new policies requiring double confirmation of monthly subscriptions. In May 2007, China Mobile started to send to its customers' handsets notices of transmission fees to be incurred by using GPRS when those customers launched their browsers, which discouraged some customers from purchasing our WAP products or visiting our wireless Internet sites Kong.net and Ko.cn.

As a result of these new measures, monthly subscriptions no longer account for the majority of our WVAS revenues. Also mainly because of these new measures, our WVAS revenues in 2007 decreased to \$70.2 million from \$104.0 million in 2006. However, as a result of our ongoing effort in developing and promoting our services, our WVAS revenues in 2008 increased to \$86.9 million from \$70.2 million in 2007.

We cannot assure you that China Mobile or other PRC telecommunications operators will not introduce additional requirements with respect to the procedures for ordering monthly subscriptions or single-transaction downloads of our WVAS, notifications to customers, the billing of customers or other consumer-protection measures, or adopt other policies that may require significant changes in the way we promote and sell our WVAS and do business, any of which new requirements or policies could have a material adverse effect on our financial condition and results of operations. See "Item 3 — Key Information — Risk Factors — Risks Relating to Our Business — Significant changes in the policies or guidelines of China Mobile or other PRC telecommunications operators with respect to services provided by us may result in lower revenues or additional costs for us and materially adversely affect our business operation, financial condition or results of operations."

#### Mobile Games Revenues

Mobile games revenues include revenues from mainly two types of games, the traditional downloadable games, such as those on the Java™ platform, and the online mobile games under the massively multiplayer online role-playing game, or MMORPG, model. As a result of our effort in developing our mobile games business, decreases in 2.5G data tariffs and the increased penetration of higher-end handsets capable of playing mobile games, our mobile games revenues increased to \$7.7 million in 2008 from \$2.8 million in 2007 and \$2.5 million in 2006.

Revenues from downloadable mobile games accounted for 100%, 100% and 80% of our total mobile games revenues in 2006, 2007 and 2008, respectively. In 2008, revenues from online mobile games were derived mainly from one game, Tian Jie (Reincarnation) On-line. We plan to diversify the offerings of our mobile games and expect our mobile games revenues to continue to increase in 2009, both in absolute terms and as a percentage of our total revenues, as we continue to intensify our product development effort and expand our distribution channels.

#### WIS Revenues

WIS revenues include mainly mobile advertising revenues, which are generated from advertisements placed on Kong.net, Ko.cn and cn.NBA.com. As a result of our effort in developing more attractive features and content on our wireless Internet sites and decreases in 2.5G data tariffs, which in turn resulted in increased traffic to our wireless Internet sites, our mobile advertising revenues increased to \$1.9 million in 2008 from \$0.9 million in 2007 and \$0.3 million in 2006. We expect our mobile advertising revenues to continue to increase in 2009 as we continue our effort in developing more attractive features and content on our wireless Internet sites. In addition, in 2009 we plan to complement our mobile advertising business by offering paid services such as mobile games and virtual items to Kong.net users.

Cost of Revenues

Our cost of revenues includes WVAS cost of revenues, mobile games cost of revenues and WIS cost of revenues.

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## WVAS Cost of Revenues

Our WVAS cost of revenues includes the following:

- Service fees payable by us to the telecommunications operators. In the case of China Mobile and its subsidiaries, service fees are generally 15% of the revenues with an additional 15% when the China Mobile operator provides customer services for us or an additional 35% when the China Mobile operator provides a package of customer services, marketing and promotional services for us. In the case of China Unicom and China Telecom, service fees are in the range of 15%-52%, varying according to the service platform. We are not obligated to pay the service fees to the telecommunications operators if the customers cannot be billed or do not pay the telecommunications operators;
- Net transmission charges payable by us to the telecommunications operators, calculated as the number of messages we send to customers in any given month, minus the number of messages we receive from customers regarding our services in that month, multiplied by a per-message transmission fee. We are obligated to pay the telecommunications operators the net transmission charges even if the customers cannot be billed or do not pay the telecommunications operators;
- Payments to content providers for the use of their content, and to mobile handset manufacturers and other industry partners with whom we have cooperation arrangements, in the form of a fixed fee or a percentage of our aggregate net cash received from the telecommunications operators with respect to services provided through the cooperation arrangements; and
- Bandwidth leasing charges and depreciation and facility costs relating to equipment used to provide WVAS.

Our total WVAS cost of revenues for the years ended December 31, 2008, 2007 and 2006 was \$47.0 million, \$34.4 million and \$45.9 million, respectively. As a percentage of our WVAS revenues, our WVAS cost of revenues for the years ended December 31, 2008, 2007 and 2006 was 48.6%, 46.5% and 43.0%, respectively. During the year ended December 31, 2008, as a percentage of our WVAS cost of revenues, service fees to the telecommunications operators represented 38.4%, payments to handset manufacturers represented 28.1%, net transmission charges to the telecommunications operators represented 4.0%, payments to content providers represented 15.5%, payment to other cooperation partners represented 6.7% and bandwidth leasing charges, depreciation and other facility costs represented 7.3%.

Our WVAS cost of revenues increased in 2008 as a result of an increase in the volume of our services and the related revenues. As our overall WVAS revenues increased, the amount that we paid to telecommunications operators in service fees and net transmission charges also increased. The service fees that we paid to other business partners, including mobile handset manufacturers and media partners, also grew as we sought to diversify our non-operator distribution channels and as revenues of WVAS delivered through non-operator partners increased as a percentage of our total WVAS revenues.

As part of our business strategy, we intend to continue to pursue more cooperation arrangements with business partners such as handset manufacturers because such arrangements make it easier for customers to access our products and services and are a cost-effective way to increase our market share as compared to traditional advertising. However, because we generally pay higher rates of service fees, in terms of percentages of revenues generated from cooperation arrangements, to such business partners than those paid to telecommunications operators, this strategy may result in a decrease in our gross profit margin.



### Mobile Games Cost of Revenues

Our mobile games cost of revenues consists mainly of service fees and net transmission charges to the telecommunications operators, payments to content providers for the use of their content and bandwidth leasing charges.

Total mobile games cost of revenues for the years ended December 31, 2008, 2007 and 2006 was \$3.5 million, \$1.4 million and \$1.3 million, respectively. The increase in 2008 resulted largely from an increase in our overall mobile games business and associated service fees paid to telecommunications operators. To a lesser extent, the increase was also due to an increase in the payments to content providers and licensors and higher bandwidth leasing charges associated with our online mobile games.

We intend to develop internally the majority of our mobile games because such games tend to have lower cost of revenues. However, in order to expand our mobile games business and increase our market share, we also plan to actively identify quality mobile games to be purchased or licensed from third parties.

### WIS Cost of Revenues

Our WIS cost of revenues includes mainly depreciation, facility maintenance and commissions paid to the advertising sales team for generating mobile advertising revenues.

Total WIS cost of revenues for the years ended December 31, 2008, 2007 and 2006 was \$1.1 million, \$0.7 million and \$0.5 million, respectively.

The increases from 2006 to 2007 and from 2007 to 2008 mainly resulted from increases in our WIS business and related revenues. We expect our WIS cost of revenues to increase in 2009 as our WIS business continues to grow.

### Operating Expenses

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

The following table sets forth the historical consolidated operating expenses data in terms of amount and as a percentage of our revenues for the periods indicated:

	For the year ended December 31,					
	2006		2007		2008	
	Amount	Percentage of revenues	Amount	Percentage of revenues	Amount	Percentage of revenues
(in thousands of U.S. dollars, except percentages)						
Product development	\$ 12,026.2	11.3%	\$ 12,535.2	16.9%	\$ 15,180.8	15.7%
Sales and marketing	16,755.2	15.7%	18,094.2	24.4%	21,338.9	22.1%
General and administrative	9,105.2	8.5%	7,221.0	9.8%	11,640.0	12.0%
Provision for impairment of goodwill and intangibles	—	—	—	—	21,623.3	22.4%
<b>Total</b>	<b>\$ 37,886.6</b>	<b>35.5%</b>	<b>\$ 37,850.4</b>	<b>51.1%</b>	<b>\$ 69,783.0</b>	<b>72.2%</b>

### Product Development Expenses

Our product development expenses consist primarily of compensation and benefits for our product development team. Our product development expenses for the years ended December 31, 2008, 2007 and 2006 were \$15.2 million, \$12.5 million and \$12.0 million, respectively. We expect our product development expenses to increase in 2009 because we plan to continue increasing our effort to develop our wireless Internet sites and mobile games.

### Sales and Marketing Expenses

Our sales and marketing expenses consist primarily of expenses associated with sponsoring promotional events and compensation and benefits for our sales, marketing and customer service teams. Our sales and marketing expenses for the years ended December 31, 2008, 2007 and 2006 were \$21.3 million, \$18.1 million and \$16.8 million, respectively. We expect our sales and marketing expenses to continue to increase in 2009 because we plan to continue increasing our effort to promote our wireless Internet sites and mobile games.

### General and Administrative Expense

Our general and administrative expenses consist primarily of business taxes, compensation and benefits for general management, finance and administrative personnel, professional fees and other office expenses. Our general and administrative expenses for the years ended December 31, 2008, 2007 and 2006 were \$11.6 million, \$7.2 million and \$9.1 million, respectively. We expect our general and administrative expenses to increase if our business grows in future periods because higher revenues will incur higher business taxes and we may incur more expenses relating to employee compensation.

### Provision for Impairment of Goodwill and Intangible

As of December 31, 2008, the fair value of the goodwill in our WVAS segment had decreased significantly, mainly due to the rapid deterioration of the global capital markets and, as a result, the significant drop in our market capitalization. A goodwill test in the third quarter of 2008 found that the goodwill in the WVAS segment was impaired, thus necessitating a charge of \$21,623,279. We re-evaluated the goodwill impairment during our annual goodwill impairment test in December 2008 and determined that there was no additional goodwill impairment as of December 31, 2008.

### Critical Accounting Policies

The methods, estimates and judgments we use in applying our accounting policies have a significant impact on the results we report in our financial statements. Some of our accounting policies require us to make difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Below we have summarized our accounting policies that we believe are both important to the portrayal of our financial results and involve the need to make estimates about the effect of matters that are inherently uncertain. We also have other policies that we consider to be key accounting policies. However, these policies do not meet the definition of critical accounting estimates because they do not generally require us to make estimates or judgments that are difficult or subjective.

### Revenue Recognition

Our revenues are primarily derived from providing wireless interactive entertainment, media and community value-added services to customers of the PRC telecommunications operators. The fees for such services are determined by us in consultation with the telecommunications operators, are charged on a single-transaction basis or on a monthly subscription basis and vary according to the type of services delivered.

We deliver WVAS to users through the telecommunications operators' networks and we rely upon the telecommunications operators to provide us with billing and collection services. We record revenues based on monthly statements from the telecommunications operators confirming the value of our services that they billed to users in the month. China Mobile and its provincial subsidiaries usually send such statements within 30 days after the end of each month.

The billing and collection cycles of China Unicom, China Telecom, China Netcom and their respective subsidiaries are generally somewhat longer than those of China Mobile. During 2006, we generally received statements from China Unicom within 40 days after the end of each month, and from China Telecom and China Netcom within 70 days after the end of each month. Beginning with the statement for April 2007, it has taken China Unicom about 105 days as compared to 40 days it had previously taken to send us a statement after the end of each month. We cannot assure you that the length of the billing cycle will not increase further in the future.



It is our practice to release our unaudited quarterly financial statements to the market. Due to our past experience with the timing of receipt of the monthly statements from the operators, we expect that we may need to rely on our own internal estimates for the portion of our reported revenues and cost of revenues for which we will not have received monthly statements. In such an instance, our internal estimates would be based on our own internal data of expected revenues and related fees from services provided. As a result of reliance on our internal estimates, we may overstate or understate our revenues and cost of revenues for the relevant reporting period. Our internal estimates of revenues and cost of revenues for any period are subsequently adjusted in our financial reports when we actually receive the monthly statements for such period.

In 2007 and 2008, estimated revenues generally accounted for less than 5% of our reported quarterly revenues and less than 1% of our reported annual revenues. Our estimates are based on:

- our internal data management system;
- our past experience; and
- our verbal communications with the telecommunications operators.

We internally tabulate the value of a WVAS that we have provided based in part on delivery confirmations sent to us by the networks of the PRC telecommunications operators with respect to each delivery of our services to a user within 72 hours of delivery. We record these confirmations in our internal data management system. There has historically been a discrepancy between the value that we estimate and the value that we are entitled to receive based on the monthly statements provided by the telecommunications operators. This discrepancy varies across different technology platforms and arises for various reasons, including the following:

- Late notification of delinquent customers. The telecommunications operators may from time to time classify certain customers as delinquent customers for non-payment of services. The telecommunications operators request all service providers to cease delivering services to customers once they are classified as delinquent. However, time lags often exist between when a customer is classified as delinquent and when we receive such information from the telecommunications operators. As a result, we occasionally provide services to these delinquent customers for which the telecommunications operators will not make payments to us.
- Customer database out of synchronization. Customers may cancel their subscriptions through the telecommunications operators. Although we synchronize our and the telecommunications operators' databases of customer information on an ongoing basis, our databases are not always completely in synchronization with those of the telecommunications operators. As a result, until our databases are synchronized with those of the telecommunications operators, we could provide services to customers who have cancelled their subscriptions, for which we are not entitled to receive revenues.
- Duplicate billing. China Mobile typically generates system identification numbers to identify customers who use our WAP services, rather than directing the real phone numbers to us. Occasionally the platform operators inadvertently generate multiple identification numbers for one mobile number. In such case, the multiple bills for the multiple identification numbers have to be eliminated from the monthly statement the telecommunications operators provide to us.
- Delivery failure. When telecommunications operators send us delivery confirmations within 72 hours of our delivery of value-added services, the confirmations will indicate three possible outcomes: success, failure, or unknown. Our internal system recognizes successful confirmations as services provided. As a result, there exist discrepancies between our records and the monthly statement provided by the telecommunications operators for

confirmations marked as “unknown” where our services were successfully delivered or where the confirmation was incorrect.

- Unbillable users. In 2005, certain provincial subsidiaries of China Mobile began to offer 2.5G services to customers who receive mobile telephone services on a pre-paid basis. Such customers may subscribe to our services or download our products, and our internal databases do not distinguish between these and other customers. However, the telecommunications operators do not yet have any means to bill these pre-paying customers for the WVAS that they receive. As a result, the telecommunications operators' monthly statements do not include fees for such users.

In addition, the telecommunications operators remit to us amounts net of an allowance they have made for the doubtful debts in respect of the amounts due to us from our customers. They also net their fees for the services they provide to us, including billing and collection services, and net transmission charges from their remittances to us. Certain telecommunications operators do not provide an itemized analysis of their remittances and we are therefore unable to determine what allowance, if any, for doubtful or bad debts should be recorded for our services delivered through such telecommunications operators. Accordingly, recognition of revenues is based upon the amounts reported on the telecommunications operators' monthly statements to us, which are net of doubtful debts and represent the amounts we reasonably believe will be collected.

Because of the factors set out above, we would multiply our internal tabulation of expected revenues from telecommunications operators from whom we have not received monthly statements by a realization factor applicable to the relevant telecommunications operator and service and determined according to the average discrepancy over the previous 12 months between our internal tabulations of expected revenues and the actual revenues based on the monthly statements. In addition, our employees verbally communicate with the telecommunications operators' billing personnel regarding the estimated revenues for the period in question. We may or may not get additional comfort from such verbal communications. We endeavored to reduce the discrepancy between our revenue estimates and the revenues calculated by telecommunications operators and their subsidiaries. We cannot assure you that our effort will be successful.

In 2008, the average time from our receipt of statements from the telecommunication operators until they paid us the amounts due under such statements was approximately 62 days. We cannot assure you that our period to collect accounts receivables will not increase in the future.

We evaluate our cooperation arrangements with the telecommunications operators to determine whether to recognize our revenues on a gross basis or net of the service fees and net transmission charges paid to the telecommunications operators. Our determination is based upon an assessment of whether we act as a principal or agent when providing our services. We have concluded that we act as principal in the arrangement. Factors that support our conclusion mainly include:

- we are the primary obligor in the arrangement;
- we are able to establish prices within price caps prescribed by the telecommunications operators to reflect or react to changes in the market;
- we determine the service specifications of the services we will be rendering;
- we are able to control the selection of our content suppliers; and
- the telecommunications operators usually will not pay us if users cannot be billed or if users do not pay the telecommunications operators for services delivered and, as a result, we bear the delivery and billing risks for the revenues generated with respect to our services.

Based on these factors, we believe that recognizing revenues on a gross basis is appropriate. However, as noted above, our reported revenues are net of bad debt charges that have been deducted by the telecommunications operators.

We generate revenues from offering two kinds of mobile games, downloadable mobile games and online mobile games. Downloadable games are delivered and the related revenues are recognized in the same manner as our WVAS. Our online mobile games are generally free of charge for mobile phone users. We recognize revenues when we deliver the merchandise or premium features embedded in the games that users purchase to enhance their gaming experience.

WIS is delivered through our wireless Internet portals such as Kong.net. As long as the collection of fees appears probable, we recognize advertising revenues associated with those sites on a pro rata basis over the period during which advertisements are displayed on the sites.

#### Stock-based Compensation Expense

Our stock-based employee compensation plans are described in more detail under “Item 6 — Directors, Senior Management and Employees — Stock Options.” We grant stock options and restricted share units to our employees and we record a compensation charge on a pro rata basis over the vesting periods of the related options and restricted share units, which are generally four years.

Starting from January 1, 2006, we adopted SFAS 123(R) to account for share-based compensation. We have used the modified prospective transition method and therefore have not restated the results from prior periods.

The historical pro forma net income (loss) and pro forma net income (loss) per share that we used in calculating the fair value of the options granted to employees prior to January 1, 2006 may not be representative of the pro forma effects in future years of net income (loss) and earnings per share for the following reasons:

- The number of future shares to be issued under these plans is not known; and
- The assumptions used to determine the fair value can vary significantly.

#### Goodwill

In December 2006, 2007 and 2008, we performed annual impairment assessments of the carrying value of the goodwill recorded in connection with various acquisitions as required under Statement of Financial Accounting Standards No. 142, or SFAS 142, “Goodwill and Other Intangible Assets.” In accordance with SFAS 142, we compared the carrying value of each of our reporting units that existed at those times to their estimated fair value. In December 2006, December 2007 and December 2008, we had one, two and three reporting units, respectively, as determined and identified in accordance with SFAS 142. We estimated the fair values of our reporting units primarily using the income approach valuation methodology that includes the discounted cash flow method, taking into consideration the market approach and certain market multiples as a validation of the values derived using the discounted cash flow methodology. The discounted cash flows for each reporting unit were based on discrete four year financial forecasts developed by our management for planning purposes. Cash flows beyond the four-year forecast were estimated using a terminal value calculation, which incorporated historical and forecasted financial trends for each identified reporting unit and considered long-term earnings growth rates for publicly-traded peer companies. Specifically, the income approach valuations included reporting unit cash flow discount rate of 24.5% and terminal value growth rate of 3%. Publicly-available information regarding the market capitalization of our company was also considered in assessing the reasonableness of the cumulative fair values of our reporting units estimated using the discounted cash flow methodology.

In estimating the fair value of a reporting unit, based on a present value of estimated future cash flow method, we have taken into consideration the overall and industry-specific economic conditions and trends, market risk and historical financial information of our company. Major management assumptions adopted in a goodwill impairment test in 2008

were as follows:

- there will be no major changes in the existing political, legal, fiscal and economic conditions in the PRC;

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- except for the new enterprise income tax law that took effect on January 1, 2008, there will be no major changes in the current tax law in the PRC and all applicable laws and regulations will be complied with;
  - exchange rates and interest rates will not differ materially from those presently prevailing;
- each reporting unit will retain and have competent management, key personnel, and technical staff to support its ongoing operations;
- the annual revenue growth rate will be at the range of 9% to 15% and the cost and expense structure will remain consistent with historical trends in the coming four years, with reference to the overall and industry specific economic conditions and trends, the historical financial performance and the up-to-date business performance;
  - the availability of finance will not be a constraint on the forecasted growth of operations; and
- industry trends and market conditions for related industries will not deviate significantly from economic forecasts.

We perform goodwill assessment for each reporting unit level at least once a year. We have two reporting units, the WVAS segment and mobile games segment, that have a significant amount of goodwill. In 2008, the fair value of the goodwill in our WVAS segment had decreased significantly, mainly due to the rapid deterioration of the global capital markets and, as a consequence, the significant drop in our market capitalization. A goodwill test in the third quarter of 2008 found that the goodwill in the WVAS segment was impaired, thus necessitating a charge of \$21,623,279. We re-evaluated the goodwill impairment during our annual goodwill impairment test in December 2008 and determined that there was no additional goodwill impairment as of December 31, 2008.

Going forward, we will continue to test goodwill for impairment on an annual basis or more frequently if an event occurs or circumstances change that could more likely than not reduce the fair value of the goodwill below its carrying amount.

#### Income taxes

Deferred income taxes are recognized for temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements, net operating loss carry forwards and credits by applying enacted statutory tax rates applicable to future years. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are classified as current or non-current depending on their individual characteristics. Current income taxes are provided for in accordance with the laws of the relevant taxing authorities.

In June 2006, the Financial Accounting Standards Board, or FASB, issued Interpretation No. 48, or FIN 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109." FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006, with early adoption permitted. We have adopted FIN 48 since January 1, 2007. The adoption of FIN 48 did not result in a cumulative adjustment on January 1, 2007 and had no significant impact on our accounting for income taxes for the years ended December 31, 2007 and 2008. We did not incur any interest or penalties related to potential underpaid income tax expenses, and also do not expect to have a significant increase or decrease on the unrecognized tax benefits within 12 months from December 31, 2008.





### Recently Issued Accounting Standards

In September 2006, FASB issued Statement of Financial Accounting Standards No. 157, or SFAS 157, "Fair Value Measurements." Effective January 1, 2008, our company adopted the measurement and disclosure requirements contained in SFAS 157 other than those requirements related to nonfinancial assets and liabilities in accordance with guidance from FASB Staff Position 157-2, "Effective Date of FASB Statement No. 157," which delayed the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of fiscal year 2009. Our company does not believe that the adoption of SFAS 157 for nonfinancial assets and liabilities would have a significant effect on our consolidated financial position or results of operations.

In December 2007, the FASB issued Statement of Financial Accounting Standard No. 141R, or SFAS 141R, "Business Combination," to improve reporting and creating greater consistency in the accounting and financial reporting of business combinations. The standard requires the acquiring entity in a business combination to recognize all (and only) the assets acquired and liabilities assumed in the transaction; establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. Our company does not believe that the adoption of SFAS 141R would have a significant effect on our consolidated financial position or results of operations.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, or SFAS 160, "Noncontrolling Interests in Consolidated Financial Statements," to improve the relevance, comparability, and transparency of financial information provided to investors by requiring all entities to report noncontrolling (minority) interests in subsidiaries in the same way as required in the consolidated financial statements. Moreover, SFAS 160 eliminates the diversity that currently exists in accounting for transactions between an entity and noncontrolling interests by requiring they be treated as equity transactions. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. Our company does not believe that the adoption of SFAS 160 would have a significant effect on our consolidated financial position or results of operations.

In April 2008, the FASB issued FASB Staff Position FAS 142-3, or FSP 142-3, "Determination of the Useful Life of Intangible Assets." FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, "Goodwill and Other Intangible Assets." FSP 142-3 is effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The guidance for determining the useful life of a recognized intangible asset in the FSP 142-3 shall be applied prospectively to intangible assets acquired after the effective date. Our company does not believe that the adoption of FSP 142-3 would have a significant effect on our consolidated financial position or results of operations.

At the November 24, 2008 meeting, the FASB ratified the consensus reached by its Emerging Issues Task Force in Issue No. 08-6, or EITF 08-6, "Equity Method Investment Accounting Considerations." Because of the significant changes to the guidance on subsidiary acquisitions and subsidiary equity transactions and the increased use of fair value measurements as a result of SFAS 141R and SFAS 160, questions have arisen regarding the application of that accounting guidance to equity method investments. EITF 08-6 provides guidance for entities that acquire or hold investments accounted for under the equity method. This issue is effective for transactions occurring in fiscal years and interim periods beginning on or after December 15, 2008. Early adoption is not permitted. Our company does not believe that the adoption of EITF 08-6 would have a significant effect on our consolidated financial position or results

of operations.

In November 2008, the FASB ratified Emerging Issue Task Force Issue No. 08-7, or EITF 08-7, "Accounting for Defensive Intangible Assets." EITF 08-7 applies to defensive intangible assets, which are acquired intangible assets that the acquirer does not intend to actively use but intends to hold to prevent its competitors from obtaining access to them. As these assets are separately identifiable, EITF 08-7 requires an acquiring entity to account for defensive intangible assets as a separate unit of accounting which should be amortized to expense over the period the asset diminished in value. Defensive intangible assets must be recognized at fair value in accordance with SFAS 141R and SFAS 157. EITF 08-7 is effective for financial statements issued for fiscal years beginning after December 15, 2008. Our company does not believe that the adoption of EITF 08-7 would have a significant effect on our consolidated financial position or results of operations.

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In April 2009, the FASB issued FASB Staff Position FAS 115-2/FAS 124-2, or FSP 115-2/124-2, "Recognition and Presentation of Other-Than-Temporary Impairments." FSP 115-2/124-2 amends the other-than-temporary impairment guidance in U.S. GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. FSP 115-2/124-2 does not amend existing recognition and measurement guidance related to other-than-temporary impairments of equity securities. FSP 115-2/124-2 will be effective on April 1, 2009. It does not require disclosures for earlier periods presented for comparative purposes at initial adoption. In periods after initial adoption, FSP 115-2/124-2 requires comparative disclosures only for periods ending after initial adoption. Our company does not believe that the adoption of FSP 115-2/124-2 would have a significant effect on our consolidated financial position or results of operations.

In April 2009, the FASB issued FASB Staff Position FAS 157-4, or FSP 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly." FSP 157-4 provides additional guidance for estimating fair value in accordance with SFAS 157, when the volume and level of activity for the asset or liability have significantly decreased. It also includes guidance on identifying circumstances that indicate a transaction is not orderly. FSP 157-4 emphasizes that even if there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. FSP 157-4 will be effective on April 1, 2009 and will be applied prospectively. It does not require disclosures for earlier periods presented for comparative purposes at initial adoption. In periods after initial adoption, FSP 157-4 requires comparative disclosures only for periods ending after initial adoption. Our company does not believe that the adoption of FSP 157-4 would have a significant effect on our consolidated financial position or results of operations.

## Results of Operations

Year ended December 31, 2008 compared to year ended December 31, 2007

The following table sets forth, for the periods presented, certain data from our consolidated results of operations. This information should be read in conjunction with the consolidated financial statements and related notes contained elsewhere in this annual report.

	For the year ended December 31,					
	2006	2007		2008		
	Amount	Percentage of revenues	Amount	Percentage of revenues	Amount	Percentage of revenues
(in thousands of U.S. dollars, except percentages)						
<b>Revenues</b>						
2G(1) and others	\$ 54,685.3	51.2%	\$ 46,371.6	62.6%	\$ 61,253.2	63.4%
2.5G(2)	49,288.9	46.2%	23,807.2	32.2%	25,658.5	26.5%
WVAS	103,974.2	97.4%	70,178.8	94.8%	86,911.7	89.9%
Mobile games(3)	2,506.0	2.3%	2,835.9	3.8%	7,743.3	8.0%
WIS	289.0	0.3%	1,002.2	1.4%	2,034.7	2.1%
<b>Total revenues</b>	<b>106,769.2</b>	<b>100.0%</b>	<b>74,016.9</b>	<b>100.0%</b>	<b>96,689.7</b>	<b>100.0%</b>
<b>Cost of revenues</b>						
WVAS	(45,863.4)	(43.0%)	(34,440.3)	(46.5%)	(46,985.5)	(48.6%)
Mobile games	(1,266.0)	(1.2%)	(1,375.9)	(1.9%)	(3,479.8)	(3.6%)
WIS	(536.0)	(0.5%)	(679.4)	(0.9%)	(1,147.3)	(1.2%)

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Total cost of revenues	(47,665.4)	(44.6%)	(36,495.6)	(49.3%)	(51,612.5)	(53.4%)
<b>Gross profit (loss)</b>						
WVAS	58,110.8	54.4%	35,738.5	48.3%	39,926.3	41.3%
Mobile games	1,240.0	1.2%	1,460.0	2.0%	4,263.5	4.4%
WIS	(247.0)	(0.2%)	322.9	0.4%	887.4	0.9%
<b>Total Gross profit</b>	<b>59,103.8</b>	<b>55.4%</b>	<b>37,521.4</b>	<b>50.7%</b>	<b>45,077.2</b>	<b>46.6%</b>
<b>Operating expenses:</b>						
Product development	(12,026.2)	(11.3%)	(12,535.2)	(16.9%)	(15,180.8)	(15.7%)
Sales and marketing	(16,755.2)	(15.7%)	(18,094.2)	(24.4%)	(21,338.9)	(22.1%)
General and administrative	(9,105.2)	(8.5%)	(7,221.0)	(9.8%)	(11,640.0)	(12.0%)

	For the year ended December 31,					
	2006	2007		2008		
	Amount	Percentage of revenues	Amount	Percentage of revenues	Amount	Percentage of revenues
	(in thousands of U.S. dollars, except percentages)					
Goodwill impairment loss	—	—	—	—	(21,623.3)	(22.4%)
Total operating expenses	(37,886.6)	(35.5%)	(37,850.4)	(51.1%)	(69,783.0)	(72.2%)
Income (loss) from operations	21,217.2	19.9%	(329.1)	(0.4)%	(24,705.8)	(25.6%)
Other expense, net	(49.1)	(0.0%)	—	—	—	—
Interest income, net	3,866.9	3.6%	3,810.0	5.1%	4,897.4	5.1%
Gain on sales of investment	1,240.8	1.2%	207.6	0.3%	-	—
Income before tax expense	26,275.8	24.6%	3,688.5	5.0%	(19,808.4)	(20.5%)
Income tax	1,584.2	1.5%	856.8	1.2%	851.9	0.9%
Net (loss) income	\$ 24,691.6	23.1%	\$ 2,831.7	3.8%	\$ (20,660.3)	(21.4%)

- (1) Includes SMS, IVR and CRBT. We began to provide SMS, IVR and CRBT services on a paid basis in July 2002, December 2003 and October 2003, respectively.
- (2) Includes WAP and MMS. We began to provide WAP and MMS services on a paid basis in September 2002 and April 2003, respectively.
- (3) Includes downloadable mobile games and online mobile games. We began to provide downloadable mobile games and online mobile games on a paid basis in May 2002 and August 2007, respectively.

Year ended December 31, 2008 compared to year ended December 31, 2007

Revenues. Our WVAS revenues increased to \$96.7 million in 2008 from \$74.0 million in 2007. The increase in our WVAS revenues was primarily due to our effort in developing and promoting our 2G services. Our 2.5G revenues increased by 7.8% to \$25.7 million in 2008 from \$23.8 million in 2007 and our 2G revenues increased by 32.1% to \$61.3 million in 2008 from \$46.4 million in 2007.

Our mobile games revenues increased to \$7.7 million in 2008 from \$2.8 million in 2007 primarily due to our effort in developing our mobile games business in 2008.

Our WIS revenues increased to \$2.0 million in 2008 from \$1.0 million in 2007 primarily due to our continuing effort in developing our wireless Internet sites.

Cost of Revenues. Our WVAS cost of revenues increased to \$47.0 million in 2008 from \$34.4 million in 2007. The increase was mainly due to an increase in the amount that we paid to the PRC telecommunications operators in service fees and transmission charges as our WVAS revenues increased.

Our mobile games cost of revenues increased to \$3.5 million in 2008 from \$1.4 million in 2007 mainly due to an increase in the volume of our mobile games business.

Our WIS cost of revenues increased to \$1.1 million in 2008 from \$0.7 million in 2007 mainly due to an increase in the volume of our WIS business.

Gross Profit. Our WVAS gross profit in 2008 increased from 2007 primarily due to the increase in the volume of our services and related revenues. We achieved a gross profit of \$39.9 million in 2008, compared to \$35.7 million in

2007. Our WVAS gross profit as a percentage of total revenues decreased to 41.3% in 2008 from 48.3% in 2007 in part due to an increase in the percentage of revenues derived from 2G services, which have a lower gross profit margin. Our WVAS gross profit margin decreased also because we paid a higher percentage of our revenues to the mobile handset manufacturers, content providers and other business partners in 2008 as compared to 2007.

Our mobile games gross profit increased to \$4.3 million in 2008 from \$1.5 million in 2007 primarily due to an increase in the volume of our mobile games business and related revenues.

Our WIS gross profit increased to \$0.9 million in 2008 from \$0.3 million in 2007 primarily due to an increase in the volume of our WIS business and related revenues.

**Operating Expenses.** Our operating expenses increased to \$69.8 million in 2008, which includes the \$21.6 million provision for the impairment of goodwill, from \$37.9 million in 2007.

Our product development expenses increased to \$15.2 million in 2008 from \$12.5 million in 2007 primarily due to increased employee compensation, office rental and expenses connected to the development of our wireless Internet sites and our mobile games business. Product development expenses as a percentage of our total revenues decreased to 15.7% in 2008 from 16.9% in 2007. The number of our product development employees increased to 477 as of December 31, 2008 from 444 as of December 31, 2007.

Our sales and marketing expenses increased to \$21.3 million in 2008 from \$18.1 million in 2007 as a result of increased sales and marketing expenditures in promoting the KongZhong brand and marketing our wireless Internet sites and increased expenses in connection with the promotion of our WAP services. As a result of our effort to improve efficiency by recruiting more experienced staff, our sales and marketing team decreased to 152 employees as of December 31, 2008 from 212 employees as of December 31, 2007, and our customer service team decreased to 65 employees as of December 31, 2008 from 69 employees as of December 31, 2007.

Our general and administrative expenses increased by \$4.4 million to \$11.6 million in 2008 from \$7.2 million in 2007. The increase was primarily due to an increase in business taxes as a result of our increased revenues and our foreign exchange loss resulting from the depreciation of the value of euro, in which a portion of our cash and cash equivalents were denominated, against U.S. dollar, our reporting currency. Our general and administrative staff consisted of 52 employees as of December 31, 2008, compared to 53 employees as of December 31, 2007.

Our provision for goodwill impairment was \$21.6 million in 2008. The carrying amount of our goodwill as of December 31, 2008 was \$15.7 million.

**Income Tax.** Income tax decreased in 2008 mainly due to the decrease in our pre-tax income and the decrease in the standard income tax rate.

Year ended December 31, 2007 compared to year ended December 31, 2006

**Revenues.** Our WVAS revenues decreased to \$70.2 million in 2007 from \$104.0 million in 2006. The decrease in our WVAS revenues was largely due to the adverse impact of the new policies adopted by the PRC telecommunications operators since the second half of 2006. As a result of these new policies, our quarterly WVAS revenues declined since the third quarter of 2006 until the third quarter of 2007. Starting from the third quarter of 2007, our quarterly WVAS revenues have increased. This increase is primarily due to our effort in developing and promoting our 2G services. Our 2.5G revenues decreased by 51.7% to \$23.8 million in 2007 from \$49.3 million in 2006, and our 2G revenues decreased by 15.2% to \$46.4 million in 2007 from \$54.7 million in 2006.

Our mobile games revenues increased to \$2.8 million in 2007 from \$2.5 million in 2006 primarily due to our effort in developing our mobile games business in 2007.

Our WIS revenues increased to \$1.0 million in 2007 from \$0.3 million in 2006 primarily due to our effort in developing our wireless Internet sites in 2007.

**Cost of Revenues.** Our WVAS cost of revenues decreased to \$34.4 million in 2007 from \$45.9 million in 2006. As our WVAS revenues decreased, the amount that we paid to the PRC telecommunications operators in service fees and net

transmission charges also decreased. The service fees that we paid to other business partners, including mobile handset manufacturers, also decreased as a result of the decrease in our revenues, but the percentage of our net revenues we paid to such business partners as service fees increased.

Our mobile games cost of revenues increased to \$1.4 million in 2007 from \$1.3 million in 2006 mainly due to an increase in the volume of our mobile games business.



Our WIS cost of revenues increased to \$0.7 million in 2007 from \$0.5 million in 2006 mainly due to an increase in the volume of our WIS business.

Gross Profit. Our WVAS gross profit in 2007 decreased from 2006 primarily due to the decrease in the volume of our services and related revenues. We achieved a gross profit of \$35.7 million in 2007, compared to \$58.1 million in 2006. Our WVAS gross profit as a percentage of total revenues decreased to 48.3% in 2007 from 54.4% in 2006 in part due to the higher percentage of revenues derived from 2G services, which have a lower gross profit margin. Our WVAS gross profit margin decreased also because we paid a higher percentage of our net revenues to the mobile handset manufacturers, content providers and other business partners in 2007 as compared to 2006.

Our mobile games gross profit increased to \$1.5 million in 2007 from \$1.2 million in 2006 primarily due to an increase in the volume of our mobile games business and related revenues.

Our WIS gross profit increased to \$0.3 million in 2007 from a gross loss of \$0.2 million in 2006 primarily due to an increase in the volume of our WIS business and related revenues.

Operating Expenses. Our operating expenses remained at \$37.9 million in each of 2006 and 2007.

Our product development expenses increased to \$12.5 million in 2007 from \$12.0 million in 2006 primarily due to an increase in the size of our WIS product development team. Product development expenses as a percentage of our total revenues also increased to 16.9% in 2007 from 11.3% in 2006. The number of our product development employees increased to 444 as of December 31, 2007 from 371 as of December 31, 2006.

Our sales and marketing expenses increased to \$18.1 million in 2007 from \$16.8 million in 2006 mainly due to our effort to promote the KongZhong brand and our wireless Internet sites. As a result of our effort to improve efficiency by recruiting more experienced staff, our sales and marketing team decreased to 212 employees as of December 31, 2007 from 276 employees as of December 31, 2006, and our customer service team decreased to 69 employees as of December 31, 2007 from 77 employees as of December 31, 2006.

Our general and administrative expenses decreased to \$7.2 million in 2007 from \$9.1 million in 2006 mainly because of our cost-controlling effort, a decrease in business tax as a result of a decrease in our revenues and our foreign exchange gain resulting from the appreciation of the value of euro, in which a portion of our cash and cash equivalents were denominated, against U.S. dollar, our reporting currency. Our general and administrative staff consisted of 53 employees as of December 31, 2007, compared to 49 employees as of December 31, 2006.

Gain on Sales of Investment. In December 2004, we signed an agreement with eFriendsNet Entertainment Corp., or EFN, a leading social networking company in the PRC, to purchase 10% of the total equity interest in EFN for \$0.5 million. We completed the investment in March 2005. In January 2006, we sold all our shares in EFN for an immediate cash consideration of \$1.7 million. We received an additional payment of \$0.2 million in February 2007 pursuant to a payment mechanism in the sale agreement that provides for an additional payment if certain financial performance milestones are met by EFN after the completion of the sale of our equity interest.

Income Tax. Income tax decreased in 2007 mainly due to the decrease in the volume of our services and related revenues and the decrease in our operating profit.

#### Liquidity and Capital Resources

#### Cash Flows and Working Capital

The following table sets forth our cash flows with respect to operating, investing and financing activities for the periods indicated.

	For the year ended December 31,		
	2006	2007	2008
	(in thousands of U.S. dollars)		
Net cash provided by operating activities	\$ 28,010.2	\$ 3,315.3	\$ 12,521.5
Net cash used in investing activities	(17,916.5)	(18,720.1)	(4,811.9)
Net cash provided by (used in) financing activities	2,190.3	152.2	(759.3)
Effect of exchange rate changes	1,976.5	6,193.3	6,761.3
Net (decrease) increase in cash and cash equivalents	14,260.5	(9,059.3)	13,711.6
Cash and cash equivalents, beginning of year	117,141.5	131,402.0	122,342.7
Cash and cash equivalents, end of year	\$ 131,402.0	\$ 122,342.7	\$ 136,054.3

Prior to our initial public offering in July 2004, our primary sources of liquidity were capital contributions from our founders, private placements of preferred shares to investors and cash generated from operating activities. Since the completion of our initial public offering, our primary sources of liquidity have been cash flow from operating activities and the proceeds of our initial public offering. We used a portion of the proceeds of our public offering to expand our business through acquisitions in 2006, 2008 and 2009, and we anticipate that additional proceeds may be used to fund more acquisition activities. As of December 31, 2007 and December 31, 2008, our cash and cash equivalents were \$122.3 million and \$136.05 million, respectively.

We do not bill or collect payment from users of our services directly, but instead depend on the billing systems and records of China Mobile and other PRC telecommunications operators to record the volume of our services provided, charge our customers, collect payments and remit to us our revenues, minus transmission fees and service fees. If China Mobile or any other PRC telecommunications operator ceases to continue to cooperate with us, we will explore further cooperation with other telecommunications service providers and explore alternative billing systems to collect bills from customers.

Net cash provided by operating activities was \$12.5 million in 2008 compared to \$3.3 of net cash provided by operating activities in 2007. The increase resulted mainly from the increase in the volume of our services and related revenues, income from operations and improved net working capital management in 2008.

Net cash used in investing activities decreased to \$4.8 million in 2008 from \$18.7 million in 2007. The amounts in both years represent mainly the payments of cash consideration in 2007 for our acquisition of Sharp Edge and in 2008 for our investment in HiU! Media and acquisition of XCHY.

Net cash used for financing activities in 2008 was \$0.8 million, which represents mainly payments for our share repurchase plan announced on October 27, 2008.

In March 2009, we issued to NGP a convertible senior note due in 2014 with an aggregate principal amount of \$6,775,400. We are required to pay the principal amount of the convertible senior note then outstanding plus any accrued but unpaid interest on March 18, 2014. Our convertible senior note would initially pay an annual interest at a rate of 8%, subject to reduction to 6% based on the financial performance of our company. The accrued interest is payable on each of January 15 and July 15 of each year until the principal amount is fully repaid. NGP has the right to declare the principal amount then outstanding plus any accrued but unpaid interest due before its due date upon the occurrence of certain events. Such events include a material default on any of our material debt instruments; the decrease of the ratio between our total current assets less our total current liabilities on one hand and the sum of the then outstanding principal amount and accrued but unpaid interest on the other hand to less than 2.5; default in the payment of any interest under the convertible senior note when due and payable and such default continues for 30 days; commencement of any action or proceeding to make any assignment for the benefit of creditors, or any bankruptcy, liquidation, dissolution, termination of existence or other similar action, voluntarily or involuntarily, of our company, KongZhong Beijing or KongZhong China; or involvement of our company or any of our Directors or executive officers in litigation or regulatory or governmental investigations, actions or proceedings, that NGP reasonably expects, after consultation with our company, will have a material adverse effect on the Nokia brand. In addition, our material breach of any of the covenants in connection with the convertible senior note and warrant could also entitle NGP to declare the principal amount of the convertible senior note then outstanding plus any accrued but unpaid interest due and payable. See “Item 3 — Key Information — Risk Factors — Risks Relating to Our Business — We are subject to certain covenants in connection with the issuance of the convertible senior note and the warrant, and such covenants could have a material adverse effect on our business, financial condition and results of operations.”



We believe that our current cash and cash equivalents and cash flow from operations will be sufficient to meet our anticipated cash needs, including for working capital purposes, capital expenditures and various contractual obligations, for at least the next 12 months. We may, however, require additional cash resources due to changed business conditions or other future developments, including any investments or acquisitions we may decide to pursue. If these sources are insufficient to satisfy our cash requirements, we may seek to sell additional debt securities or equity or to obtain a credit facility. The sale of additional convertible debt securities or equity securities could result in additional dilution to holders of our ordinary shares and ADSs. The incurrence of indebtedness would result in incurring debt service obligations, which could result in operating and financial covenants that would restrict our operations. Given our short operating history, we currently do not have any lines of credit or loans with any commercial banks. As a result, we are unlikely to rely on any bank loans to meet our liquidity needs. We cannot assure you that financing will be available in amounts or on terms acceptable to us, if at all.

We are a holding company with no operations of our own. Our operations are conducted through Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Tianjin Mammoth, BJXR, Beijing Chengxitong or Mailifang and our subsidiaries in the PRC. As a result, our ability to pay dividends and to finance any debt that we may incur is dependent upon license and service fees paid by Beijing AirInbox, Beijing Boya Wuji, Beijing WINT, Tianjin Mammoth, BJXR, Beijing Shiyuan Leya, Beijing Chengxitong or Mailifang and dividends and other distributions paid by our subsidiaries. If our subsidiaries incur debt on their own behalf in the future, the instruments governing the debt may restrict their ability to pay dividends to us. In addition, PRC legal restrictions permit payment of dividends to us by our subsidiaries only out of the net income from our subsidiaries, if any, determined in accordance with PRC accounting standards and regulations. Under PRC law, our subsidiaries are also required to set aside up to 10% of their after-tax net income, if any, each year to fund certain reserve funds. These reserve funds are not distributable as cash dividends. See “Item 3 — Key Information — Risk Factors — The dividends and other distributions on equity we may receive from our subsidiaries are subject to restrictions under PRC law or agreements that our subsidiaries may enter into with third parties.”

#### Indebtedness

As of December 31, 2008, we did not have any indebtedness, and we did not have any material debt securities or material mortgages or liens. In March 2009, we issued to NGP a convertible senior note due in 2014 with an aggregate principal amount of \$6,775,400. The convertible senior note would initially pay an annual interest at a rate of 8%, subject to reduction to 6% based on the financial performance of our company.

We intend to meet the majority of our future funding needs through cash flow generated from operating activities and our current cash and cash equivalents. Our treasury objective is to maintain safety and liquidity of our cash. Therefore, we have kept our cash and cash equivalents in short-term deposits and short-term government and high-grade corporate notes.

Our indebtedness as of each of December 31, 2006, 2007 and 2008 was nil.

Our operations in the PRC are subject to business tax at the rate of 3% to 8% on PRC taxable revenues as defined by the related PRC tax rules and regulations. We have calculated our PRC taxable revenues after deducting certain costs of revenues, including service fees, transmission charges payable to the telecommunications operators and business cooperation fees. We believe that our calculation of our PRC taxable revenues is consistent with PRC tax rules and regulations. However, we cannot assure you that PRC tax authorities in the future will not require changes in our calculation of taxable revenues for historical periods, which could have a material adverse impact on our financial position and results of operations.

Except as described above, as of December 31, 2008, we did not have any outstanding loan capital issued or agreed to be issued, bank overdrafts, loans, debt securities or other similar indebtedness, liabilities under acceptance (other than normal trade bills) or acceptance credits, debentures, mortgages, charges, finance leases or purchase commitments, guarantees or other material contingent liabilities.

Contractual Obligations and Commercial Commitments

The following table sets forth our contractual obligations as of December 31, 2008:

	Total	Payments due by period			
		Within			More than
		Less than 1 year	1-3 years	3-5 years	5 years
		(in thousands of U.S. dollars)			
Short-Term Debt Obligations	\$ —	\$ —	\$ —	\$ —	\$ —
Long-Term Debt Obligations	—	—	—	—	—
Capital (Finance) Lease Obligations	—	—	—	—	—