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

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**FORM 20-F**

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(Mark One)

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

OR

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

For the fiscal year ended December 31, 2018

OR

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

OR

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

Commission file number: 001-34271

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**CHANGYOU.COM LIMITED**

(Exact name of Registrant as specified in its charter)

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N/A

(Translation of Registrant's name into English)

**Cayman Islands**

(Jurisdiction of incorporation or organization)

**Changyou Building, Raycom Creative Industrial Park  
No. 65 Bajiao East Road, Shijingshan District  
Beijing 100043  
People's Republic of China  
(Address of principal executive offices)**

**Yaobin Wang  
Chief Financial Officer**

**Changyou Building, Raycom Creative Industrial Park  
No. 65 Bajiao East Road, Shijingshan District  
Beijing 100043  
People's Republic of China  
Telephone: (86 10) 6192 0800  
Email: IR@cyou-inc.com**

(Name, Telephone, E-mail and/or Facsimile Number and Address of Company Contact Person)

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

(Title of each class)  
**American Depositary Shares, each representing two Class A ordinary shares, par value US\$0.01 per share**

(Name of each exchange on which registered)  
**The Nasdaq Global Select Market**

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

**None**

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

**None**

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Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report: 36,251,420 Class A ordinary shares, par value \$0.01 per share, and 70,250,000 Class B ordinary shares, par value \$0.01 per share, as of December 31, 2018.

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

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

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 every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files).  Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or an emerging growth company. See definition of "large accelerated filer," "accelerated filer," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Emerging growth company

If an emerging growth company that prepares its financial statements in accordance with U.S. GAAP, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13 (a) of the Exchange Act.

† The term "new or revised financial accounting standard" refers to any update issued by the Financial Accounting Standards Board to its Accounting Standards Codification after April 5, 2012.

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

U.S. GAAP  International Financial Reporting Standards as issued by the International Accounting Standards Board  Other

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

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

(APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PAST FIVE YEARS)

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.  Yes  No

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## Introduction

In this annual report, except where the context otherwise requires and for purposes of this annual report only:

- “we,” “us,” “our company,” “Changyou,” and “our” refer to Changyou.com Limited, and unless the context requires otherwise, include its subsidiaries and variable interest entities;
- “Sohu.com Limited” refers to our ultimate parent and controlling shareholder, whose ordinary shares are listed on the Nasdaq Global Select Market under the symbol “SOHU”;
- “Sohu” or “Sohu Group” refers to Sohu.com Limited and its subsidiaries and consolidated variable interest entities and, unless the context requires otherwise, excludes Changyou.com Limited and its subsidiaries and variable interest entities;
- “PC games” refers to interactive online games that may be accessed and played simultaneously by hundreds of thousands of game players through personal computers with local game client-end access software installation requirements. In previous annual reports, we have sometimes used the terms “MMOGs” and “MMORPGs” when referring to these client-end installed games played through personal computers;
- “MMORPGs” refers to massively multiplayer online role-playing games;
- “Web games” are online games that are played through a Web browser with no local game software installation requirements;
- “Mobile games” are online games that are played on mobile devices and require an Internet connection;
- “Tian Long Ba Bu” refers to the popular novel of that name by the famous Chinese writer Louis Cha;
- “TLBB” refers to the PC game developed based on the title and characters of Tian Long Ba Bu;
- “TLBB 3D” refers to a mobile game that we developed based on the title and characters of Tian Long Ba Bu, and was launched in October 2014;
- “Legacy TLBB Mobile” refers to another mobile game that we developed based on the title and characters of Tian Long Ba Bu, which is operated by Tencent Holdings Limited, or Tencent, under license from us and was launched in May 2017;
- “IVAS” refers to our Internet value-added services;
- “VIE” refers to an entity that is a variable interest entity under U.S. GAAP, including a subsidiary of an entity that is a variable interest entity under U.S. GAAP;
- “U.S. GAAP” refers to generally accepted accounting principles in the United States;
- “PRC GAAP” refers to generally accepted accounting principles of the PRC;
- “ADSs” refers to our American depository shares, each of which represents two Class A ordinary shares, par value \$0.01 per share;
- “China” or “PRC” refers to the People’s Republic of China, and for the purpose of this annual report, excludes Hong Kong, Macau and Taiwan;
- “RMB” refers to the Renminbi, which is the legal currency of China; and
- “US\$,” “U.S. dollars,” and “\$” refer to the United States dollar, which is the legal currency of the United States.

This annual report on Form 20-F includes our audited consolidated statements of comprehensive income for the years ended December 31, 2016, 2017 and 2018 and audited consolidated balance sheets as of December 31, 2017, and 2018.

We completed an initial public offering of our ADSs on April 7, 2009. Our ADSs are traded on the Nasdaq Global Select Market under the symbol “CYOU.”

## FORWARD-LOOKING INFORMATION

This annual report on Form 20-F contains “forward looking statements.” These statements are made under the “safe harbor” provisions of the U.S. Private Securities Litigation Reform Act of 1995. You can identify these forward-looking statements by terms such as “may,” “will,” “expects,” “anticipates,” “future,” “intend,” “plan,” “believe,” “estimate,” “is/are likely to” and similar expressions. These statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance, or achievements to be materially different from those expressed or implied by the forward-looking statements. The forward-looking statements made in this annual report relate only to events as of the date on which the statements are made. We undertake no obligation, beyond any that is required by law, to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made, even though our situation will change in the future.

These forward-looking statements include, but are not limited to, the following:

- our ability to maintain and strengthen our position as a leading provider of products and services to online game players in China;
- our expected development, launch and market acceptance of additional mobile games and PC games;
- our ability to maintain and strengthen our 17173.com Website as a leading game information portal in China;
- our ability to continue to increase the revenues of our cinema advertising business;
- our various initiatives to implement our business strategies to expand our business through organic growth and strategic acquisitions;
- our future business development, results of operations and financial condition;
- the expected growth of and change in the online game industry in China; and
- the PRC government policies relating to the Internet and Internet content providers, including online game developers and operators.

We operate in an emerging and evolving environment. New risk factors emerge from time to time and it is impossible for our management to predict all risk factors, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statement.

We would like to caution you not to place undue reliance on forward-looking statements and you should read these statements in conjunction with all other parts of this annual report, including the risk factors set forth in Item 3. See “Key Information—Risk Factors”

## **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 Consolidated Financial Data***

The following table presents the selected consolidated financial information for our company. The selected consolidated statements of comprehensive income data for the three years ended December 31, 2016, 2017, and 2018 and the consolidated balance sheets data as of December 31, 2017 and 2018 have been derived from our audited consolidated financial statements included in this annual report beginning on page F-1. The selected consolidated statements of comprehensive income data for the years ended December 31, 2014 and 2015 and our consolidated balance sheets data as of December 31, 2014, 2015, and 2016 have been derived from audited consolidated financial statements that are not included in this report. The selected consolidated financial data should be read in conjunction with, and are qualified in their entirety by reference to, our audited consolidated financial statements and related notes and “Item 5. Operating and Financial Review and Prospects” below. Our consolidated financial statements are prepared and presented in accordance with U.S. GAAP. Our historical results do not indicate the results that may be expected for any future periods.

	For the Year Ended December 31,				
	2014	2015	2016	2017	2018
(US\$ in thousands, except for per share and per ADS data)					
<b>Consolidated Statement of Comprehensive Income Data:</b>					
Revenues:					
Online game	652,008	636,846	395,708	449,533	389,790
Online advertising	58,963	57,832	39,409	25,129	19,697
Cinema advertising	21,938	42,573	68,542	91,419	70,202
IVAS	22,357	24,385	21,726	14,180	6,074
Total revenues	<u>755,266</u>	<u>761,636</u>	<u>525,385</u>	<u>580,261</u>	<u>485,763</u>
Cost of revenues: <sup>(1)</sup>					
Online game	142,549	156,318	96,171	62,774	60,983
Online advertising	14,838	11,565	10,104	6,660	5,204
Cinema advertising	21,490	29,231	45,959	84,944	89,233
IVAS	22,985	19,647	13,576	9,408	5,408
Total cost of revenues	<u>201,862</u>	<u>216,761</u>	<u>165,810</u>	<u>163,786</u>	<u>160,828</u>
Gross profit	<u>553,404</u>	<u>544,875</u>	<u>359,575</u>	<u>416,475</u>	<u>324,935</u>
Operating expenses:					
Product development <sup>(1)</sup>	194,113	170,605	121,619	131,032	124,166
Sales and marketing <sup>(1)</sup>	241,307	92,355	56,543	60,917	54,303
General and administrative <sup>(1)</sup>	107,451	80,269	50,560	47,163	30,116
Goodwill impairment and impairment of intangible assets acquired as part of acquisition of a business <sup>(2)</sup>	52,282	40,324	—	86,882	16,369
Total operating expenses	<u>595,153</u>	<u>383,553</u>	<u>228,722</u>	<u>325,994</u>	<u>224,954</u>
Operating profit/(loss)	<u>(41,749)</u>	<u>161,322</u>	<u>130,853</u>	<u>90,481</u>	<u>99,981</u>
Interest income	26,091	23,777	21,490	32,319	34,409
Foreign currency exchange gain/(loss)	(668)	2,954	5,108	(5,196)	1,320
Interest expense	(6,452)	(8,333)	(4,321)	(4,372)	(10,197)
Other income, net	4,112	64,962	15,523	9,374	22,879
Income/(loss) before income tax expense	<u>(18,666)</u>	<u>244,682</u>	<u>168,653</u>	<u>122,606</u>	<u>148,392</u>
Income tax expense	2,493	54,055	21,583	40,767	64,467
Net income/(loss)	<u>(21,159)</u>	<u>190,627</u>	<u>147,070</u>	<u>81,839</u>	<u>83,925</u>
Less: Net income/(loss) attributable to the non-controlling interest shareholders	<u>(17,778)</u>	<u>(22,157)</u>	<u>2,123</u>	<u>(26,995)</u>	<u>(407)</u>
Net income/(loss) attributable to Changyou.com Limited	<u>(3,381)</u>	<u>212,784</u>	<u>144,947</u>	<u>108,834</u>	<u>84,332</u>
Net income/(loss)	<u>(21,159)</u>	<u>190,627</u>	<u>147,070</u>	<u>81,839</u>	<u>83,925</u>
Change in foreign currency translation adjustment (net of tax of nil, nil, and nil, respectively)	(2,949)	(74,904)	(66,321)	68,028	(60,466)
Available-for-sale securities:					
Change in unrealized gain/(loss) (net of tax of nil, nil, and nil respectively)	18	(1,454)	—	—	—
Less: reclassification adjustment for net gain included in net income/(loss) (net of tax of nil, nil, and nil, respectively)	—	1,436	—	—	—
Net change in unrealized gain/ (loss) on available-for-sale securities, net of tax	18	(18)	—	—	—
Total other comprehensive income/ (loss)	<u>(2,931)</u>	<u>(74,922)</u>	<u>(66,321)</u>	<u>68,028</u>	<u>(60,466)</u>
Comprehensive income/(loss)	<u>(24,090)</u>	<u>115,705</u>	<u>80,749</u>	<u>149,867</u>	<u>23,459</u>
Comprehensive income/(loss) attributable to the non-controlling interest shareholders	<u>(17,778)</u>	<u>(22,176)</u>	<u>2,127</u>	<u>(26,995)</u>	<u>(407)</u>
Comprehensive income/(loss) attributable to Changyou.com Limited	<u>(6,312)</u>	<u>137,881</u>	<u>78,622</u>	<u>176,862</u>	<u>23,866</u>
Cash dividend per share	—	—	—	—	4.70
Basic net income/(loss) per share	(0.03)	2.03	1.39	1.03	0.79
Diluted net income/(loss) per share	(0.03)	2.01	1.36	1.02	0.79
Basic net income/(loss) per ADS	(0.06)	4.06	2.78	2.06	1.59
Diluted net income/(loss) per ADS	(0.06)	4.02	2.72	2.04	1.57

	For the Year Ended December 31,				
	2014	2015	2016	2017	2018
Weighted average number of ordinary shares outstanding, basic	105,722	104,924	104,560	105,188	106,170
Weighted average number of ordinary shares outstanding, diluted	105,722	105,762	106,278	106,570	107,236
Weighted average number of ADS outstanding, basic	52,861	52,462	52,280	52,594	53,085
Weighted average number of ADS outstanding, diluted	52,861	52,881	53,139	53,285	53,618

(1) Share-based compensation expense/(benefit) is included in the following financial statements line items:

	For the Year Ended December 31,				
	2014	2015	2016	2017	2018
	(US\$ in thousands)				
Cost of revenues	152	35	31	73	(31)
Product development	1,069	5,475	2,881	6,163	(2,427)
Sales and marketing	105	1,017	572	1,212	(497)
General and administrative	2,788	8,497	4,918	9,945	(3,506)

(2) In 2014, we recognized a total impairment loss of \$52.3 million for goodwill and acquired intangible assets related to RaidCall, which we acquired in 2013 and was unable to provide expected synergies with our online games business. In 2015, we recognized a total impairment loss of \$40.3 million for goodwill and acquired intangible assets related to the Dolphin Browser, as a result of our managements' assessment that the previously expected synergies between our other mobile Internet products and the Dolphin Browser were not likely to materialize. For goodwill impairment and impairment losses recognized in 2017 and 2018, please refer to "Item 5. Operating and Financial Review and Prospects – Results of Operations – Operating Expenses."

**Selected Consolidated Balance Sheet Data**  
(In thousands, except par value)

	As of December 31,				
	2014	2015	2016	2017	2018
	(US\$)				
<b>Consolidated Balance Sheet Data:</b>					
Cash and cash equivalents	220,794	569,917	597,188	571,139	454,534
Restricted time deposits	417,442	354,739	—	—	243,910
Accounts receivable, net	77,969	67,959	47,150	91,636	57,389
Short-term investments	191,577	174,515	233,491	404,584	190,068
Fixed assets, net	243,837	214,306	189,770	189,947	170,746
<b>Total assets</b>	<b>1,547,965</b>	<b>1,779,506</b>	<b>1,708,037</b>	<b>1,922,023</b>	<b>1,965,484</b>
Receipts in advance and deferred revenue	39,178	42,166	43,541	42,917	45,343
Short-term bank loans	25,500	344,500	—	—	—
Long-term bank loans	344,500	—	—	—	220,000
<b>Total liabilities</b>	<b>605,267</b>	<b>720,257</b>	<b>559,873</b>	<b>606,666</b>	<b>1,133,840</b>
Class A ordinary shares (par value \$0.01, 200,000 authorized; 22,977, 34,089, 34,501, 35,186 and 36,251, respectively, issued and outstanding as of December 31, 2014, 2015, 2016, 2017 and 2018)	245	368	372	379	390
Class B ordinary shares (par value \$0.01, 97,740 authorized; 82,490, 70,250, 70,250, 70,250 and 70,250, respectively, issued and outstanding as of December 31, 2014, 2015, 2016, 2017 and 2018)	825	703	703	703	703
<b>Total shareholders' equity</b>	<b>942,698</b>	<b>1,059,249</b>	<b>1,148,164</b>	<b>1,315,357</b>	<b>831,644</b>
Non-controlling interests	52,310	29,770	30,397	3,352	1,909
<b>Total liabilities and shareholders' equity</b>	<b>1,547,965</b>	<b>1,779,506</b>	<b>1,708,037</b>	<b>1,922,023</b>	<b>1,965,484</b>

## **Risk Factors**

### ***Risks Related to Our Business and Our Industry***

#### **Overall Risks**

*The markets for our products and services are evolving rapidly and significantly, which makes evaluating our business and prospects difficult.*

Our three primary businesses are the online game business; the platform channel business, which consists primarily of online advertising; and the cinema advertising business. Our businesses and the industries in which we operate are evolving rapidly. We were incorporated on August 6, 2007 in the Cayman Islands and began our online game business as an indirect wholly-owned subsidiary of Sohu. In 2007 Sohu transferred all of its PC game business to us. In 2011 we acquired 7Road and began generating Web game revenues. In 2012, we began to develop and operate mobile games, but did not begin to generate any significant revenues from mobile games until late in 2014 when we launched TLBB 3D; and in May 2017, we successfully launched another in-house developed mobile game, Legacy TLBB Mobile, which is operated by Tencent under license from us. In August 2015, as revenues from our Web games Wartune and DDTank had begun to decline, we sold 7Road's operating entity and as a result we have no remaining significant Web games in operation or development. In 2011, we began to expand into the platform channel business with our acquisition from Sohu of the 17173.com Website, which operates our online advertising business. In December 2013, we acquired RaidCall, which operates free social communication software; and in July 2014 we acquired a majority interest in MoboTap Inc. ("MoboTap"), a Cayman Islands company that operates the Dolphin Browser. However, our acquisitions of RaidCall and MoboTap were not successful, as expected synergies did not materialize. In 2011, we acquired the entities that operate our cinema advertising business. Our cinema advertising business experienced strong growth in 2016 and 2017 and has remained a significant part of our overall business, but we experienced a significant decline in our revenues from our cinema advertising business in early 2018 and in the future we may not be able to again generate the same rate of revenue growth as we experienced in 2016 and 2017, and may suffer further declines in our revenues.

Our past successes in our online games business with PC games may not provide a meaningful basis for you to evaluate our current business and prospects, as a substantial number of game players have migrated from personal computers to mobile devices to access online games and the relative popularity of PC games continues to decline.

In response to such rapid migration, we have devoted and we expect to continue to devote substantial resources to the development of our mobile games as a critical component of our business strategy. However, our mobile games strategy has not been proven, and presents very different challenges from those presented in the past by our operation of PC games and Web games. Despite the early success of our mobile game TLBB 3D after we introduced it in late 2014 and of our mobile game Legacy TLBB Mobile after we launched it in May 2017, the popularity of, and the revenues generated from, TLBB 3D and Legacy TLBB Mobile continued to decline through 2018. We cannot be certain that we will be successful in our efforts to launch additional mobile games that generate sufficient revenues and income to sustain or grow our mobile game business.

You should also consider additional risks and uncertainties that may be experienced by companies operating in a rapidly developing and evolving industry. Some of these risks and uncertainties relate to our ability to:

- raise our brand recognition and game players' loyalty;
- develop, license or operate new games that are appealing to game players; adapt to new trends and game player tastes; meet our expected timetables for their launch; and, if they are successful, have acceptably long lifespans and result in an acceptable level of profit for us;
- successfully adapt to evolving business models, industry trends and market environments by developing and investing in new business strategies, products, services and technologies, including, in particular, virtual reality, or VR, technology, for our new games;
- arrange for our mobile games to be distributed through popular mobile application stores, with commercial terms, including revenue-sharing arrangements, that are favorable enough to us and allow us to achieve an acceptable level of profit from the games;
- integrate new technologies, businesses and personnel of acquired entities, and generate sufficient revenues to offset the costs and expenses of such acquisitions;
- maintain or expand our marketing efforts to attract more game players to our games and to the game information portal of the 17173.com Website in a rapidly changing and increasingly competitive business environment, and generate sufficient revenues to offset the costs and expenses of such marketing efforts; and reverse the recent decline in our revenues from the 17173.com Website, particularly in view of the rapid emergence of mobile games and the decline in the relative popularity of PC games and Web games as users switched to mobile devices; and



- successfully expand our marketing efforts to attract advertisers to place advertisements in pre-film advertising slots that we purchase from operators of movie theaters, which are critical to our ability to recoup our significant upfront payments and committed payments under our contracts with the operators of movie theaters.

If we do not adapt our business to address these risks and uncertainties, our ability to continue our past success or to expand our business in the future is likely to be impeded.

*Our business may not succeed in a highly competitive market.*

Competition in the online game market in China is becoming increasingly intense. We compete primarily with other online game developers in China, including Tencent and NetEase, Inc. Many of our competitors have, or may over time be able to gain, competitive advantages over us in terms of:

- greater financial and technical resources;
- more aggressive and effective strategies for hiring talent for game development, which may make it difficult for us to retain our existing employees and attract new employees, which are necessary for us to be able to grow our business;
- substantially greater financial resources and more effective methods for acquiring exclusive license rights to the titles, characters, themes and story lines of popular works in order to adapt online games from such works (which has become increasingly important for new online games to be successful);
- more aggressive and effective marketing strategies for promoting their online games and penetrating the mobile game market; and
- more capability for developing and releasing new software for mobile devices to attract a growing number of game players that access Internet products and services through mobile devices.

The 17173.com Website derives revenue primarily from providing online advertising services to advertisers that develop, operate and distribute PC games. As the market demand for PC games continues to decline, the 17173.com Website faces intense competition, particularly from mobile application stores and other Internet platforms through which game players access mobile games, for advertising business targeting online players of mobile games. We compete with other game information portals, such as duowan.com, operated by YY Inc., and game.qq.com, operated by Tencent, and other Internet portals which have, or may over time be able to build, competitive advantages over us in terms of:

- greater brand recognition among game players and advertising clients;
- larger user and customer bases;
- more extensive and well developed marketing and sales networks;
- more attractive mobile versions of their game information portals and more extensive mobile game-related products and services, such as mobile game discussion forums, in response to the rapid migration of users of Internet services from PCs to mobile devices such as tablets and mobile phones, and the unique preferences and demands of mobile users and mobile game players; and
- substantially greater financial and technical resources.

Our cinema advertising business generates revenues through contracts that we enter into with advertisers to place their advertisements in pre-film advertising slots that we purchase from operators of movie theaters. We compete with Focus Media Group, Wanda Group and other companies selling pre-film advertisement slots to advertisers. These competitors in general, and Wanda Group in particular, have, and may be able to build further, competitive advantages over us arising from their having significantly greater financial resources, greater brand recognition among operators of movie theaters and advertisers and more capable and effective sales and marketing forces and strategies than we do. Wanda Group has a particular competitive advantage over us, as Wanda Group itself is one of the largest operators of movie theaters in China. Therefore it is beneficial for Wanda Group to expand its own cinema advertising business together with the expansion of its self-operated movie theaters. In addition, Wanda Group competes with us for advertising slots in other movie theaters that Wanda does not own or operate, which may force us to increase our bidding price for such advertising slots, which may impair our ability to compete effectively in those markets.

In order to compete effectively in the PRC, as well as in the worldwide market, we must continue to invest in research and development, to enhance our technology and our existing games, advertising and other services, and to introduce new game products and services in order for us to adapt to industry trends and shifting demands of game players and advertising clients and to remain competitive. If our products and services are not responsive to the needs of our game players and advertisers, are not appropriately timed with market opportunities, or are not effectively brought to market, or if our competitors are more successful than we are in developing compelling products or in attracting and retaining game players and advertisers, we may not be able to compete effectively.

*Our business could suffer if we do not successfully manage any future growth.*

We experienced a period of rapid growth and expansion through 2013 that placed strain on our management personnel, systems and resources. In addition, to accommodate any future growth, we anticipate that we will need to implement a variety of new and upgraded operational and financial systems, including procedures and controls, and improvement of our accounting and other internal management systems and security systems related to the foregoing, all of which require substantial management efforts and financial resources. We will also need to continue to train, manage and motivate our workforce, and manage our relationships with our third-party operators, distributors and service providers and our game player base. All of these endeavors will require substantial management effort and skills and the incurrence of additional expenditures. We may not be able to efficiently or effectively implement our growth strategies and manage the growth of our operations, and any failure to do so may limit our future growth and hamper our business strategy.

*We may not be able to avoid slowing growth or declines in our revenues, or future losses.*

Our revenues grew significantly in a relatively short period of time prior to 2014, but our revenue growth stalled in 2014 and 2015, and our revenues decreased in 2016. Primarily due to the commercial success of TLBB, our revenues grew from \$623.4 million for the year ended December 31, 2012 to \$737.9 million for the year ended December 31, 2013. However, our revenues increased only slightly to \$755.3 million and to \$761.6 million, respectively, for the years ended December 31, 2014 and 2015 and our revenues decreased to \$525.4 million for the year ended December 31, 2016. Although our revenues increased from 2016 to \$580.3 million for the year ended December 31, 2017, largely due to the early success of our mobile game Legacy TLBB Mobile, they remained below our revenues for 2013, 2014, and 2015, and our revenues decreased to \$485.8 million for the year ended December 31, 2018. Even if our revenues increase in future years, we are not likely to experience rates of revenue growth in the future similar to those that we experienced prior to 2014. We suffered a net loss attributable to Changyou.com Limited of \$3.4 million for the year ended December 31, 2014. Our net income attributable to Changyou.com Limited was \$212.8 million for the year ended December 31, 2015, but decreased to \$144.9 million for the year ended December 31, 2016, to \$108.8 million for the year ended December 31, 2017 and to \$84.3 million for the year ended December 31, 2018. We may experience declines in our revenues or suffer net losses in the future due to a number of factors, including, among other things, expected continued declines in TLBB's, Legacy TLBB Mobile's, and TLBB 3D's revenues; the uncertain level of popularity of our future games; uncertainty as to our ability to develop and launch high-quality mobile games that are commercially successful; the relatively higher game development and distribution costs generally associated with mobile games; the need to expend greater amounts in order to develop or acquire new games, technologies, assets, and businesses; and uncertainty as to our ability to integrate such newly acquired games, technologies, assets, and businesses. Accordingly, you should not rely on the results of any prior period as an indication of our future financial and operating performance.

*Our previous and any future acquisitions and/or strategic alliances may have an adverse effect on our ability to manage our business and may also result in impairment charges.*

We have made acquisitions of, and may potentially acquire in the future, technologies, businesses or assets that are complementary to our business and/or enter into strategic alliances in order to leverage our position in the China market and expand our business domestically and internationally. Such acquisitions or strategic alliances may expose us to potential risks, including risks associated with the integration of new technologies, businesses and personnel including our continued reliance on the management teams of the acquisition targets to operate the acquired businesses, unforeseen or hidden liabilities, the diversion of management attention and resources from our existing business, and the inability to generate sufficient revenues to offset the costs and expenses of acquisitions or strategic alliances. Any difficulties encountered in the acquisition and strategic alliance process may have an adverse effect on our ability to manage our business. In addition, acquired businesses may not perform to our expectations for various reasons, including the loss of key personnel or key clients, and our strategic focus may change. As a result, we may not realize the benefits we anticipated. If we fail to integrate acquired technologies, businesses and assets or realize the expected benefits, we may not receive a return on our investment and our transaction costs for such acquisitions. The benefits of an acquisition or investment may also take considerable time to develop, and we cannot be certain that any particular acquisition or investment will produce the intended benefits, which could adversely affect our business and operating results. Acquisitions could result in contingent liabilities or amortization expenses related to intangible assets or write-offs of goodwill and/or intangible assets, which could adversely affect our results of operations. For example, in December 2013, we acquired RaidCall with the expectation of generating benefits from synergies with our online game business; in November 2013 we acquired Beijing Doyo Internet Technology Co., Ltd. ("Doyo") with the expectation of generating benefits from synergies with our online advertising business; and in July 2014 we acquired MoboTap, which operates the Dolphin Browser, with the expectation of generating benefits from synergies with our platform channel business. In 2014 we recognized a \$33.8 million impairment loss for goodwill and a \$15.3 million impairment loss for acquired intangible assets related to RaidCall; in 2015 we sold Doyo and recognized a \$1.9 million impairment loss for goodwill; in 2015 we recognized a \$29.6 million impairment loss for goodwill and an \$8.9 million impairment loss for acquired intangible assets relating to the MoboTap business; in 2017 we recognized a further \$83.5 million impairment loss for goodwill and a \$3.4 million impairment loss for intangible assets relating to the MoboTap business, as a result of our management's conclusion that the expected synergies would not materialize; and in 2018, we recognized a \$16.4 million impairment loss for goodwill relating to the 17173.com Website and we sold MoboTap.

*We are dependent upon our management and upon our key development and technical personnel, and our business may be disrupted if we lose the services of any of them.*

Our future success depends substantially on the services of the members of our management and our key development and technical personnel, such as our Chief Executive Officer Dewen Chen and our key game development personnel. If one or more of the members of our management or key development or technical personnel were unable or unwilling to continue in their present positions, we might not be able to replace them easily, or at all. If any of the members of our management or our key employees joins a competitor or forms a competing company, not only would we lose know-how, key professionals, staff members and suppliers, but such members of our management and key employees could develop and operate games and other services that could compete with and take game players and users away from our existing and future business. Although each of these members of our management and key personnel has entered into an employment agreement with non-competition provisions, these non-competition provisions may not be enforceable in China.

*Our prospects for growth may be adversely affected if we cannot successfully manage and make timely adjustments to our hiring needs to support our business strategies.*

The Internet industry in China is characterized by high demand and intense competition for talent, particularly for game developers and related technical personnel, and our success in the implementation of our growth strategies depends on our ability to successfully manage, and make timely adjustments to, our hiring needs. The number of our employees decreased by 13.0% in 2016, by 13.0% in 2017, and by 13.7% in 2018, as we emphasized the development of mobile games and laid off a number of employees who had been focused primarily on international markets and the platform channel business. These layoffs could have an adverse effect on our remaining employees' morale and their loyalty to us, and cause us to lose employees whose talent and experience are important for our business, and could also have a negative impact on our reputation as an employer and our ability to attract qualified employees in the future. Laid-off employees could also make claims against us for additional compensation, causing us to incur additional expense.

*We may not have exclusive rights to trademarks, designs and technologies that are crucial to our business.*

We have applied for initial registrations in the PRC and overseas, and/or changes in registrations relating to transfers of our key trademarks in the PRC, including ChangYou.com, cyou.com, TLBB, TLBB logos, New Blade Online, 17173, TLBB 3D, and the corresponding Chinese versions of the marks, so as to establish and protect our exclusive rights to these trademarks. We have succeeded in registering the trademarks ChangYou.com, cyou.com, TLBB, TL logos and 17173 in the PRC under certain classes. The applications for initial registration, and/or changes in registrations relating to transfers, of other marks and/or of some of these marks under other classes are still under examination by the Trademark Office of the State Administration of Market Regulation of the PRC (the "SAMR") and relevant authorities overseas. Moreover, if we are unable to renew the licenses from the estate of Louis Cha for our mobile games TLBB 3D and Legacy TLBB Mobile and for our PC game TLBB, we could lose the right to use the trademarks related to those games to the extent that they relate to Louis Cha's novel Tian Long Ba Bu. We have applied for patents relating to the design of our games and to technology intended to enhance the functionalities of our games. We have various patent applications under examination by the State Intellectual Property Office of the PRC. Approvals of our initial trademark registration applications, and/or of changes in registrations relating to such transfers, or of our patent applications, are subject to determinations by the Trademark Office of the SAMR, the State Intellectual Property Office of the PRC and relevant authorities overseas that there are no prior rights in the applicable territory. We cannot be certain that these applications will be approved. Any rejection of these applications could adversely affect our rights to the affected marks, designs and technologies. In addition, even if these applications are approved, we cannot assure you that any registered trademark or issued patent will be sufficient in scope to provide adequate protection of our rights.

*We may need to incur significant expenses to enforce our proprietary rights, and if we are unable to protect such rights, our competitive position and financial performance could be harmed.*

We regard our intellectual property and proprietary rights as critical to our success. In particular, we have spent a significant amount of time and resources in developing our current games and possible future games. Our ability to protect our proprietary rights in connection with our games is critical for their success and our overall financial performance. While we have registered software in China for copyright protection and have taken various measures to protect our source codes, such measures may not be sufficient to protect our proprietary information and intellectual property. Intellectual property rights and confidentiality protection in China may not be as effective as they are in the United States and other developed countries. Policing unauthorized use of proprietary technology is difficult and expensive. In addition, while we have registered some trademarks relating to our games in the PRC and other jurisdictions, and have applied for additional registrations of trademarks, in some instances we may not succeed in obtaining registration of trademarks that we have applied for in different languages, such as English. We cannot assure that these pending or future trademark applications will be approved. Any failure to register trademarks in any country or region may limit our ability to protect our rights in such country or region under relevant trademark laws, and we may need to change the name of the relevant trademark in certain cases, which may adversely affect our branding and marketing efforts.

Despite our efforts to protect our intellectual property, online game developers may copy our ideas and designs, and other third parties may infringe our intellectual property rights. For example, certain third parties have misappropriated the source codes of previous versions of TLBB and have set up unauthorized servers in China and elsewhere to operate TLBB to compete with us. The existence of unauthorized servers may attract game players away from our games and may result in decreases in our revenues. Any measures we take in response may not be successful in eliminating these unauthorized servers. Litigation relating to intellectual property rights may result in substantial costs to us and diversion of resources and management attention away from our business, and may not be successful. In addition, our ideas and certain of our designs, if not fixed in a tangible form of expression or registered with the appropriate PRC authorities, may not be protected by patents or other intellectual property rights. As a result, we may be limited in our ability to assert intellectual property rights against online game developers who independently develop ideas and designs that compete with us.

*We may be exposed to infringement or misappropriation claims by third parties, which, if determined adversely to us, could subject us to significant liabilities and other costs.*

Our success depends largely on our ability to use and develop our technology and know-how without infringing the intellectual property rights of third parties. We cannot assure you that third parties will not assert intellectual property claims against us. We are subject to additional risks if entities licensing to us intellectual property, including, for example, game source codes, do not have adequate rights in any such licensed materials. The validity and scope of claims relating to the intellectual property of game development and technology involve complex scientific, legal and factual questions and analyses and, therefore, tend to be uncertain. If third parties assert copyright or patent infringement or violation of other intellectual property rights against us, we will have to defend ourselves in litigation or administrative proceedings, which can be both costly and time consuming and may significantly divert the efforts and resources of our technical and management personnel. An adverse determination or settlement in any such litigation or proceedings to which we may become a party could subject us to significant liability to third parties, or require us to seek licenses from third parties, pay ongoing royalties, or redesign our games or subject us to injunctions prohibiting the development and operation of our games.

#### **Risk Related to Online Games**

*There are uncertainties regarding the future growth of the online game industry in China.*

The online game industry, from which we derive most of our revenues, is a rapidly evolving industry. The growth of the online game industry and the level of demand and market acceptance of our games are subject to a high degree of uncertainty. Our future operating results will depend on numerous factors affecting the online game industry, many of which are beyond our control, including:

- whether the online game industry, particularly in China and the rest of the Asia-Pacific region, continues to grow and the rate of any such growth;
- the availability and popularity of other forms of entertainment, particularly games on console systems, which are already popular in developed countries and may gain popularity in China;
- growth in users of the Internet and broadband and penetration in China and other markets in which we offer our games, and the rate of any such growth;
- whether recent declines in the use of personal computers and growth in users of mobile devices such as smart phones and tablets in general, and for purposes of accessing online games in particular, continue or accelerate in China and other markets in which we offer our games;
- changes in consumer demographics and public tastes and preferences; and
- general economic conditions in China, particularly economic conditions adversely affecting discretionary consumer spending, such as the slowdown in China's economic growth that occurred between the first quarter of 2010 and the third quarter of 2012 and from 2014 through 2018.

There is no assurance that online games in general will continue to be popular in China or elsewhere. If the current decline in the popularity of PC games continues or accelerates as users increasingly switch to mobile devices, our revenues from our PC games may decrease significantly; and if the PC games that we have launched, or expect to launch in the future, are not successful, we may not be able to recoup the investments in our development and marketing of those games.

*We currently depend on TLBB for a significant portion of our revenues, and continued decrease in the popularity of TLBB or interruption in its operation will adversely affect our results of operations.*

We currently rely on TLBB for a significant portion of our revenues. We launched TLBB in May 2007 and, despite our efforts to improve TLBB, our game players have nevertheless lost interest in it over time as the relative popularity of PC games that are accessed through personal computers continues to decline and TLBB's popularity, revenues, and profitability have continued to decline. See "We may not be successful in operating and improving our games to satisfy the changing demands of game players."

To prolong TLBB's lifespan and slow down the pace of its decline, we need to continually improve and update it on a timely basis with new features, including enhanced social interaction features, that appeal to existing game players, attract new game players (including those who played earlier versions of TLBB), and improve player stickiness to the game. If we fail to improve and update TLBB on a timely basis, or if our competitors introduce more popular games, including mobile games, catering to our game player base, the decline in TLBB's popularity can be expected to accelerate, which would cause our revenues to decrease at a faster pace. Furthermore, if there are any interruptions in TLBB's operation due to unexpected server interruptions, network failures or other factors, game players may be prevented or deterred from making purchases of virtual items, which could also cause significant decreases in our revenues.

*The market demand for PC games in general, and for the PC games that we operate in particular, can be expected to continue to decline, and the number of game players of PC games can be expected to continue to decrease, which will have an adverse effect on our online game business and prospects.*

A significant portion of our online game revenues is generated from our PC games, and from TLBB in particular. However, the popularity of PC games continues to decline and an increasing number of online game developers are delaying or suspending their plans to develop and launch new PC games, as a substantial number of game players have switched to mobile devices to access online games. It has become increasingly difficult for PC game developers and operators to retain existing players of their games and the number of game players who are willing to spend time and money to play new PC games continues to decrease. If this downward trend accelerates, it may make it increasingly difficult for our existing PC games in general, and TLBB in particular, to slow the decline in their popularity and for our new PC games to ever become commercially successful; the game player base of our PC games in general, and of TLBB in particular, may shrink at a more rapid pace, which would accelerate and increase our costs to acquire and retain players of our PC games and would have a negative impact on our online game revenues. In addition, our PC games generally produce relatively higher profit margins for us than do our mobile games, because we must distribute our mobile games through third-party mobile game distributors or mobile application stores and enter into revenue-sharing arrangements with such distributors or mobile application stores. Accordingly, any decrease in our revenues from our PC games may have a relatively larger negative impact on our overall profits.

*As mobile devices such as tablets, mobile phones and other devices other than personal computers are increasingly used to access online games, we must continue to acquire or develop increasing numbers of mobile games that work on such devices.*

Devices other than personal computers, such as mobile phones and tablets, are used increasingly in China and in overseas markets. We believe that, for our business to be successful, we will need to continue to develop versions of our existing games and any future games that work well with such devices. The games that we develop for such devices may not function as smoothly as our existing games, and may not be attractive to game players in other ways. In addition, manufacturers of such devices may establish restrictive conditions for developers of applications to be used on such devices, and as a result our games may not work well, or at all, on such devices. As new devices are released or updated, we may encounter problems in developing versions of our games for use on such devices and we may need to devote significant resources to the development, support, and maintenance of games for such devices. Since 2014 we have been investing, and we expect to continue to invest, significant amounts in the development, promotion and operation of games for mobile devices. If we are unable to successfully expand the types of devices on which our existing and future games are available; if mobile versions of games that we develop for such devices do not function well or are not attractive to users and game players; if the popularity and revenues of our mobile game Legacy TLBB Mobile continue to decline; or if the other mobile games that we have launched, or expect to launch in the future, are not successful, we may not be able to maintain or increase our revenues and recoup our investments in the mobile market.

*Our mobile game Legacy TLBB Mobile is currently generating a significant portion of our revenues. We increasingly rely on dominant third-party game distributors and operators that obtain licenses from us to market, distribute, and operate our mobile games, including Legacy TLBB Mobile, which is operated by Tencent under a license from us. If we are not able to establish and maintain collaborative relationships with Tencent and other dominant third-party game distributors and operators for our existing and future mobile games, it is likely that we will not be able to maintain or expand our mobile game business.*

Our mobile game Legacy TLBB Mobile has been generating a significant portion of our revenues since its launch in May 2017. We increasingly rely on dominant third-party game distributors and operators with large user bases, leading big data analytical capabilities, and track records and experience with successful operation of mobile games to operate our mobile games. For example, Tencent, which is an Internet conglomerate with a very large user base and is a dominant game developer and distributor in China, is the exclusive operator and distributor of Legacy TLBB Mobile under license from us, and shares with us the revenues generated by the game. For the year ended December 31, 2018, revenues from Legacy TLBB Mobile were \$102.6 million, accounting for approximately 26% of our online game revenues and approximately 21% of our total revenues. If Tencent terminates the current licensing arrangements with us for Legacy TLBB Mobile or curtails its marketing efforts to promote Legacy TLBB Mobile, or if we are not able to establish and maintain collaborative relationships with other dominant game distributors and operators in China for our existing and future mobile games on commercial terms that are acceptable to us, it will be difficult for us to maintain or expand our mobile game business. In addition, we rely on Tencent and other third-party operators to collect payments from game players for their purchases of virtual items in our mobile games, and to pay to us the pre-agreed revenue-sharing amounts, and there is usually a delay between the time of a game player's purchase and the time when the operator pays us, which has placed, and may continue to place, constraints on our cash flow.

*Our business will suffer if we are unable to develop successful high-quality games for mobile devices, expand our game portfolio with a variety of genres that are appealing to game players, monetize mobile games we develop, or acquire and maintain for a reasonable period the popularity and revenue levels of any of our mobile games that are successful.*

Developing high-quality games for mobile devices is an important component of our online game strategy. China's mobile games market recently has been dominated by a small number of high-quality games, which collectively generate a substantial majority of the total revenues and profits of all mobile games in the market. We have devoted and we expect to continue to devote substantial resources to the development of our mobile games, focusing on those that we believe have the potential to become high-quality games. Despite the early success of our mobile game Legacy TLBB Mobile, we cannot guarantee that we will be able to develop additional high-quality games that appeal to players or, even if we are able to develop high-quality games that are successful, that such games will have lifespans that are long enough to generate an acceptable level of revenues, as mobile games tend to have relatively shorter lifespans than PC games. In addition, we may encounter difficulty in integrating features into games developed for mobile devices that a sufficient number of players will pay for, or in otherwise sufficiently monetizing mobile games. As the mobile-device market in China is saturated or near saturation, mobile-game developers and operators have increasingly devoted substantial resources to the expansion of their mobile-game portfolios with a variety of genres, such as MMORPG, multiplayer online battle arena ("MOBA") games, or first person shooter ("FPS") games, that are appealing in the mobile game market, in order to acquire and retain game players and maintain or increase revenues from the games. However, we have not been successful in the development of mobile games other than those in the MMORPG genre. If we are unable to develop successful high-quality games and expand our game portfolio with games in a variety of genres that are in line with market trends, or implement successful monetization strategies for our mobile games in general, our ability to maintain or grow revenues will be adversely affected.

Our ability to successfully develop and monetize games for mobile devices will depend on our ability to:

- expand the portfolio of mobile games, and particularly high-quality games, in a variety of genres that we develop in-house and license from third-party developers;
- effectively develop new mobile games for multiple mobile operating systems and mobile devices;
- anticipate and effectively respond to the growing number of players switching to mobile games, the changing mobile landscape, and the interests of players;
- attract, retain and motivate talented game designers, product managers and engineers with experience in developing games for mobile devices;
- minimize launch delays and cost overruns on the development of new games;
- effectively monetize mobile games without degrading the social game experience for our players;
- develop games that provide for a compelling and optimal user experience through existing and developing third-party technologies, including third-party software and middleware utilized by our players; and
- acquire and successfully integrate high-quality mobile game assets, personnel, and companies.

Further, even if we develop or acquire license rights to a mobile game that is successful, the game's lifespan may be short, as even successful mobile games tend to have less sustained user loyalty than do successful PC games. For example, the revenues generated from our mobile game Legacy TLBB Mobile, which was launched in May 2017, declined sequentially through 2018, which is typical for a mobile game. In addition, although a relatively large number of the mobile games available at any given time may be low-quality games that attract fewer game players than do high-quality games, such games may on an aggregate level have the effect of attracting away a significant number of game players who would otherwise play high-quality mobile games. In view of the uncertain lifespans of mobile games and the large quantity of mobile games competing for game players, it is necessary for us to make considerable investments in order to have a number of mobile games, and particularly mobile games that have the potential to become high-quality hit games, in our pipeline.

If we are unable to develop or acquire new mobile games in general, and high-quality games in particular, that are successful, or to maintain for a reasonable period the popularity and revenue levels of any mobile games that we develop or acquire that are successful, we may not be able to recoup our development and acquisition costs and our ability to expand our business in the future is likely to be impeded.

*We believe that the chance of success for online games is improved if they are adapted from the titles, characters, themes, and story lines of popular works of Chinese and foreign authors. However, there are many risks and uncertainties related to obtaining the rights to adapt such works for online games, and our games adapted from such works may not be successful.*

We believe that, in order for many of the new online games that we develop to be successful in China, it is important for us to obtain license rights, and preferably exclusive license rights, to adapt the titles, characters, themes and story lines of popular works for use in the games. For example, we developed and we operate our PC game TLBB and our mobile games Legacy TLBB Mobile and TLBB 3D with various features that are included in reliance on the rights under our existing license agreements with the Chinese martial arts author Louis Cha, with respect to his popular novel Tian Long Ba Bu. We believe that these features have had a critical role in attracting and retaining many of the players of TLBB, Legacy TLBB Mobile, and TLBB 3D. However, Mr. Cha died in 2018, and we will need to negotiate with his estate for the right to extend the licenses when they expire. If we are unable to agree on extensions of the licenses, we will be unable to develop new expansion packs for the applicable games if they incorporate Tian Long Ba Bu features, and we may lose the rights to trademarks that we have claimed as to various features and character names based on or inspired by Tian Long Ba Bu. In addition, it can be difficult to identify a sufficient number of such works that are suitable for adaptation for use in online games, and we face significant competition for the rights to such works from other online game companies that also adapt their online games from popular works. Obtaining license rights, and particularly exclusive license rights, to adapt suitable works for use in online games can involve significant expense, as the license fees, and the percentage of revenues from the games adapted from such works, payable to authors have continued to rise as competition for such license rights has intensified. In addition, we have previously obtained, and intend to continue to seek to obtain, license rights for works from certain authors in foreign countries, and our ability to obtain such rights has previously been, and may be in the future be, adversely affected by greater scrutiny of such works, and a stricter approval process for permission to obtain such rights, by relevant Chinese authorities compared to the scrutiny of and approval process applicable to domestic works.

Even if we obtain license rights for works, we cannot assure you that games that we adapt from such works will be popular and commercial successes and that we will be able to recoup the amounts we pay for the license rights. Obtaining such rights and adapting such works for mobile games present additional risks, because of the relatively short lifespans of mobile games. Moreover, after the expiration of the terms of our existing license agreements with the estate of Mr. Cha and other holders of copyrights, we may not be able to renew the agreements with commercial terms that are favorable to us, if at all. Our inability to renew such agreements could force us to discontinue the related online games or, in the case of games based on Tian Long Ba Bu, to cease issuing any further expansion packs based on Tian Long Ba Bu, and have a significant adverse impact on our online game operations and revenues.

*We may not be able to distribute our mobile games through our desired Internet platforms, our profits from any successful mobile games can be expected to be relatively lower than the profits we have enjoyed historically from PC games and our mobile game revenues are subject to additional risks as we rely on mobile application stores to collect payments from players of our mobile games.*

We may not be able to arrange for our mobile games to be distributed through our desired popular third-party mobile application stores with commercial terms, including revenue-sharing arrangements, that are favorable enough to us to allow us to achieve an acceptable level of profit from the games. Our profits from mobile games, even if the games are successful, are likely to be relatively lower than the profits we generate from PC games, because, in order to gain access for our games on mobile application stores, we must enter into revenue-sharing arrangements that generally result in lower profit margins than those generated from our PC games. Due to market competition and pressures, only a handful of third-party mobile application stores and other game distribution channel providers have survived and, of the remaining providers, an even smaller number of key providers, including Tencent and Mobile Hardcore Alliance, collectively control a substantial share of the market. As a result, we have reduced leverage and weaker bargaining power in business negotiations with game distribution channel providers, which may lead to our being forced to agree to receiving relatively low revenue-sharing percentages for many of our mobile games.

We rely on mobile application stores to collect payments from game players for their purchases of our virtual items and to pay to us pre-agreed revenue-sharing amounts; if mobile application stores cease to offer our games over their platforms, change their user payment policies, such as return policies, or fail to make revenue-sharing payments that are due to us, our revenues will be adversely affected. When we distribute our games through smaller, less well-known application stores, we may not receive revenue-sharing payments when they are due to us. In addition, the iOS-based mobile application store allows game players to use foreign currency to purchase virtual items or game points in our games, and the store pays to us pre-agreed revenue-sharing amounts after converting the foreign-currency denominated revenues from such purchases into RMB using an exchange rate effective at the time of the payment. Since there is usually a delay between the time of a game player's purchase and the time when the store pays us, if the foreign currency used has depreciated against the RMB during the delay we will receive lower share-sharing amounts at the time of the payment than we would have received if the payment had been made at the time of the game player's purchase.

*Our new mobile games will be less likely to be successful if we cannot adopt and implement innovative and effective marketing strategies to attract attention to our games from game players in our targeted demographic groups.*

A relatively large number of mobile games are typically available at any given time in the markets in which we launch and operate our mobile games, and such games compete for attention from the same game player population that we target. Our ability to successfully promote and monetize our mobile games will depend on our ability to adopt and effectively implement innovative marketing strategies, and particularly precision marketing through new media such as Weibo, WeChat, bilibili.com Website and other online game forums, targeting potential mobile game players in general, and game players in specific demographic groups for certain games in particular, and our ability to cross-market mobile games to players of our current PC games and mobile games. If we fail to adopt and implement such marketing and cross-marketing strategies, or if the marketing strategies of our competitors are more innovative and effective than ours, our mobile games will be less likely to be successful and as a result we may not be able to achieve an acceptable level of revenue from those games.

*Our development and operation of mobile games may be adversely affected by the promulgation of new, and the implementation and interpretation of existing, PRC laws and regulations affecting mobile games.*

As mobile games are a relatively new type of online game in China, developers and operators of mobile games, including us, have been facing increasingly intense regulatory scrutiny from PRC regulatory authorities regarding the development and operation of mobile games. Substantial uncertainties exist regarding the timing of the promulgation of, and any changes to, current and future PRC laws and regulations and the effect of the interpretation and implementation thereof, which may, among other things:

- have an adverse impact on the way we design our games and game features, which may make the games less attractive to game players;
- have an adverse impact on our ability to achieve an acceptable level of revenues and profit from our mobile games;
- make it harder to access our mobile games and cause a decrease in our player base;
- increase the cost of the development and operation of our mobile games; and
- require substantial management attention and effort in monitoring the development of, and ensuring our compliance with, existing and future PRC laws and regulations affecting the mobile games business.

For a discussion of the risks associated with PRC laws and regulations affecting online games in general and mobile games in particular, see “Risks Related to Doing Business in China” in this Item 3 of this annual report.

*Our new games may attract game players away from our existing games.*

With our increasingly diversified game portfolio, we cannot assure you that players of our existing games will not be attracted to play other newly launched games, including our new mobile games. If this occurs, it will decrease our existing games’ player bases, which could in turn make these games less attractive to other game players, resulting in decreased revenues from our existing games. For example, revenues generated from our mobile game TLBB 3D decreased significantly in the second quarter of 2017, and we believe that this may have been due in part to the launch of our mobile game Legacy TLBB Mobile in May 2017. Game players who switch from playing our existing games to our new games may also spend less money to purchase virtual items in our new games than they would have spent if they had continued playing our existing games, resulting in an adverse effect on our overall revenues. In addition, game players’ switching from playing our existing PC games to our new mobile games, as well as from our in-house developed games to our licensed games, could cause our overall online game profits to be relatively lower, as our profits from mobile games and licensed games tend to be relatively lower as a result of revenue-sharing arrangements.

*We rely on recorded data for game revenue recognition and tracking of game players’ consumption patterns of virtual items. If our data systems fail to operate effectively, such failure will affect the completeness and accuracy of our revenue recognition, and also our ability to design and improve virtual items that appeal to game players.*

Our game operation revenues are generated through the direct online sale of game points and sale of our prepaid game cards, and our recognition of those revenues depends on such factors as whether the virtual items purchased by game players are considered consumable or perpetual. Our revenue recognition policy with respect to perpetual virtual items is based on our best estimate of the lives of the items. We consider the average period that paying players typically play our games and other player behavior patterns to arrive at our best estimate of the lives of these perpetual items. However, given the fast-evolving nature of the game industry and the various types of online games that we offer to players with different tastes and preferences, our estimate of the period that players typically play our games may not accurately reflect the actual lives of these perpetual virtual items. We revise our estimates as we gain operating data, and we attempt to refine our estimation process accordingly. Any future revisions to these estimates could adversely affect the time period during which we recognize revenues from these items. For example, an increase in the estimated lives of these perpetual virtual items would increase the period over which revenues from these items are recognized. See “Item 5. Operating and Financial Review and Prospects—Critical Accounting Policies and Management Estimates—Revenue Recognition.”



We rely on our data systems to record and monitor the purchase and consumption of virtual items by our game players and the types of virtual items purchased. If our data systems fail to accurately record the purchase and consumption information of the virtual items, we may not be able to accurately recognize our revenues. In addition, we rely on our billing systems to capture historical game player behavior patterns and other information. If such information is not accurately recorded, or if we do not have sufficient information due to the short operating history of any of our games, we will not be able to accurately estimate the lives of, or the estimated average period the game players play our games with respect to, the perpetual virtual items, which will also affect our ability to accurately recognize our revenues from such perpetual virtual items. If our data systems were damaged by system failure, network interruption, or virus infection, or attacked by a hacker, the integrity of data would be compromised, which could adversely affect our revenue recognition and the completeness and accuracy of our recognized revenues.

In addition, we rely on our data systems to record game player purchase and consumption patterns, based on which we improve our existing virtual items and design new virtual items. For example, we intend to increase development efforts on the number and variety of virtual items that our game players like to purchase, and we may also adjust prices accordingly. If our data systems fail to record data accurately, our ability to improve existing virtual items or design new virtual items that are appealing to our game players may be adversely affected, which could in turn adversely affect our revenues.

*We could be liable for breaches in the security of our online payment platforms and those of third parties with whom we transact business, and any such breaches could cause our customers to lose confidence in the integrity of the payment systems that we use.*

Currently, we sell a substantial portion of our virtual game points and prepaid game cards to our game players through third-party online payment platforms. In these online transactions, secure transmission of confidential information, such as customers' credit card numbers and expiration dates, personal information and billing addresses, over public networks is essential if we are to maintain our consumers' confidence in us. In addition, we expect that an increasing amount of our sales will be conducted over the Internet as a result of the growing use of online payment systems. As a result, the risk of associated online crime will increase. Our current security measures and those of the third-party online payment platforms with whom we transact business may not be adequate. We must be prepared to increase our security measures and efforts so that our game players have confidence in the reliability of the online payment systems that we use, which will require us to incur additional expense. Such increased security measures may still not make our online payment systems completely safe. In addition, we do not have control over the security measures of our third-party online payment vendors. Breaches in the security of online payment systems that we use could expose us to litigation and liability for failing to secure confidential customer information, and could harm our reputation, ability to attract customers and ability to encourage customers to purchase virtual items.

*Any failure of third-party developers of online games that we license from or jointly develop with them to fulfill their obligations under our license or joint operation agreements with them could have an adverse effect on our operation of and revenues from those games.*

We derive a portion of our revenues from PC games and mobile games that we license from, or jointly develop with, third-party developers. Under our license and joint development agreements for these games, we rely on the third-party developers to provide game updates, enhancements and new versions, provide materials and other assistance in promoting the games and resolving game programming errors and issues with "bots" and other intrusions. Any failure of third-party developers to provide game updates, enhancements and new versions in a timely manner and that are appealing to game players, provide assistance that enables us to effectively promote the games, or otherwise fulfill their obligations under our license and joint development agreements could adversely affect the game-playing experience of our game players, damage our reputation, or shorten the life-spans of those games, any of which could result in the loss of game players, acceleration of our amortization of the license fees we have paid for those games, or a decrease in or elimination of our revenues from those games.

Furthermore, for games that we license from or jointly develop with third parties, we may not have access to the game source codes during the initial period of the license, or at all. Without the source codes, we have to rely on the licensors to provide updates and enhancements, giving us less control over the quality and timeliness of updates and enhancements. If our game players are not satisfied with the level of services they receive, they may choose to not play the games.

There are additional risks associated with our licensing from overseas developers of online games that are successful only in particular overseas markets, because such games may not be successful in the China market and other markets if we are not able to successfully customize the games to adapt to differences in culture and user preferences in the China market and other markets.

*We receive relatively lower profits from the operation of online games that we license from or jointly develop with third-party developers.*

Our revenue-sharing arrangements for games that we license from or jointly develop with third-party developers provide us with relatively less profit than games that we develop in-house, and in some cases we may not be able to recoup our investments in such games. Moreover, to secure the rights to games from third-party developers, we often must pay up-front fees and also commit to pay additional fees in the future. We also have invested in mobile game development studios in order to assure access to an extensive pipeline of mobile games. We often must make such commitments and investments without knowing whether the games we are licensing or jointly developing will be successful and generate sufficient revenues to enable us to recoup our costs or for the games to be profitable.

*We face significant risks and incur substantial costs when we license our games to, or jointly operate them with, third-party operators, and we face additional risks and costs when we directly operate our games or license our games to, or jointly operate our games with, third-party operators in overseas markets.*

We currently, and expect to continue to, exclusively license to, or jointly operate with, third-party operators some of our games, including an increasing number of our mobile games, in markets that we select, including overseas markets. We face significant risks associated with the licensing or joint operation of our games, including:

- difficulties in identifying appropriate markets;
- difficulties in identifying, negotiating and maintaining good relationships with licensees or joint operators who are knowledgeable about, and can effectively operate our games in, particular markets;
- difficulties in maintaining our reputation and the reputation of our games when our games are operated by licensees or joint operators pursuant to their own standards; and
- difficulties in protecting our intellectual property.

We currently license and operate, and expect to continue to expand the licensing and operation of, some of our existing and future games, either directly or jointly with third-party operators, in selected overseas markets. Additional risks associated with the licensing or direct or joint operation of our games overseas include:

- difficulties and significant costs in protecting our intellectual property in overseas markets;
- difficulties in retaining and maintaining local management and key development and technical personnel who are experienced and knowledgeable about, and can effectively operate our games in, particular markets;
- uncertainties relating to our ability to develop our games and/or expansion packs catering to particular overseas markets;
- uncertainties relating to our ability to renew our license and joint operation agreements with licensees and joint operators upon their expiration;
- for our direct operation of our games overseas, interruptions in the operation of the games due to cross-border Internet connection or other system failures;
- significant costs for translation of our games into the local languages of, or customization of our games for, the overseas markets in which we plan to license or jointly operate our games;
- limited choices of third-party Internet platforms to distribute our mobile games in certain overseas markets;
- difficulty for our management to exercise timely and effective supervision and administration of local management and employees in general, and their interactions with local third-party Internet platforms or other service providers in particular, in order to identify and prevent any sloppy, dishonest or illegal activities, which could harm our business and reputation or subject us to penalties;
- significant marketing costs to promote our games in certain overseas markets where third-party Internet platforms do not include marketing services as part of the revenue-sharing arrangements;
- different game player preferences in certain overseas markets;

- difficulties and significant costs relating to compliance with the different legal requirements and commercial terms, such as game export regulatory procedures, taxes and other restrictions and expenses, in the overseas markets in which we license or directly or jointly operate our games;
- exposure to different regulatory systems governing the protection of intellectual property and the regulation of online games, the Internet and the export of technology;
- costs for compliance with different legal requirements and commercial terms in overseas markets;
- difficulties in verifying revenues generated from our games by our licensees for purposes of determining royalties payable to us;
- difficulties and delays in contract enforcement and collection of receivables through the use of foreign legal systems;
- changes in the political, regulatory or economic conditions, or public policy, affecting online games in particular foreign countries or regions;
- the risk that regulatory authorities in foreign countries or administrative regions may impose withholding taxes, or place restrictions on repatriation of our profits; and
- fluctuations in currency exchange rates.

If we are unable to manage these risks and control these costs effectively, our ability to license or operate our games in China or in regions and countries outside of Mainland China, either directly or jointly with third-party joint operators, may be impaired.

*We may not be successful in operating and improving our games to satisfy the changing demands of game players.*

We depend on purchases and continual consumption of virtual items by our game players to generate revenues, which in turn depend on the continued attractiveness of our games to the game players and their satisfactory game-playing experience. Various issues could arise that would cause our games to be less attractive to our game players or could limit the continued attractiveness of our games. For example:

- we may fail to provide game updates, expansion packs and other enhancements in a timely manner due to technological or resource limitations, or other factors;
- our game updates, expansion packs and new versions may contain programming errors, and their installation may create other unforeseen issues that adversely affect the game-playing experience;
- we may fail to timely respond and/or resolve complaints from our game players;
- we may fail to eliminate computer “bots” that can disrupt our games’ smooth operation and reduce the attractiveness of our games; and
- our game updates, expansion packs and other enhancements may change rules or other aspects of our games that our game players do not welcome, resulting in a reduction in the active accounts or active paying accounts of our online games.

Our failure to address these issues could adversely affect the game-playing experience of our game players, damage the reputation of our games, shorten the lifespans of our games, and result in the loss of game players and a decrease in our revenues.

*We may fail to launch new games according to our timetable, and our new games may not be commercially successful.*

All online games have limited lifespans. We must launch new games that can generate additional revenue and diversify our revenue sources in order to remain competitive. We will not generate any meaningful revenue from a game in development until it is commercially launched after open beta testing, and we cannot assure you that we will be able to meet our timetable for new game launches or that our new games will be successful. A number of factors, including technical difficulties, lack of sufficient game development capabilities, personnel and other resources, failure to obtain or delays in obtaining relevant governmental authorities’ approvals and adverse developments in our relationships with the licensors or third-party operators of our new games could result in delayed launching of our new games or the cancellation of the development of our pipeline games. In addition, we cannot assure you that our new games will be as well received in the market as TLBB, Legacy TLBB Mobile, and TLBB 3D have been, and you should not view our historical game revenues or the success of TLBB, Legacy TLBB Mobile, and TLBB 3D as indications of the commercial success of any of our new or future games. We may fail to anticipate and adapt to future technical trends, new business models and changed game player preferences and requirements, fail to effectively plan and organize marketing and promotion activities, or fail to differentiate our new games from our existing games. If the new games we introduce are not commercially successful, we may not be able to generate sufficient revenues from new games to sustain or grow our revenues or to recover our product development costs and sales and marketing expenses, which can be significant. If we acquire and pay for a license giving us the right to adapt an online game from an author’s work, but do not complete the development and introduction into the market of the game, or we introduce the game but it is not successful, we may not be able to recover the license fees we have paid.

*We generate all of our game revenues under the item-based revenue model, which presents risks related to consumer preferences and regulatory restrictions.*

All of our games, including PC games and mobile games, are operated under the item-based revenue model. Under this revenue model, our game players are able to play the games for free, but are charged for the purchase of virtual items in the games. The item-based revenue model requires us to design games that not only attract game players to spend more time playing, but also encourage them to purchase virtual items. The sale of virtual items requires us to track closely consumer tastes and preferences, especially as to in-game consumption patterns. If we fail to design and price virtual items so as to incentivize game players to purchase them, we may not be able to effectively translate our game player base and their playing time into revenues. In addition, the item-based revenue model may cause additional concerns with PRC regulators who have been implementing regulations designed to reduce the amount of time that Chinese youths spend on online games and intended to limit the total amount of virtual currency issued by online game operators and the amount purchased by individual game players. A revenue model that does not charge for time played may be viewed by the PRC regulators as inconsistent with these goals. The item-based revenue model may not continue to be commercially successful and in the future we may need to change our revenue model to a time-based or other revenue model. Any change in revenue model could result in disruption of our game operations, a decrease in the number of our game players and a decline in our revenues.

*Undetected programming errors or defects in our games could harm our reputation and adversely affect our results of operations.*

We make frequent improvement and updates to our online games, which may contain bugs or flaws that become apparent only after the updated games are accessed by users, particularly as we launch new updates under tight time constraints. If for any reason programming bugs or flaws are not resolved in a timely fashion, we may lose some of our users, and third-party operators that license or jointly operate our games may seek to recover damages from us, which could have an adverse effect on our results of operations, and could harm our reputation and the market acceptance of our games.

*Breaches in the security of our server network, or cloud-based servers that we lease from third-party operators, could cause disruptions in our service or operations, facilitate piracy of our intellectual property, or compromise confidential information of our game players and our business.*

We store on our servers, including physical servers that we own or rent and cloud-based servers that we lease from third-party operators, and transmit over the Internet considerable and continually increasing amounts of data, much of which is essential to the operation of our business and some of which is highly-confidential information concerning our business and our game players. In addition, the expansion of our business to include mobile games and our need to comply with PRC regulations requiring real-name registration of our game players are likely to cause the amount of personal data concerning our game players that is transmitted over our networks to increase over time. Any breaches by hackers of our network or of cloud-based servers we lease from third-party operators could cause severe disruptions in our game development and operations and other business activities, allow piracy of the source code used in the operation of our games and allow pirated versions of our games to enter the marketplace, or result in the release of confidential personal or financial information of our game players or confidential information concerning our business, any of which could have an adverse impact on our business, our revenues, and our reputation among game players. In order to minimize the likelihood of such breaches as our business expands and the amount of confidential and sensitive data increases, we expect that we will need to expend considerable resources to maintain and enhance the effectiveness of our security systems.

*Rapid technological changes may increase our game development costs.*

Technological development in online game industry is evolving rapidly, so we need to anticipate new technologies and evaluate their possible market acceptance. For example, the use of VR technology has become prevalent in the industry, and an increasing number of game players hope to have VR included in online games that they access. We have begun investing, and expect to continue to invest, in the future, resources to develop VR technology and online games using VR technology. However, we are not aware of any proven business or monetization model for online games using VR technology, and playing online games with VR technology generally requires devices with particularly high-level technical specifications, which may limit the number of players. If online games using VR technology that we develop and launch are not well received by game players, we may not be able to recoup our related development costs. In addition, government authorities or industry organizations may adopt new technical standards that apply to game development. Any new technologies and new standards may require increases in expenditures for PC game and mobile game development and operations and continuing professional training of our development and technical personnel, and we will need to adapt our business and prepare our workforce to cope with the changes and support these new services to be successful. If we fall behind in adopting new technologies or standards, our existing games may lose popularity, and our newly developed games may not be well received in the marketplace.

*The proliferation of “cheating” programs and scam offers that seek to exploit our games and players harms the game-playing experience and may lead players to stop playing our games.*

Third parties have developed, and may continue to develop, “cheating” programs that enable players to exploit our games, play the games in an automated way or obtain unfair advantages over other players who play fairly. These programs harm the experience of players who play fairly and may disrupt the economics of our games. In addition, unrelated third parties may attempt to scam our players with fake offers for virtual items. We need to devote significant resources to discover, disable and prevent such programs and activities, and if we are unable to do so quickly our operations may be disrupted, our reputation may be damaged and players may stop playing our games. This may lead to lost revenue and increased costs for us to develop technological measures to combat such programs and activities.

*Game players’ spending on our games may be adversely affected by slower growth in the Chinese economy and adverse conditions in the global economy.*

We rely for our revenues on the spending of our game players, which in turn depends on the players’ level of disposable income, perceived future earnings capabilities and willingness to spend. The real estate market in the PRC and the level of exports from the PRC have both experienced significant declines recently and, according to the National Bureau of Statistics of China, the growth rate of China’s gross domestic product, compared to that of the previous year, went from 7.4% in 2014, to 6.9% in 2015, to 6.7% in 2016, to 6.9% in 2017 and to 6.6% in 2018. Such growth may also slow in the future, which could in turn result in a reduction in spending by our game players.

In addition, the global economy has experienced significant instability and there has been volatility in global financial and credit markets in recent years, recent growth in the United States economy may not be sustainable and some analysts are concerned that the European Community may experience a sustained downturn. It is unclear how long such instability and volatility will continue, whether it will increase, whether it will lead to a renewed worldwide economic downturn such as the one that began in 2008, and how much adverse impact such instability and volatility or any such downturn might have on the economies of China and other jurisdictions where we operate our games. Any such instability, volatility or adverse impact in China or in overseas markets could cause our game players to reduce their spending on our games in China or overseas and reduce our revenues.

#### **Risks Related to the Platform Channel Business**

*Notwithstanding our significant investment in our platform channel business, we were unable to successfully monetize it beyond the operation of our 17173.com Website, and we were not able to recoup all of our investment. We may have similar adverse experiences with future investments.*

During 2013 and 2014 we made significant investments in acquiring assets and marketing, including both domestic and overseas marketing, and spent considerable sums to increase our staffing levels, with the goal of expanding and promoting our platform channel business beyond the operation of the 17173.com Website. However, we did not generate meaningful revenues from such additions to our platform channel business, as our efforts to monetize those products and services were not successful, and we do not expect to be able to make our platform channel business apart from the 17173.com Website profitable or to recoup the investments we made in assets, marketing and staffing for the platform channel business. For example, after our acquisition of a majority interest in MoboTap, our management concluded that the Dolphin Browser operated by MoboTap would not be able to provide expected synergies with our platform channel business, and we recognized substantial impairment charges as a result and sold MoboTap in 2018. Also see “Our previous and any future acquisitions and/or strategic alliances may have an adverse effect on our ability to manage our business and may also result in impairment charges.”

*Online advertising revenues from the 17173.com Website could fail to grow, or could decline further, as a result of the shift from PC games to mobile games in the online games market and uncertainties in the online advertising market.*

Our online advertising revenues of \$19.7 million for the year ended December 31, 2018, which were mainly derived from the operation of the 17173.com Website, represented 4.0% of our total revenues for the year, and represented a decline of \$5.4 million, or 22%, from our online advertising revenues for the year ended December 31, 2017. Our ability to avoid further declines in, or grow, our online advertising revenues may be adversely affected by any of the following risk factors:

- Changes in government policy could restrict or curtail our online advertising services;
- The decline in the demand for online advertising services from developers and operators of PC games, as the relative popularity of such games continues to decline;
- Advertising clients may adopt new methods and strategies other than online advertising to promote their brands, which would have an adverse impact on our advertising revenues; and
- The acceptance of the Internet as a medium for advertising depends on the development of a measurement standard. No standards for the measurement of the effectiveness of online advertising have been widely accepted. Industry-wide standards may not develop sufficiently to support the Internet as an effective advertising medium. If these standards do not develop, advertisers may choose not to advertise on the Internet in general, or through our Websites.

In addition, our ability to generate and maintain significant online advertising revenues will also depend upon:

- the development of a large base of users possessing demographic characteristics attractive to advertising clients;
- the development of successful mobile versions of the 17173.com Website and the provision of extensive mobile game-related products and services in response to the rapid migration of users of Internet services from PCs to mobile devices, such as tablets and mobile phones;
- the acceptance of online advertisements, either through PCs or mobile devices, as an effective method of business marketing;
- the effectiveness of our advertising delivery, tracking and reporting systems;
- the extent of resistance from existing or potential customers to online advertising prices; and
- the development of new formats for online advertising, such as streaming video.

*The expansion of Internet advertisement blocking software may result in a decrease in advertising revenues.*

The development of Web software that blocks Internet advertisements before they appear on a user's screen may hinder the growth of online advertising. The expansion of advertisement blocking on the Internet may decrease our revenues from the 17173.com Website because, when an advertisement is blocked, it is not downloaded from the server, which means that it will not be tracked as a delivered advertisement. In addition, advertisers may choose not to advertise on the Internet or on our 17173.com Website because of the use by third parties of Internet advertisement blocking software.

*We rely on advertising agencies to sell online advertising services on the 17173.com Website. If current trends of consolidation of advertising agencies in the China market continue, the bargaining power of the large advertising agencies resulting from such consolidation may permit them to require that we pay higher sales rebates, which would adversely affect our online advertising revenues.*

Most of the online advertising services of the 17173.com Website are distributed by, and most of the online advertising revenues of the 17173.com Website are derived from, advertising agencies. For example, in 2018 we engaged eight advertising agencies, which contributed approximately 99.6% of the online advertising revenues of the 17173.com Website. In consideration for these agencies' services, we are required to pay certain percentages of revenues as sales rebates. If the online advertising market is consolidated and effectively controlled by a small number of large advertising agencies, such advertising agencies may be in a position to demand higher sales rebates based on increased bargaining power, which could negatively affect our online advertising growth, as we book our online advertising revenue net of our sales rebates to advertising agencies.

### **Risks Related to the Cinema Advertising Business**

*There are uncertainties regarding the future growth of the cinema advertising industry in China.*

Our cinema advertising business experienced strong growth in 2016 and 2017 and has benefited from robust growth in China's cinema and movie industry in recent years, but suffered a significant decline in revenues in 2018 due to our having adjusted our strategy in relation to the acquisition and sale of advertising resources. If the recent growth in China's cinema and movie industry slows or the industry declines in the future, pre-film advertising slots are likely to become less attractive to advertisers, which would have an adverse effect on our cinema advertising business. In addition, advertisers are increasingly turning to new advertising formats, such as video streaming, as Internet technology develops. If pre-film advertising becomes less attractive to advertisers than such new formats, our cinema business will be adversely affected. Moreover, the rapid growth of our cinema advertising business in recent years placed strain on our management personnel, systems and resources. We may not be able to efficiently or effectively implement our growth strategies and manage the growth of our cinema advertising business, and any failure to do so may limit our future growth and hamper our overall business strategy.

*We may not be able to successfully manage our growth in the highly competitive cinema advertising market.*

We face intense competition for the acquisition of the rights to and placement of pre-film advertising slots. See “Our business may not succeed in a highly competitive market.” We may not be able to effectively compete with our competitors in developing, maintaining or expanding the types of cooperative relationships with operators of movie theaters that will permit us to maintain our existing rights or to obtain additional rights to pre-film advertisement slots at reasonable prices, on the one hand, and in attracting advertisers that will place their advertisements in the pre-film advertisement slots that we offer, on the other hand, as our competitors may have greater financial resources, greater brand recognition among operators of movie theaters and advertisers and more capable and effective management, sales and marketing forces and strategies than we do, which would have an adverse impact on the prospect for growth of our cinema advertising business.

*We face risks related to our purchase of pre-film advertising slots.*

In order for us to compete effectively in our desired markets, we must continue to build and maintain a competitive reserve of pre-film advertisement slots in those markets and have incurred, and expect to continue to incur, significant upfront costs to acquire the pre-film advertising rights for such pre-film advertising slots under long-term contracts, typically with one to three-year terms, with operators of various movie theaters, which has placed, and will continue to place, constraints on our cash flow. There is a risk that we will lose those upfront acquisition costs, because we are not able to generate corresponding revenues and begin to recoup the costs until we have both entered into contracts with advertisers for the pre-film advertising slots that we have acquired and displayed the advertiser’s advertisements in those slots. Such delay in generating corresponding revenues may also place constraints on the cash flow available to us for maintaining and expanding our cinema advertising business. Moreover, we may be forced to make additional payments to operators of popular movie theaters in certain regional markets that are particularly competitive if the average market prices for pre-film advertisement slots in such markets increase significantly during the contract period and the operators threaten to terminate their contracts with us in order to enter into more profitable contracts with our competitors.

*We may not be able to maintain or expand the revenues that we receive from cinema advertising services.*

Our cinema advertising business generates revenues through contracts that we enter into with advertisers to place their advertisements in the pre-film advertising slots that we have purchased from operators of movie theaters. We rely on our sales force to identify and sell pre-film advertising slots to potential advertisers. If we cannot maintain a stable and capable sales force or if we are unable to sell to advertisers a large enough portion of the pre-film advertising slots, we may not be able to generate sufficient revenues to recoup our upfront payments and additional committed payments under the contracts with the operators of the movie theaters. Any failure by us to develop, maintain or expand cooperative relationships with advertisers could cause our cinema advertising revenues to decrease.

*The prospects for growth of our cinema advertising business may be adversely affected by the promulgation, implementation, and interpretation of PRC laws and regulations concerning cinema advertising.*

Under the *Notice on Strengthening the Administration of Cinema Advertising* and the *Notice on Further Regulating the Administration of the Cinema Advertising*, effective on July 2004 and February 2009, respectively, cinema advertising operators and the content of cinema advertisements must comply with the *Advertising Law of the People’s Republic of China* (the “New Advertising Law”) issued by the Standing Committee of the National People’s Congress, which became effective April 24, 2015 and was amended on October 26, 2018, and other relevant laws and regulations. The Standing Committee of the National People’s Congress promulgated the *Film Industry Promotion Law of PRC* (the “FIPL”) effective March 1, 2017. Among other things, the FIPL forbids the displaying of advertisements during the presentation of a feature film. If any existing or future PRC laws or regulations, or their implementation or interpretation by the relevant authorities, place burdensome restrictions on cinema advertising, our cinema advertising business may be adversely affected.

#### **Risks Related to Our Corporate Structure and Corporate Governance.**

*If the PRC government determines that the VIE structure for operating our business does not comply with applicable PRC government restrictions on foreign investment in telecommunication industry, we could face severe penalties.*

Various regulations in China currently restrict foreign-invested entities from engaging in value-added telecommunication services, which are defined by PRC authorities to include operating online games and providing platform channel services. Because of these restrictions, we operate certain aspects of our game business and platform channel business in the PRC through our principal VIEs, which are not owned of record by us and include Beijing Gamease Age Digital Technology Co., Ltd. (“Gamease”); Beijing Guanyou Gamespace Digital Technology Co., Ltd. (“Guanyou Gamespace”); and Shanghai ICE Information Technology Co., Ltd. (“Shanghai ICE”), which is a wholly-owned subsidiary of Gamease. Each of the nominee shareholders of Gamease and Guanyou Gamespace is either a PRC citizen or a PRC company. Through a series of contractual arrangements, our VIEs are effectively controlled by our wholly-owned subsidiaries in China. For details of these contractual arrangements, see “Related Party Transactions” in Item 7 of this annual report.

The Ministry of Industry and Information Technology (the “MIIT”) issued a circular in 2006 that emphasizes restrictions on foreign investment in value-added telecommunications businesses. In addition, a notice jointly issued in 2009 by the State Administration of Press, Publication, Radio, Film and Television (the “SAPPRFT”), the National Copyright Administration, and the National Office of Combating Pornography and Illegal Publications states that foreign investors are not permitted to invest in online game operating businesses in China or to exercise control over or participate in the operation of such businesses through indirect means. Due to a lack of interpretative materials from the relevant PRC authorities, there are uncertainties regarding whether PRC authorities would consider our corporate structure and contractual arrangements to be a kind of foreign investment in value-added telecommunications services or online game operation businesses. While we are not aware of any online game companies that use the same or similar contractual arrangements as ours having been penalized or ordered to terminate operations by PRC authorities claiming that the arrangements constituted foreign investment in value-added telecommunication services or a kind of control over or participation in the operation of online game operating businesses through indirect means, it is unclear whether and how the various regulations of the PRC authorities might be interpreted or implemented in the future.

If we were found to be in violation of any existing or future PRC law or regulations relating to foreign ownership of value-added telecommunications businesses, regulatory authorities with jurisdiction over the operation of our business would have broad discretion in dealing with such a violation, including levying fines, confiscating our income, revoking the business or operating licenses of PRC subsidiaries and/or VIEs, requiring us to restructure our ownership structure or operations, requiring us to discontinue or divest ourselves of all or any portion of our operations or assets, restricting our right to collect revenues, blocking our Websites, or imposing additional conditions or requirements with which we may not be able to comply. Any of these actions could cause significant disruption to our business operations and have an adverse impact on our business, financial condition and results of operations. Further, if changes were required to be made to our ownership structure, our ability to consolidate our VIEs could be adversely affected.

For a detailed discussion of PRC regulations, notices and circulars with respect to such restrictions, see “PRC Regulation—Regulation of Value-Added Telecommunication Services in general”, “PRC Regulation—Restrictions on Foreign Ownership of Value-Added Telecommunication Services”, and “PRC Regulation—Online Games and Cultural Products” in Item 4 of this annual report.

*Our contractual arrangements with our VIEs and their shareholders may not be as effective in providing control over our VIEs as direct ownership of the VIEs and the shareholders of our VIEs may have conflicts of interest with us or with each other.*

We have no ownership interest in our principal VIEs Gamease, Guanyou Gamespace, and Shanghai ICE (which is a wholly-owned subsidiary of Gamease) and we conduct most of our operations and generate substantially all of our revenues through contractual arrangements that our indirect subsidiaries Beijing AmazGame Age Internet Technology Co., Ltd. (“AmazGame”) and Beijing Changyou Gamespace Software Technology Co., Ltd. (“Gamespace”) entered into with Gamease and Guanyou Gamespace, respectively, and their shareholders. Such contractual arrangements are designed to provide us with effective control over Gamease, Guanyou Gamespace and Shanghai ICE. See “Related Party Transactions” in Item 7 of this annual report for a description of these contractual arrangements. We depend on Gamease, Guanyou Gamespace and Shanghai ICE, directly or through their subsidiaries, to hold and maintain certain licenses and permits necessary and material for our online game business and for our operation of the 17173.com Website. Gamease, Guanyou Gamespace and Shanghai ICE, directly or through their subsidiaries, collectively own all of the key necessary intellectual property, facilities and other assets relating to the operation of our online games and the 17173.com Website that are not owned directly by our subsidiaries, and employ personnel for the operation and distribution of our online games and the 17173.com Website that are not employed directly by our subsidiaries.

These contractual arrangements may not be as effective in providing us with control over Gamease, Guanyou Gamespace and Shanghai ICE as direct ownership. For example, if we had direct ownership of Gamease, Guanyou Gamespace and Shanghai ICE, we would be able to exercise our rights as a shareholder to effect changes in their boards of directors, which in turn could effect changes at the management level. Due to our VIE structure, we have to rely on contractual rights to effect control and management of Gamease, Guanyou Gamespace and Shanghai ICE, which exposes us to the risk of potential breach of contract by the shareholders of Gamease and Guanyou Gamespace. In addition, as each of Gamease and Guanyou Gamespace is owned by its respective shareholders, it may be difficult for us to change our corporate structure if such shareholders refuse to cooperate with us. Furthermore, if the shareholders of any of our principal VIEs were involved in proceedings that had an adverse impact on their shareholder interests in such VIE or on our ability to enforce relevant contracts related to the VIE structure, our business would be adversely affected.



The shareholders of Gamease and Guanyou Gamespace may breach, or cause Gamease or Guanyou Gamespace to breach, the VIE contracts for a number of reasons. For example, their interests as shareholders of these companies and the interests of our company may conflict and we may fail to resolve such conflicts; the shareholders may believe that breaching the contracts will lead to greater economic benefit for them; or the shareholders may otherwise act in bad faith. If any of the foregoing were to happen, we might have to rely on legal or arbitral proceedings to enforce our contractual rights. In addition, disputes may arise among the shareholders of any of our principal VIEs with respect to their ownership of such VIE which could lead them to breach their agreements with us. Such arbitral and legal proceedings and disputes may cost us substantial financial and other resources, and result in disruption of our business, and the outcome might not be in our favor. For example, a PRC court or arbitration panel could conclude that our VIE contracts violate PRC law or are otherwise unenforceable. If the contractual arrangements with any of our principal VIEs were found by PRC authorities with appropriate jurisdiction to be unenforceable, we could lose our ability to consolidate such VIE's results of operations, assets and liabilities in our consolidated financial statements and/or to transfer the revenues of such VIE to our corresponding PRC subsidiary. In addition, such a finding of unenforceability by PRC authorities could cause more than 75% of our gross income or more than 50% of our assets to be passive in the year that this finding was made or in subsequent years, which, in a given year for which we otherwise did not expect to be classified as a passive foreign investment company ("PFIC") for United States federal income tax purposes, could cause us to be classified as a PFIC for years in which we would not otherwise be so classified. See "Taxation—United States Federal Income Taxation—Passive Foreign Investment Company" in Item 10 of this annual report.

Under the contractual arrangements with our principal VIEs and their shareholders, no shareholder or group of shareholders of any of our principal VIEs has the ability to unilaterally terminate any of the agreements between the VIEs in which they hold shares and our corresponding PRC subsidiary. However, (i) the shareholders of Gamease and Guanyou Gamespace have a termination right under the loan agreements if our corresponding PRC subsidiary engages in gross negligence, fraud or other material illegal actions or if our corresponding PRC subsidiary's existence is terminated as a result of bankruptcy, dissolution, or legal process by government authorities and (ii) the shareholders of our principal VIEs have a termination right under the equity purchase right agreements if the corresponding VIE's existence is terminated as a result of bankruptcy, dissolution, or legal process by government authorities.

In addition, as all of these contractual arrangements are governed by PRC law and provide for the resolution of disputes through either arbitration or litigation in the PRC, they would be interpreted in accordance with PRC law and any disputes would be resolved in accordance with PRC legal procedures. We would have to rely for enforcement on legal remedies under PRC law, including specific performance, injunctive relief or damages, which might not be effective. For example, if we sought to enforce the equity interest purchase right agreements for the transfer of equity interests in any of our principal VIEs, if the transferee was a foreign company the transfer would be subject to approval by governmental authorities such as the MIIT and the Ministry of Commerce (the "MOFCOM"), and the transferee would be required to comply with various requirements, including qualification and maximum foreign shareholding percentage requirements. As these governmental authorities have wide discretion in granting such approvals, we could fail to obtain such approval. In addition, our VIE contracts might not be enforceable in China if PRC governmental authorities or courts or arbitral tribunals took the view that such contracts contravened PRC law or were otherwise not enforceable for public policy reasons.

Furthermore, the legal environment in the PRC is not as developed as in other jurisdictions, such as the United States. As a result, uncertainties in the PRC legal system could further limit our ability to enforce these contractual arrangements. In the event we were unable to enforce these contractual arrangements, we would not be able to exert effective control over Gamease, Guanyou Gamespace and Shanghai ICE, and our ability to conduct our business, and our financial condition and results of operations, would be severely adversely affected.

*Our contractual arrangements with our principal VIEs may result in adverse tax consequences to us.*

Under PRC law and regulations, arrangements and transactions among related parties may be subject to audit or challenge by PRC tax authorities. We could face adverse tax consequences if PRC tax authorities determined that our contractual arrangements with any of Gamease or Guanyou Gamespace were not made on an arm's length basis and adjusted our income and expenses for PRC tax purposes in the form of a transfer pricing adjustment. A transfer pricing adjustment could result in a reduction, for PRC tax purposes, of adjustments recorded by any of our principal VIEs, which could adversely affect us by (i) increasing the tax liability of such VIE without reducing the tax liability of our corresponding PRC subsidiary, which could further result in interest and penalties being levied on us for underpaid taxes or (ii) limiting such VIE's ability to maintain preferential tax treatments and other financial incentives. In addition, if for any reason we needed to cause the transfer of any of the shareholders' shares in any of our VIEs to a different nominee shareholder (such as if, for example, one of such shareholders is no longer employed by us), we might be required to pay individual income tax, on behalf of the transferring shareholder, on any gain deemed to have been realized by such shareholder on such transfer.

*We may lose the ability to use and enjoy assets held by any of our principal VIEs that are important to the operation of our business if such VIE declares bankruptcy or becomes subject to a dissolution or liquidation proceeding.*

Each of our VIEs holds assets that are critical to our business operations, such as our core intellectual property, licenses and permits, and/or joint operation agreements relating to our games and game operations. Although the equity interest purchase right agreements among our wholly foreign-owned entities ("WFOEs"), our VIEs and the shareholders of our VIEs contain terms that specifically obligate the shareholders of our VIEs to ensure the valid existence of our VIEs, in the event the shareholders breached this obligation and voluntarily liquidated our VIEs, or if any of our VIEs declared bankruptcy and all or part of its assets became subject to liens or rights of third-party creditors, we might be unable to continue some or all of our business operations. Furthermore, if any of our VIEs were to undergo a voluntary or involuntary liquidation proceeding, its shareholders or unrelated third-party creditors might claim rights to some or all of such VIE's assets and their rights could be senior to our rights under the VIE contracts, thereby hindering our ability to operate our business.

*Nearly all of our revenues are generated through our principal VIEs Gamease, Guanyou Gamespace and Shanghai ICE, which are consolidated in our financial statements, and we rely on payments made by these entities to our subsidiaries AmazGame and Gamespace, respectively, pursuant to contractual arrangements requiring the transfer of any such revenues to these subsidiaries. Any restriction on such payments and any increase in the amount of PRC taxes applicable to such payments may adversely affect our business and our ability to pay dividends to our shareholders and ADS holders.*

We conduct nearly all of our operations through our principal VIEs Gamease, Guanyou Gamespace and Shanghai ICE, which generate nearly all of our revenues. As our VIEs are not owned by our subsidiaries, they are not able to make dividend payments to our subsidiaries. Instead, our China subsidiaries AmazGame and Gamespace are parties to a number of contracts with their corresponding VIEs, pursuant to which the VIE pays the PRC subsidiary for certain services that the PRC subsidiary provides to the VIE. However, depending on the nature of services provided, certain of these payments are subject to PRC taxes, including business taxes and value-added tax (“VAT”), which effectively reduce the amount that we receive from the VIEs. The PRC government might impose restrictions on such payments or change the tax rates applicable to such payments. Any such restrictions on such payment or increases in the applicable tax rates could limit our ability to receive payments from the VIEs or limit the amount of such payments, and could in turn adversely affect our business, our net income and our ability to pay dividends to our shareholders and ADS holders.

*We are party to an agreement with Sohu that limits our ability to enter certain businesses.*

We are a party to an Amended and Restated Non-Competition Agreement with Sohu which prohibits us, during the non-competition period (which commenced on January 1, 2009 and ends after Sohu no longer owns in the aggregate at least 10% of the voting power of our then outstanding voting securities), from engaging in online portal, search, mobile value-added services and other businesses that Sohu conducted or contemplated conducting as of April 1, 2009, not including the client-end installed MMORPG business and the business associated with the 17173.com Website. See “Major Shareholders and Related Party Transactions” in Item 7 of this annual report. As a result, during such non-competition period, we will not be able to diversify our business into such businesses, other than the client-end installed MMORPG business and the business associated with the 17173.com Website, that Sohu was conducting, or contemplated conducting, as of that date, even if such businesses present growth opportunities for us. In addition, the Amended and Restated Non-Competition Agreement does not prohibit Sohu from engaging in the development and operation of online games other than client-end installed MMORPGs, even during the non-competition period. Any online games (other than client-end installed MMORPGs) that we develop and operate that are not prohibited under the Amended and Restated Non-Competition Agreement may face competition from other online games, including those developed and/or operated by Sohu.

*We may not be able to continue to receive the same level of support from Sohu as we have in the past and may not be successful in establishing our brand identity.*

Sohu has been a leading Internet portal in China, and our business has benefited significantly from Sohu’s strong Internet market position in China. For example, we have benefited from marketing and advertising across Sohu’s domains (such as Sohu.com, the Sohu portal), and using Sohu’s email system and the Sohu Group’s single-user ID system, which provide Sohu’s large number of registered users easy access to our games. Since our acquisition from Sohu in December 2011 of the assets associated with the 17173.com Website, Sohu has continued to provide links and advertising space on Sohu’s Websites and related technical support to us in connection with our operation of the 17173.com Website. We also benefit from the strong brand recognition of Sohu in China, which has provided us a broad marketing reach. We cannot assure you we will continue to receive adequate support from Sohu for our business.

*Sohu controls the outcome of shareholder actions in our company.*

Our ordinary shares are divided into Class A ordinary shares and Class B ordinary shares. Holders of Class A ordinary shares are entitled to one vote per share, while holders of Class B ordinary shares are entitled to 10 votes per share. We issued Class A ordinary shares represented by our ADSs in our initial public offering and Sohu holds Class B ordinary shares. As of the date of this report, Sohu holds approximately 67.4% of the combined total of Changyou’s outstanding Class A and Class B ordinary shares and controls approximately 95.3% of the total voting power in Changyou due to the additional voting power of the Class B ordinary shares it holds. Sohu’s voting power gives it the power to control actions that require shareholder approval under Cayman Islands law, our memorandum and articles of association and Nasdaq requirements, including the election and removal of any member of our Board of Directors, significant mergers and acquisitions and other business combinations, changes to our memorandum and articles of association, the number of shares available for issuance under share incentive plans, and the issuance of significant amounts of our ordinary shares in private placements. Due to the disparate voting powers attached to the two classes of our ordinary shares, Sohu has sufficient voting power to determine the outcome of all matters requiring shareholder approval even if it should, at some point in the future, hold considerably less than a majority of the combined total of our outstanding Class A and Class B ordinary shares.

Sohu's voting control may cause transactions to occur that might not be beneficial to the holders of our ADSs, and may prevent transactions that would be beneficial to them. For example, Sohu's voting control may prevent a transaction involving a change of control of us, including transactions in which a holder of our ADSs might otherwise receive a premium for such securities over the then-current market price. In addition, Sohu is not prohibited from selling a controlling interest in us to a third party and may do so without approval of the holders of our ADSs and without providing for a purchase of outstanding ADSs. If Sohu is acquired or otherwise undergoes a change of control, or sells a controlling interest in us, any acquirer or successor will be entitled to exercise the voting control and contractual rights of Sohu, and may do so in a manner that could vary significantly from that of Sohu.

*We may have conflicts of interest with Sohu and, because of Sohu's controlling ownership interest in our company, may not be able to resolve such conflicts on favorable terms for us.*

Conflicts of interest may arise between Sohu and us in a number of areas relating to our past and ongoing relationships. Potential conflicts of interest that we have identified include the following:

- **Indemnification arrangements with Sohu.** We have agreed to indemnify Sohu with respect to lawsuits and other matters relating to our client-end installed MMORPG business, including operations of that business when it was a business unit of Sohu prior to the carve-out transactions. These indemnification arrangements could result in our having interests that are adverse to those of Sohu; for example, we might have different interests with respect to settlement arrangements in a litigation matter. In addition, under these arrangements, we agreed to reimburse Sohu for liabilities incurred (including legal defense costs) in connection with litigation, while Sohu will be the party prosecuting or defending the litigation.
- **Non-competition arrangements with Sohu.** We and Sohu have each agreed not to compete with the core business of each other. Sohu has agreed not to compete with us anywhere in the world in the client-end installed MMORPG business during the non-competition period (which commenced on January 1, 2009 and ends on the later of three years after Sohu no longer owns in the aggregate at least 10% of the voting power of our then outstanding voting securities and March 17, 2014). We have agreed not to compete with Sohu in the Internet portal, search, mobile value-added services and any other businesses conducted or contemplated to be conducted by Sohu as of the date of the prospectus for our initial public offering, except for the business associated with the 17173.com Website after we acquired it from Sohu on December 15, 2011. Sohu had agreed not to compete with us in the business associated with the 17173.com Website, but the non-competition period expired on December 15, 2016, so Sohu is now free to compete with our 17173.com Website if it should choose to do so.
- **Employee recruiting and retention.** Because both Sohu and we operate primarily in Beijing and both Sohu and we are engaged in the development and operation of online portals and mobile games, we may compete with Sohu in the hiring of new employees, in particular with respect to software development. We have a non-solicitation arrangement with Sohu that restricts Sohu and us from hiring any of the other's employees.
- **Our board members or executive officers may have conflicts of interest.** Dr. Charles Zhang, our Chairman of the Board, is currently also serving as Sohu.com Limited's Chairman and Chief Executive Officer. Some of our board members and executive officers also own shares, restricted share units and/or options in Sohu. Sohu may grant incentive share compensation to our board members and executive officers from time to time. These relationships could create, or appear to create, conflicts of interest when these persons are faced with decisions with potentially different implications for Sohu and us.
- **Use of our cash.** Sohu is our controlling shareholder and has significant influence over our company's actions, including decisions of our Board of Directors. Sohu may from time to time influence our Board of Directors to make decisions to use our cash, such as authorizing share repurchase programs, declaring and distributing dividends to our shareholders or refraining from declaring and distributing dividends, which may benefit Sohu but may not be in the best interest of our business or coincide with the interests of our other shareholders.
- **Loan Arrangement with Sohu.** On October 24, 2016, Sohu entered into a loan agreement with us, pursuant to which Sohu may borrow from time to time from us up to RMB1.0 billion (or approximately \$148.64 million). When amounts become due under the loan, Sohu could use its position as our controlling shareholder to cause our Board of Directors to declare cash dividends payable to our shareholders in order for Sohu to be able to use its share of such dividends repayment of the loan, which might not be in the best interests of us or our other shareholders. For a detailed description of such loan arrangement, see Item 7 "Major Shareholders and Related Party Transactions—Related Party Transactions."
- **Sale of shares in our company.** Sohu may decide to sell all or a portion of our shares that it holds to a third party, including to one of our competitors, thereby giving that third-party substantial influence over our business and our affairs. Such a sale could be contrary to the interests of certain of our shareholders, including our employees or our public shareholders.
- **Allocation of business opportunities.** Business opportunities may arise that both we and Sohu find attractive, and which would complement our respective businesses. Sohu may decide to take the opportunities itself, which would prevent us from taking advantage of the opportunity ourselves.

- **Developing business relationships with Sohu's competitors.** So long as Sohu remains as our controlling shareholder, we may be limited in our ability to do business with its competitors, such as other Internet portals in China. This may limit the effectiveness of our online advertisement for the best interest of our company and our other shareholders.
- **Strategic decisions by Sohu may not coincide with our interests.** Although our company is a separate, stand-alone entity, we expect to operate, for as long as Sohu is our controlling shareholder, as a part of the Sohu Group. Sohu may from time to time make strategic decisions that it believes are in the best interests of its business as a whole, including our company. These decisions may be different from the decisions that we would have made on our own. Sohu's decisions with respect to us or our business may be resolved in ways that favor Sohu and therefore Sohu's own shareholders, which may not coincide with the interests of our other shareholders.

We may not be able to resolve any potential conflicts, and even if we do so, the resolution may be less favorable to us than if we were dealing with an unaffiliated shareholder. Even if both parties seek to transact business on terms intended to approximate those that could have been achieved among unaffiliated parties, this may not succeed in practice.

### ***Risks Related to Doing Business in China***

*Adverse changes in political and economic policies of the PRC government could have a material and adverse effect on the overall economic growth of China, which could reduce the demand for our products.*

Most of our business operations are conducted in China and most of our revenues are generated in China. Accordingly, our business, financial condition, results of operations and prospects are affected significantly by economic, political and legal developments in China. The Chinese economy differs from the economies of most developed countries in many respects, including the amount of government involvement, the level of development, the growth rate, the control of foreign exchange, and the allocation of resources.

While the Chinese economy has grown significantly in the past 35 years, the growth has been uneven geographically among various sectors of the economy, and during different periods. The Chinese economy may not continue to grow, and if there is growth, such growth may not be steady and uniform; if there is a slowdown, such a slowdown may have a negative effect on our business. The Chinese economy experienced high inflation in 2010 and 2011, and to curb the accelerating inflation the PBOC, China's central bank, raised benchmark interest rates three times in 2011. Partly as a result of these measures, the real estate market in the PRC experienced significant declines in those years. The level of exports from the PRC also declined significantly recently. According to the National Bureau of Statistics of China, the growth rate of China's gross domestic product, compared to that of the same period in the previous year, slowed from 7.7% in 2013, to 7.4% in 2014, to 6.9% in 2015, to 6.7% in 2016, to 6.9% in 2017, and to 6.6% in 2018. Various macroeconomic measures and monetary policies adopted by the PRC government to guide economic growth and manage inflation and the allocation of resources may not be effective in sustaining the growth rate of the Chinese economy. In addition, such measures, even if they benefit the overall Chinese economy in the long run, may have an adverse effect on us if they reduce the disposable income of our game players or if they cause our advertising clients to reduce their spending for our online advertising services on the 17173.com Website.

*Uncertainties with respect to the PRC legal system, including the PRC tax system, could have a material adverse effect on us.*

We conduct most of our operations in China through our principal PRC WFOEs AmazGame, Gamespace, and our principal VIEs Gamease, Guanyou Gamespace and Shanghai ICE. Our PRC subsidiaries are generally subject to laws and regulations applicable to foreign investment in China and, in particular, laws applicable to WFOEs. Our VIEs are generally subject to laws applicable to domestic companies in China. We are subject to PRC taxes, including corporate income tax and value-added tax, with respect to our operations in China. The PRC legal system is based on written statutes and regulations. Prior court decisions may be cited for reference but have limited precedential value. The PRC legal system, including the PRC tax system, continues to rapidly evolve, the interpretations of laws and regulations are not always uniform and enforcement of laws and regulations involves discretion of the enforcing authorities and uncertainties. We cannot predict the effect of future developments in the PRC legal system, including the promulgation of new laws, changes to existing laws or the interpretation or enforcement thereof, the preemption of local regulations by national laws, or the overturning of a local government's decisions by a higher level of government. These uncertainties may limit legal protections available to us and require us to expend substantial resources and management attention and effort in monitoring the development of, and ensuring our compliance with, existing and future PRC laws and regulations. In addition, any litigation in China may be protracted and result in substantial costs and diversion of resources and management attention. For example, an amendment adopted on November 4, 2017 by the Standing Committee of the National People's Congress of the *Unfair Competition Law of the PRC*, or the Unfair Competition Law, effective January 1, 2018, stipulates, among other things, that, without the other Internet business operator's consent, an Internet business operator may not insert links into Internet products or services of another Internet business operator in order to re-direct user traffic; may not mislead or compel users to modify, terminate, or un-install any Internet products or services of another Internet business operator; and may not take actions in bad faith to cause an Internet product or service of another Internet business operator to be unusable by users of the other business operator's properties.

*If we are found to be in violation of current or future PRC law and regulations regarding Internet-related services and telecom-related activities, we could be subject to severe penalties.*

The PRC government has enacted regulations that apply to Internet-related services and telecom-related activities, and purport to limit and require licensing of various aspects of the provision of Internet information and content, online games, and online advertising services.

Under regulations issued by the Ministry of Culture and Tourism of the People's Republic of China (the "MCT"), commercial entities are required to apply to a local branch of the MCT for an Online Culture Operating Permit if they engage in the production, duplication, importation, release or broadcasting of Internet cultural products; the dissemination of online cultural products on the Internet or the transmission of such products via Internet or mobile phone networks to user terminals such as computers, phones, television sets and gaming consoles; the provision of Internet surfing service sites such as Internet cafés; or the holding or exhibition of contests related to Internet cultural products.

Many aspects of the existing regulations remain unclear. In addition, the PRC government may promulgate new laws or regulations at any time. If current or future laws or regulations regarding Internet-related activities are interpreted to be inconsistent with our ownership structure and/or our business operations, our business could be severely impaired and we could be subject to severe penalties.

*The SAPPRFT's, the MIIT's, the MCT's, and other PRC authorities' regulatory supervision of the online game industry may adversely affect our online game operations.*

The SAPPRFT has issued a series of regulations affecting the online game industry and providing guidance regarding online game operations. The SAPPRFT issued a notice in September 2009 stating that the SAPPRFT would be the only governmental agency with the authority to review and approve online games, including reviewing and approving the importation of online games from offshore copyright owners, and that all online game operators must obtain an Internet publishing license in order to operate online games and related services and obtain additional pre-approval from the SAPPRFT to make any changes to, or any new versions or expansion packs of, the originally approved online games. The *Measures of Internet Publication Service Administration* issued by the SAPPRFT and the MIIT, or the New Internet Publication Measures, which became effective on March 10, 2016 and replaced the *Temporary Measures for Internet Publication Administration* that had become effective in 2002, require that entities in the Internet publishing business apply for an online publishing service license, instead of an Internet publishing license, that entities holding an Internet publishing license apply for an online publishing service license within a specified period of time to replace their Internet publishing license, and that all such entities obtain approval from the SAPPRFT prior to the publication of new online games. On May 24, 2016, the SAPPRFT issued a *Notice of the SAPPRFT on Administration of Mobile Game Publishing Services*, or the Mobile Game Notice, which became effective on July 1, 2016. The Mobile Game Notice provides that the content of mobile games is subject to review, and that mobile game publishers and operators must apply for publishing and authorization codes for the games. Under the Mobile Game Notice, significant upgrades and expansion packs for mobile games that have previously been approved for publishing may be regarded as new works, and the operators will be required to obtain approval for such upgrades and expansion packs before they are released. In the event of any failure to meet these license and approval requirements, an operator may face heavy penalties, such as being ordered to stop operation, or having its business license revoked. In addition, the State Press Publication Administration (the "SPPA"), as a successor agency to SAPPRFT, may delay or temporarily suspend its review of, and issuance of publishing and authorization codes for online games, as was the case between April 2018 and December 2018. Our online game business may be adversely affected by these SAPPRFT and MIIT notices and related implementation measures, as the launch of online games, new versions, expansion packs and imported games might be delayed because of the approval required. Such delays may result in higher costs for our online game operation and have an adverse effect on our game revenue.

The MCT also has issued regulations affecting the online game industry. For example, on June 3, 2010, the MCT issued the *Interim Measures for Online Games Administration*, or the Online Game Measures, which became effective on August 1, 2010 and were amended on December 15, 2017. The Online Game Measures stipulate that the MCT has the power to review the content of all online games except online game publications that have been pre-approved by the SAPPRFT or the SPPA. However, the Online Game Measures do not clearly specify what constitutes "online game publication." Furthermore, the Online Game Measures provide that all domestic online games must be filed with the MCT, while all imported online games are subject to a content review prior to their launch. If a substantial change (for example, any significant modification to a game's storyline, language, tasks, or trading system) is made to an existing imported or domestic online game, it will be subject to a new content review. Our online game business may be adversely affected by the Online Game Measures. The Online Game Measures do not set forth any specific procedure for the required filing and content review procedures for online games and therefore may cause delay when we try to file or apply for content review with the MCT. For our imported licensed games, the requirement for pre-approval by the MCT of any substantial change of our games may cause delay in releasing our expansion packs of the games, which may result in higher costs for our online game operations and have an adverse effect on our game revenues. In addition, the Online Game Measures do not resolve certain inconsistencies and ambiguities resulting from pronouncements included in previous notices issued by the SAPPRFT and the MCT.

Because there is ambiguity in the scope of the authority and the roles and responsibilities of governmental departments, such as the SPPA, as a successor agency to the SAPPRFT, and the MCT, with oversight of the online game industry, we may face stricter scrutiny of the day-to-day operations of our online game business. If any of our online game operating entities cannot comply with any of the stipulations of any PRC governmental department regarding the online game industry, we may be subject to various penalties and our online game business may be adversely affected.

*PRC law and regulations governing the online game industry in China are evolving and subject to future changes. We may fail to obtain or maintain all applicable permits, approvals, registrations and filings.*

The online game industry in China is highly regulated by the PRC government. Various regulatory authorities of the PRC central government, such as the State Council, the MIIT, the SPPA, the MCT and the Ministry of Public Security (the “MPS”), have the power to issue and implement regulations governing various aspects of the online game industry.

We are required to obtain applicable permits, approvals and registrations from, and make necessary filings with, different regulatory authorities in order to operate our online games. For example, as an online game operator in China, we must obtain an ICP license from the MIIT, an Online Cultural Operating Permit from the MCT and an online publishing service license from the SPPA in order to distribute games through the Internet. Any online game we operate needs to be approved by the SPPA prior to its launch and filed with the MCT within 30 days after its launch. Once a new online game or any upgrade, expansion pack or new version of any existing game is launched, such new game or such upgrade, expansion pack or new version must be filed with the MCT and approval must be obtained from the SPPA for online publication. If we fail to maintain any of our permits, approvals or registrations, to make any necessary filings, or to apply for and obtain any new permits, approvals or registrations or make any new filings on a timely basis, we may be subject to various penalties, including fines and a requirement that we discontinue or limit our operations.

As the online game industry is at an early stage of development in China, new law and regulations may be adopted from time to time to require additional licenses and permits other than those we currently have, and address new issues that arise. In addition, substantial uncertainties exist regarding the interpretation and implementation of current and any future PRC law and regulations applicable to the online game industry. Furthermore, as mobile games are a relatively new type of online game, there are uncertainties relating to whether a game developer, such as us, which provides mobile games to mobile device users, needs to obtain a separate operating license in addition to the ICP license that it has already obtained. For any mobile games we launch, we may be required to apply for a separate operating license for the mobile applications. Therefore, we may not be able to obtain timely, or at all, required licenses or any other new license required in the future, and we may be found to be in violation of current or future PRC law and regulations, which could impede our ability to conduct business.

*We operate some of our existing games, and plan to operate certain of our future games, with Internet authorization codes that we obtained through third-party electronic publishing entities. If the SPPA challenges the commercial operation of any of our games that are operated with Internet authorization codes obtained through third-party publishing entities, we may be subject to various penalties, including restrictions on our operations.*

Under regulations issued by the SAPPRFT and the MIIT, online game operators are required to have an online publishing service license (or before the New Internet Publication Measures became effective on March 10, 2016, an Internet publishing license), and an authorization code obtained under such a license is required for each game in operation and publicly available in the PRC. We publish certain of our existing games with authorization codes obtained under Internet publishing licenses held by third parties. See “PRC Regulation—Online Games and Cultural Products” in Item 4 of this annual report. Current PRC regulations are not clear as to the consequence of obtaining authorization codes through the licenses of third-party entities. Our past and expected future practices might be challenged by the SPPA, as a successor agency to the SAPPRFT, which could subject us to various penalties, including fines, confiscation of publishing equipment and the revenues generated from the publishing activities, the revocation of our business license, or the forced discontinuation of or restrictions on our operations.

*Restrictions on virtual currency may adversely affect our online game revenues.*

Our online game revenues are collected through the online sale of game points and sale of our prepaid cards, which are considered to be the “virtual currency” as such term is defined in the *Notice on Strengthening the Administration of Online Game Virtual Currency*, or the Virtual Currency Notice, which was jointly issued by the MCT and the MOFCOM in 2009. PRC laws and regulations, including the Virtual Currency Notice, have provided various restrictions on virtual currency and imposed various requirements and obligations on online game operators with respect to the virtual currency used in their games, including that (i) the total amount of virtual currency issued by online game operators and the amount purchased by individual users in the PRC is subject to limits, and online game operators are required to report the total amount of their issued virtual currency on a quarterly basis and are prohibited from issuing disproportionate amounts of virtual currency in order to generate revenues; (ii) virtual currency may only be provided to users in exchange for payment in RMB and may only be used to pay for virtual goods and services of the issuer of the currency, and online game operators are required to keep transaction data records for no less than 180 days; (iii) online game operators are prohibited from providing lucky draws or lotteries that are conducted on the condition that participants contribute cash or virtual currency in exchange for game props or virtual currencies; (iv) online game operators are prohibited from providing virtual currency trading services to minors; and (v) companies involved with virtual currency in the PRC must be either issuers or trading platforms, and may not operate simultaneously as issuers and as trading platforms. On December 1, 2016, the MCT issued *Notice of Ministry of Culture on Regulating Online Game Operation Strengthening Interim and Ex-post Supervision*, or the Online Game Operation Notice, which became effective on May 1, 2017. The Online Game Operation Notice stipulates that online game operators may not allow online game virtual currency to be exchanged for real currency or physical items, except that, when online game operators cease offering their online game products and services to users, the operators may repay the users with real currency or other actual physical or intangible assets for unused virtual currency. We must tailor our business model carefully, including designing and operating our databases to maintain users’ information for the minimum required period, in order to comply with the requirements of current PRC laws and regulations, including the Virtual Currency Notice and the Online Game Operation Notice, in a manner that in many cases can be expected to result in relatively lower sales of our game coins and an adverse impact on our online game revenues.

*Our business may be adversely affected by public opinion and governmental policies in China as well as in other jurisdictions where we operate our online games or license our online games to third parties.*

Currently, most of our game players in China are young males, many of whom are students. Due to relatively easy access to personal computers and Internet cafés, the increasing use and popularity of mobile devices such as smart phones and tablets connected to the Internet, and the lack of other appealing forms of entertainment in China, many teenagers in China frequently play online games. This may result in these teenagers spending less time on or refraining from other activities, including education, vocational training, sports, and resting, which could result in adverse public reaction and stricter government regulation. For example, the PRC government has promulgated anti-fatigue-related regulations to limit the amount of time minors can play online games.

Adverse public opinion could discourage game players from playing our games, and could result in government regulations that impose additional limitations on the operations of online games as well as game players' access to online games. For example, under the Monitor System Circular online game operators are required to adopt various measures to maintain a system to communicate with the parents of minors playing online games and are required to monitor the activities of minors and suspend the accounts of minors if so requested by their parents. We believe that stricter government regulations, such as regulations imposing stricter age and hour limits, limiting the issuance of virtual currency by online game operators or the amount of virtual currency that can be purchased by an individual game player, and extending anti-fatigue-related regulations to adults, could be implemented in the future. Any such adverse public opinion or tightened government regulations could adversely affect our ability to maintain or increase our revenues.

In addition, the PRC State Administration of Taxation (the "SAT") has announced that it will tax game players on the income derived from the trading of virtual currencies at the rate of 20%. It is currently unclear how the tax will be collected or if there will be any effect on our game players or our business, but collection of such a tax might discourage players who are interested in trading virtual currencies from playing our games, which could reduce our revenues.

Moreover, similar adverse public reaction may arise, and similar government policies may be adopted, in other jurisdictions where we license or operate our games, which could similarly adversely affect our revenues.

*Regulation and censorship of information disseminated over the Internet in China may adversely affect our business, and we may be liable for information displayed on, retrieved from or linked to our Websites.*

The PRC government has adopted regulations governing Internet access and the distribution of news and other information over the Internet. Under these regulations, Internet content providers and Internet publishers are prohibited from posting or displaying over the Internet any content that, among other things, violates PRC law and regulations, impairs the national dignity of China, or is obscene, superstitious, fraudulent or defamatory. When Internet content providers and Internet publishers, including online game operators, find that information falling within the above scope is transmitted on their Websites or is stored in their electronic bulletin service systems, they are required to terminate the transmission of such information or delete such information immediately, keep records, and report to relevant authorities. Failure to comply with these requirements could result in the revocation of our ICP license and other required licenses and the closure of our Websites. Internet content providers may also be held liable for prohibited information displayed on, retrieved from or linked to their Websites.

In addition, the MIIT has published regulations that subject Internet content providers to potential liability for the actions of game players and others using their Websites, including liability for violations of PRC law prohibiting the dissemination of content deemed to be socially destabilizing. As these regulations are subject to interpretation by the relevant authorities, it is not possible for us to determine in all cases the type of content that could result in liability for us as a developer and operator of online games, and as an operator of the 17173.com Website. In addition, we may not be able to control or restrict the content of other Internet content providers linked to or accessible through our Websites, or content generated or placed on our Websites by our game players, despite our attempt to monitor such content. To the extent that regulatory authorities find any portion of our content objectionable, they may require us to curtail our games, which may reduce our game player base, the amount of time our games are played or the purchases of virtual items.

*We may be subject to the PRC government's ongoing crackdown on Internet pornographic content.*

The PRC government has stringent restrictions on online pornographic information and has launched several crackdowns on Internet pornography. Regulations jointly issued by the MIIT and three other government authorities jointly provide for rewards of up to RMB10,000 to Internet users who report Websites that feature pornography, and the MIIT established a committee to review such reports to determine an appropriate award. We have not, to date, received any penalty from the PRC government in this regard. However, it is possible that content considered pornographic or vulgar by PRC government agencies will appear in the future on Websites or games that we operate. In the event that we are accused by the PRC government of hosting pornographic or vulgar content, our business and reputation could be adversely affected.

*There are currently no laws or regulations in the PRC governing property rights with respect to virtual assets and therefore it is not clear what liabilities, if any, we may have relating to the loss of virtual assets by our game players.*

In the course of playing our games, game players can acquire and accumulate virtual assets, such as game player experience, skills and weaponry. Such virtual assets can be highly valued by game players and in some cases are traded among game players for real money or assets. In practice, virtual assets can be lost for various reasons, such as data loss caused by delay of network service by a network crash, or by hacking activities. There are currently no PRC laws or regulations governing property rights with respect to virtual assets. As a result, it is unclear who the legal owner of virtual assets is and whether the ownership of virtual assets is protected by law. In addition, it is unclear under PRC law and regulations whether an operator of online games such as us would have any liability (whether in contract, tort or otherwise) for loss of such virtual assets by game players. Based on several judgments regarding the liabilities of online game operators for loss of virtual assets by game players, the courts have generally required the online game operators to provide well-developed security systems to protect such virtual assets owned by game players. In the event of a loss of virtual assets, we may be sued by game players and may be held liable for damages.

*Our online game operations may be adversely affected by implementation of anti-fatigue-related regulations.*

The PRC government may decide to adopt more stringent policies to monitor the online game industry as a result of adverse public reaction to perceived addiction to online games, particularly by minors. Eight PRC government authorities, including the SAPPRFT, the Ministry of Education and the MIIT, jointly issued regulations, or the Anti-Fatigue Notice, requiring all Chinese online game operators to adopt an "anti-fatigue system" in an effort to curb addiction to online games by minors. Under the anti-fatigue system, three hours or less of continuous play is defined to be "healthy," three to five hours is defined to be "fatiguing," and five hours or more is defined to be "unhealthy." Game operators are required to reduce the value of game benefits for minor game players by half when those game players reach the "fatiguing" level, and to zero when they reach the "unhealthy" level. In addition, online game players in China are now required to register their identity card numbers before they can play an online game. This system allows game operators to identify which game players are minors. These restrictions could limit our ability to increase our business among minors. If these restrictions were expanded to apply to adult game players in the future, our revenues could be adversely affected.

These eight PRC government authorities subsequently promulgated additional regulations, including a *Notice on Initializing the verification of Real-name Registration for Anti-Fatigue System on Internet Games*, or the Real-name Registration Notice, to strengthen the implementation of the anti-fatigue system and real-name registration. The Real-name Registration Notice's main focus is to prevent minors from using an adult's identity to play Internet games and, accordingly, provides stringent punishment for online game operators for not implementing the anti-fatigue and real name registration measures properly and effectively. The most severe punishment contemplated by the Real-name Registration Notice is termination of the operation of the online game if it is found to be in violation of the Anti-Fatigue Notice, the Real-name Registration Notice or the circular entitled *Implementation of Online Game Monitor System of the Guardians of Minors*, or the Monitor System Circular. The Real-name Registration Notice increases our operating risks, as we will be required to spend more resources on the real-name verification and anti-fatigue system, which will lead to an increase in our operating costs. In addition, the amount of time that minors will be able to spend playing online games such as ours will be further limited, which can be expected to lead to a reduction in our revenues. Furthermore, if we are found to be violating these regulations, we may be required to suspend or discontinue our online game operations.

In February 2013, 15 PRC government authorities, including the SAPPRFT, the Ministry of Education, the MCT and the MIIT, jointly issued *the Work Plan for the Integrated Prevention of Minors Online Game Addiction*, or the Work Plan, implementing integrated measures by different authorities to prevent minors from being addicted to online games. Under the Work Plan, the current relevant regulations will be further clarified and additional implementation rules will be issued by relevant authorities. As a result, we may have to impose more stringent limits for minor game players, which may lead to an increase in our operating expenses and a reduction in our revenues from minor game players.

In July 2014, the SAPPRFT issued the *Notice on Further Launch Verification of Real-name Registration for Anti-Fatigue System on Internet Games*, stating that, in view of some of the hardware and functionality limitations inherent in mobile devices, anti-fatigue system requirements applicable to Internet games do not currently apply to mobile games. If the SPPA, as a successor agency to the SAPPRFT, in the future decides to expand the anti-fatigue system requirements to mobile games, our operating expenses would be likely to increase.



*Contract drafting, interpretation and enforcement in China involve significant uncertainty.*

We have entered into numerous contracts governed by PRC law, many of which are material to our business. As compared with contracts in the United States, contracts governed by PRC law tend to contain less detail and are not as comprehensive in defining contracting parties' rights and obligations. As a result, contracts in China are more vulnerable to disputes and legal challenges. In addition, contract interpretation and enforcement in China are not as developed as in the United States, and the result of any contract dispute is subject to significant uncertainties. Therefore, we may be subject to disputes under our material contracts, and if such disputes arise, we may not prevail. Due to the materiality of certain contracts to our business, such as our license agreements with the estate of Louis Cha regarding our rights to develop and operate TLBB, TLBB 3D, and Legacy TLBB Mobile, any dispute involving such contracts, even without merit, may adversely affect our reputation and our business operations.

*SAFE Rules and regulations may limit our ability to transfer funds we hold overseas to our subsidiaries and VIEs in the PRC, which may adversely affect our business.*

On March 30, 2015, SAFE promulgated the *Notice of the State Administration of Foreign Exchange on Reforming the Administration of Foreign Exchange Settlement of Registered Capital of Foreign-invested Enterprises*, or Circular 19, which allows foreign-invested enterprises generally to decide when to exchange into RMB their foreign exchange denominated paid-in capital, but only up to a maximum percentage specified by SAFE. The maximum percentage specified by SAFE is currently 100%, but SAFE may choose to adjust the permitted level at any time. The use of any such RMB funds by foreign-invested enterprises is also subject to review and approval by SAFE or local SAFE branches or designated banks. Circular 19 further provides that any such RMB funds of a foreign-invested enterprise may not be used for any purpose outside of the entity's business scope or if such use would violate the laws and regulations of the PRC. For example, such RMB funds may not be used for the making of RMB-denominated entrusted loans that are not within the enterprise's business scope, for the repayment of inter-enterprise loans (including third party advances), or for the purpose of relending to third parties RMB-denominated bank loans made to the enterprise. Circular 19 may limit our ability to transfer foreign exchange-denominated funds that we hold overseas to our subsidiaries and VIEs in the PRC, which may adversely affect our business.

*PRC law establishes complex procedures for some acquisitions of Chinese companies by foreign investors, which could make it more difficult for us to make acquisitions in China.*

Applicable PRC law and regulations, such as the *Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, or the M&A Rules, which became effective on September 8, 2006 and were amended on June 22, 2009, the Anti-Monopoly Law, which became effective on August 1, 2008, the *Notice on Establishing the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, or Circular 6, promulgated by the General Office of the State Council and the MOFCOM Security Review Rules, mandate procedures and requirements, including requirements in some instances that the MOFCOM be notified in advance of any change-of-control transaction in which a foreign investor takes control of a PRC domestic enterprise, or that approval from the MOFCOM be obtained in circumstances where overseas companies established or controlled by PRC enterprises or residents acquire affiliated domestic companies, that can be expected to make merger and acquisition activities in China by foreign investors time-consuming and complex. PRC law also requires certain merger and acquisition transactions to be subject to a security review. The MOFCOM Security Review Rules, which became effective September 1, 2011, provide that, when deciding whether a specific merger or acquisition of a domestic enterprise by foreign investors is subject to a security review by the MOFCOM, the principle of substance over form should be applied, and foreign investors are prohibited from bypassing the security review requirement by structuring transactions through proxies, trusts, indirect investments, leases, loans, or control through contractual arrangements. Factors that the MOFCOM considers in its review are whether (i) an important industry is concerned, (ii) such transaction involves factors that have had or may have an impact on national economic security and (iii) such transaction will lead to a change in control of a domestic enterprise that holds a well-known PRC trademark or a time-honored PRC brand. If the business of any target company that we plan to acquire falls into the ambit of security review, we may not be able to successfully acquire such company. Complying with the requirements of the relevant regulations to complete such transactions could be time-consuming, and any required approval process, including approval from the MOFCOM, may delay or inhibit our ability to complete such transactions, which could affect our ability to expand our business.

*Regulations relating to offshore investment activities by PRC residents may limit our ability to acquire PRC and foreign companies and could adversely affect our business.*

In July 2014, SAFE promulgated the *Circular on Issues Concerning Foreign Exchange Administration Over Overseas Investment and Financing and Roundtrip Investment by Domestic Residents Via Special Purpose Vehicles*, or Circular 37, which replaced *Issues Concerning Foreign Exchange Control on Domestic Residents' Corporate Financing and Roundtrip Investment through Offshore Special Purpose Vehicles*, or Circular 75. Circular 37 requires PRC residents to register with local branches of SAFE in connection with their direct establishment or indirect control of an offshore entity, referred to in Circular 37 as a "special purpose vehicle" for the purpose of holding domestic or offshore assets or interests. Circular 37 further requires amendment to a PRC resident's registration in the event of any significant changes with respect to the special purpose vehicle, such as an increase or decrease in the capital contributed by PRC individuals, share transfer or exchange, merger, division or other material event. Under these regulations, PRC residents' failure to comply with specified registration procedures may result in restrictions being imposed on the foreign exchange activities of the relevant PRC entity, including the payment of dividends and other distributions to its offshore parent, as well as restrictions on capital inflows from the offshore entity to the PRC entity, including restrictions on its ability to contribute additional capital to its PRC subsidiaries. Further, failure to comply with the SAFE registration requirements could result in penalties under PRC law for evasion of foreign exchange regulations.

Different local SAFE branches may have different views and procedures as to the interpretation and implementation of the SAFE regulations, and it may be difficult for our ultimate shareholders or beneficial owners who are PRC residents to provide sufficient supporting documents required by the SAFE or to complete the required registration with the SAFE in a timely manner, or at all. Any failure by any of our shareholders who is a PRC resident, or is controlled by a PRC resident, to comply with relevant requirements under these regulations could subject us to fines or sanctions imposed by the PRC government, including restrictions on the ability of AmazGame and Gamespace to pay dividends or make distributions to us and on our ability to increase our investment in AmazGame, Gamespace, or our VIEs.

Under Circular 37, if a non-listed special purpose vehicle uses its own equity or share option to grant equity incentive awards to directors, supervisors, members of senior management or employees directly employed by a domestic enterprise that is directly or indirectly controlled by such special purpose vehicle, or with which such employee has established an employment relationship, any of such directors, supervisors, members of senior management or employees who is a PRC resident should, prior to exercising their rights, file an application with the SAFE for foreign exchange registration with respect to such special purpose vehicle. However, in practice, different local SAFE branches may have different views and procedures as to the interpretation and implementation of the SAFE regulations and, since Circular 37 was the first regulation to regulate the foreign exchange registration of a non-listed special purpose vehicle's equity incentive granted to PRC residents, there remains uncertainty with respect to its implementation.

On August 4, 2017, the General Office of the State Council issued the *Notice of the General Office of the State Council on Furthering the Guiding Opinions of the National Development and Reform Commission, the Ministry of Commerce, the People's Bank of China, and the Ministry of Foreign Affairs Further Guiding and Regulating Offshore Investment* (the "Offshore Investment Opinions"). Under the Offshore Investment Opinions, offshore investments in real estate, hotels, movie theaters, entertainment, and sports clubs are placed in a restricted category of offshore investments that are subject to heightened review by and approval of relevant PRC governmental authorities, which may limit our ability to make offshore acquisitions or investments in those areas.

The National Development and Reform Commission (the "NDRC") issued the *Administrative Measures for the Offshore Investment by Enterprises* (the "Offshore Investment Measures") effective March 1, 2018. Under the Offshore Investment Measures, an enterprise located within the PRC is required to file documents with the NDRC or its local branches for any offshore investment made by such enterprise directly or through any overseas entity over which such enterprise has control, whether through the ownership of voting securities, by contract, or otherwise. The Offshore Investment Measures may affect our offshore investments in the future, and failure to comply with the Offshore Investment Measures' requirements could result in penalties being imposed on us.

*To fund any cash requirements we may have, we may need to rely on dividends, loans or advances made by our principal PRC subsidiaries AmazGame and Gamespace, which are subject to limitations and possible taxation under applicable PRC law.*

We may need to rely on dividends and other distributions on equity, or loans and advances made by our PRC subsidiaries AmazGame and Gamespace to fund any cash requirements we may have, including the funds necessary to pay dividends and other cash distributions, if any, to our shareholders or ADS holders, and to service any debt we may incur. The distribution of dividends and the making of loans and advances by entities organized in China are subject to limitations. Regulations in the PRC currently permit payment of dividends only out of accumulated profits as determined in accordance with accounting standards and regulations in China. AmazGame and Gamespace are also required to set aside at least 10% of their after-tax profit based on PRC accounting standards each year to their general reserves until the cumulative amount of such reserves reaches 50% of the entities' registered capital. These reserves are not distributable as cash dividends, loans or advances. AmazGame and Gamespace may also allocate a portion of their after-tax profits, as determined by their boards of directors, to their staff welfare and bonus funds, which may not be distributed to us. In addition, if AmazGame and Gamespace incurs debt on its own behalf in the future, the instruments governing the debt may restrict its ability to pay dividends or make other distributions to us. Furthermore, under regulations of the State Administration of Foreign Exchange (the "SAFE"), the RMB is not convertible into foreign currencies for capital account items, such as loans, repatriation of investments and investments outside of China, unless prior approval of the SAFE is obtained and prior registration with the SAFE is made, which could delay or prevent any transfers of funds from our PRC subsidiaries to us.

In addition, there are uncertainties under the CIT Law with regard to the PRC withholding tax on dividends paid by AmazGame and Gamespace to our Hong Kong subsidiaries. See "Risk Factors—Risks related to Doing Business in China—There are significant uncertainties under the Corporate Income Tax Law of the PRC (the "CIT Law") regarding our PRC enterprise income tax liabilities, such as tax on dividends paid to us by our PRC subsidiaries. The CIT Law also contains uncertainties regarding possible PRC withholding tax on any dividends we pay to our overseas corporate shareholders and gains realized from the transfer of our shares by our overseas corporate shareholders." Should such dividends be subject to PRC withholding tax or be subject to the usual CIT Law withholding tax rate of 10% rather than the preferential dividend withholding tax rate of 5% provided under the China-HK Tax Arrangement, the amount of cash available to us for our cash needs, including for the payment of dividends to our shareholders or ADS holders, would be reduced.

Furthermore, we control our principal VIEs Gamease and Guanyou Gamespace through contractual arrangements rather than equity ownership. See Item 7 “Major Shareholders and Related Party Transactions—Related Party Transactions.” To the extent that there is any distributable profit in Gamease and Guanyou Gamespace, it may be difficult for these entities to distribute such profit to AmazGame and Gamespace, which may further limit the amount that these PRC subsidiaries can distribute to us.

*As the special tax qualifications of certain of our PRC subsidiaries and VIEs as “High and New Technology Enterprises,” “Software Enterprises” or “Key National Software Enterprises” expire, or if they are revoked, we will have to pay additional taxes to make up any previously unpaid tax and will be subject to a higher tax rate.*

The CIT Law generally imposes a uniform income tax rate of 25% on all enterprises, but grants preferential treatment to High and New Technology Enterprises (“HNTEs”), pursuant to which HNTEs are instead subject to an income tax rate of 15%, subject to a requirement that they re-apply for HNTE status every three years. During this three-year period, an HNTE must conduct a qualification self-review each year to ensure it meets the HNTE criteria, and will be subject to the regular 25% income tax rate for any year in which it does not meet the criteria. The CIT Law and its implementing regulations provide that a “Software Enterprise” is entitled to an income tax exemption for two years beginning with its first profitable year and a 50% reduction to a rate of 12.5% for the subsequent three years. An entity that qualifies as a “Key National Software Enterprise” (a “KNSE”) is entitled to a further reduced preferential income tax rate of 10%. Enterprises wishing to enjoy the status of a Software Enterprise or a KNSE must perform a self-assessment each year to ensure they meet the relevant criteria for qualification and file required supporting documents with the tax authorities before using the preferential CIT rates. These enterprises will be subject to the relevant government authorities’ assessment each year as to whether they are entitled to use the relevant preferential CIT treatments. If at any time during the preferential tax treatment years an enterprise uses the preferential CIT rates but the relevant authorities determine that it failed to meet applicable criteria for qualification, the authorities may revoke the enterprise’s Software Enterprise or KNSE status, as applicable. A number of our PRC Subsidiaries and VIEs qualified for exemptions or rate reductions in 2015, 2016, and 2017.

There are uncertainties regarding future interpretation and implementation of the CIT Law and its implementing regulations. It is possible that the HNTE, Software Enterprise, and KNSE qualifications of our operating entities currently qualified as such, or their entitlement to an income tax exemption, will be challenged by higher level tax authorities and be repealed, or that there will be future implementing regulations that are inconsistent with current interpretation of the CIT Law. Therefore, it is possible that the qualifications of one or more of our PRC Subsidiaries or VIEs will be challenged in the future or that such companies will not be able to take any further actions, such as re-application for qualification, to enjoy such preferential tax treatments. If those operating entities cannot qualify for such income tax reductions, our effective income tax rate, as the case may be, will be increased significantly and we may have to pay additional income tax to make up the previously unpaid tax, which would reduce our net income.

*There are significant uncertainties under the Corporate Income Tax Law of the PRC (the “CIT Law”) regarding our PRC enterprise income tax liabilities, such as tax on dividends paid to us by our PRC subsidiaries. The CIT Law also contains uncertainties regarding possible PRC withholding tax on any dividends we pay to our overseas corporate shareholders and gains realized from the transfer of our shares by our overseas corporate shareholders.*

We are a holding company incorporated in the Cayman Islands which indirectly holds, through our Hong Kong subsidiaries, our equity interests in our subsidiaries in the PRC. Our business operations are principally conducted by our principal PRC subsidiaries and our principal VIEs. The CIT Law and its implementation rules provide that China-sourced income of foreign enterprises, such as dividends paid by a PRC subsidiary to its overseas parent, will normally be subject to PRC withholding tax at a rate of 10%, unless there are applicable tax treaties that reduce such rate. Under the *Arrangement Between the PRC and the Hong Kong Special Administrative Region on the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income* (the “China-HK Tax Arrangement”), the dividend withholding tax rate may be reduced to 5% if a Hong Kong resident enterprise is considered a non-PRC tax resident enterprise and holds at least 25% of the equity interests in the PRC enterprise distributing the dividends, subject to approval of the PRC local tax authority. However, if the Hong Kong resident enterprise is not considered to be the beneficial owner of such dividends under applicable PRC tax regulations, such dividends may remain subject to withholding tax at a rate of 10%. The SAT issued an *Announcement on Issues in Tax Treaties Relating to “Beneficial Owner”* (“Announcement 9”), effective April 1, 2018, which provides guidance on determining whether an enterprise is a “beneficial owner” of dividends under China’s tax treaties and tax arrangements. Announcement 9 provides that, in order to be a beneficial owner, an entity generally must be a direct owner of, and have the right to control, the income of the enterprise that is paying the dividends or must be a direct owner of, and have the right to control, the tangible or intangible assets generating such income, and also specifies that a company that is not organized for the purpose of engaging in substantive business activities may not be regarded as a beneficial owner. If any of our Hong Kong subsidiaries is, in the light of Announcement 9, determined by the SAT to not be a beneficial owner for purposes of the China-HK Tax Arrangement, any dividends paid to it by any of our PRC subsidiaries would not qualify for the preferential dividend withholding tax rate of 5%, but rather would be subject to the regular withholding tax rate of 10% under the CIT Law.

We believe we are not a PRC tax resident enterprise, but it is not clear whether we or any of our Hong Kong subsidiaries will be deemed to be PRC tax residents under the CIT Law. The tax resident status of an enterprise is subject to determination by the PRC tax authorities and uncertainties remain with respect to the interpretation of the term “de facto management body”. Under the CIT Law and its implementation rules, an enterprise established outside of the PRC with a “de facto management body” within the PRC is considered a resident enterprise and will be subject to the enterprise income tax on its global income at the rate of 25%. The implementation rules define the term “de facto management body” as a body that exercises full and substantial control and overall management over the business, productions, personnel, accounts and properties of an enterprise. On April 22, 2009, the SAT issued a circular, known as Circular 82, which provides certain specific criteria for determining whether the “de facto management body” of a PRC-controlled enterprise that is incorporated offshore is located in China. Although this circular only applies to offshore enterprises controlled by PRC enterprises or PRC enterprise groups, not those controlled by PRC individuals or foreigners, the criteria set forth in the circular may reflect the SAT’s general position on how the “de facto management body” text should be applied in determining the tax resident status of all offshore enterprises. Under Circular 82, an offshore incorporated enterprise controlled by a PRC enterprise or a PRC enterprise group will be regarded as a PRC tax resident by virtue of having its “de facto management body” in China and will be subject to PRC enterprise income tax on its global income only if all of the following conditions are met: (i) the primary location of the day-to-day operational management is in the PRC; (ii) decisions relating to the enterprise’s financial and human resource matters are made or are subject to approval by organizations or personnel in the PRC; (iii) the enterprise’s primary assets, accounting books and records, company seals, and board and shareholder resolutions, are located or maintained in the PRC; and (iv) at least 50% of voting board members or senior executives habitually reside in the PRC. If we are considered as a PRC tax resident under the CIT law by the PRC tax authorities, our global income will be subject to corporate income tax at a rate of 25%.

Although we intend to take the position that any dividends we pay to our overseas corporate shareholders or ADS holders will not be subject to a withholding tax in the PRC, if we or any of our Hong Kong subsidiaries are considered to be PRC tax resident enterprises for tax purposes, any dividends we pay to our overseas corporate shareholders or ADS holders as well as gains realized by such shareholders or ADS holders from the transfer of our shares or ADSs may be regarded as China-sourced income and as a result be subject to PRC withholding tax at a rate up to 10%. The implementation rules of the CIT Law provide that, if an enterprise that distributes dividends is domiciled in the PRC or if gains are realized from transferring equity interests of an enterprise domiciled in the PRC, then such dividends or gains are treated as “China-sourced income.” However, it is not clear how “domicile” might be interpreted under the CIT Law, and it is possible that domicile could be interpreted to mean the jurisdiction where the enterprise is a tax resident.

Due to the lack of interpretation of the CIT Law, it is difficult to ascertain how it will be implemented by the relevant PRC tax authorities. If dividend payments to us from our wholly-owned subsidiary Changyou.com (HK) Limited (“Changyou HK”) or other overseas subsidiaries are subject to PRC withholding tax, our financial condition, results of operations and the amount of dividends available to pay our shareholders may be adversely affected. If dividends we pay to our overseas shareholders or ADS holders or gains realized by such shareholders or ADS holders from the transfer of our shares or ADSs are subject to PRC withholding tax, the withholding tax will generally be at a rate of 10% and reduce their investment return and the value of their investments in us.

*Heightened scrutiny of acquisition transactions by PRC tax authorities may have a negative impact on our business operations and our acquisition strategy.*

Pursuant to the *Announcement on Issues Relating to Income Tax Withholding For Non-PRC Resident Enterprises* (“SAT Announcement 37”), which became effective on December 1, 2017 and was amended on June 15, 2018, and the *Announcement on Several Issues Related to Enterprise Income Tax for Indirect Asset Transfer by Non-PRC Resident Enterprises* (“SAT Announcement 7”), which became effective on February 3, 2015 and was amended on December 1, 2017 and December 29, 2017, issued by the SAT, if a non-resident enterprise transfers the equity interests of or similar rights or interests in an overseas company which directly or indirectly owns PRC taxable assets through an arrangement without a reasonable commercial purpose, but rather to avoid PRC corporate income tax, the transaction will be re-characterized and treated as a direct transfer of PRC taxable assets subject to PRC corporate income tax. SAT Announcement 7 specifies certain factors that should be considered in determining whether an indirect transfer has a reasonable commercial purpose. However, as SAT Announcement 7 was issued relatively recently, there is uncertainty as to the application of SAT Announcement 7 and the interpretation of the term “reasonable commercial purpose.”

Under SAT Announcement 7, the entity which has the obligation to pay the consideration for the transfer to the transferring shareholders has the obligation to withhold any PRC corporate income tax that is due. If the transferring shareholders do not pay corporate income tax that is due for a transfer and the entity which has the obligation to pay the consideration does not withhold the tax due, the PRC tax authorities may impose a penalty on the entity that so fails to withhold, which may be relieved or exempted from the withholding obligation and any resulting penalty under certain circumstances if it reports such transfer to the PRC tax authorities.

Although SAT Announcement 7 became generally effective as of February 3, 2015, it also applies to cases where the PRC tax treatment of a transaction that took place prior to SAT Announcement 7's effectiveness had not yet been finally settled as of the time SAT Announcement 7 became effective. As a result, SAT Announcement 7 could be determined by PRC tax authorities to be applicable, for example, to our acquisition of the equity interests of MoboTap, and it is possible that the transaction could be determined by PRC tax authorities to lack a reasonable commercial purpose. As a result, the transfer of MoboTap's shares to other parties could be subject to corporate income tax of up to 10% on capital gains generated from such transfer, and PRC tax authorities could impose tax obligations on the transferring shareholders or subject us to penalty if the transferring shareholders do not pay such obligations and we do not withhold such tax.

SAT Announcement 7 and its interpretation by relevant PRC authorities clarify that an exemption for transfers of shares in a publicly-traded entity that is listed overseas is available if the purchase of the shares and the sale of the shares both take place in open-market transactions. However, if a shareholder of an entity that is listed overseas purchases shares in the open market and sells them in a private transaction, or vice-versa, PRC tax authorities might deem such a transfer to be subject to SAT Announcement 7, which could subject such shareholder to additional reporting obligations or tax burdens. Accordingly, if a holder of our ADSs or ordinary shares purchases our ADSs or ordinary shares in the open market and sells them in a private transaction, or vice-versa, and fails to comply with SAT Announcement 7, the PRC tax authorities may take actions, including requesting us to provide assistance for their investigation or impose a penalty on us, which could have a negative impact on our business operations. In addition, since we may pursue acquisitions as one of our growth strategies, and may conduct acquisitions involving complex corporate structures, PRC tax authorities might impose taxes on capital gains or request that we submit additional documentation for their review in connection with any potential acquisitions, which may cause us to incur additional acquisition costs or delay our acquisition timetable.

*We may be subject to fines and legal sanctions if we or our employees who are PRC citizens fail to comply with PRC regulations relating to employee share incentives granted by overseas listed companies to PRC citizens.*

Under the *Administration Measures on Individual Foreign Exchange Control* issued by the PBOC and related implementation rules issued by the SAFE, all foreign exchange transactions involving an employee share incentive plan, share option plan or similar plan participated in by PRC citizens may be conducted only with the approval of the SAFE. Under the *Notice of Issues Related to the Foreign Exchange Administration for Domestic Individuals Participating in Stock Incentive Plan of Overseas Listed Company* (the "Offshore Share Incentives Rules") issued by the SAFE on February 15, 2012, PRC citizens who are granted share options, restricted share units or restricted shares by an overseas publicly listed company are required to register with the SAFE or its authorized branch and to comply with a series of other requirements. The Offshore Share Incentives Rule also provides procedures for registration of incentive plans, the opening and use of special accounts for the purpose of participation in incentive plans, and the remittance of funds for exercising share options and gains realized from such exercises and sales of such options or the underlying shares, both outside and inside the PRC. We, and any of our PRC employees or members of our Board of Directors who have been granted share options, restricted share units or restricted shares, are subject to the Administration Measures on Individual Foreign Exchange Control, the related implementation rules issued by the SAFE, and the Offshore Share Incentives Rule. If we, or any of our PRC employees or members of our Board of Directors who receive or hold share options, restricted share units or restricted shares, fail to comply with these registration and other procedural requirements, we may be subject to fines and other legal or administrative sanctions.

*The enforcement of the PRC Labor Contract Law and other labor-related regulations in the PRC may adversely affect our business.*

In 2008, the Standing Committee of the National People's Congress of the PRC enacted the *Labor Contract Law* (the "Labor Contract Law"), which was amended on December 12, 2012. The Labor Contract Law introduced specific provisions related to fixed-term employment contracts, part-time employment, probationary periods, consultation with labor unions and employee assemblies, employment without a written contract, dismissal of employees, severance, and collective bargaining to enhance previous PRC labor law. Under the Labor Contract Law, an employer is obligated to sign an unlimited-term labor contract with any employee who has worked for the employer for ten consecutive years. Further, if an employee requests or agrees to renew a fixed-term labor contract that has already been entered into twice consecutively, the resulting contract, with certain exceptions, must have an unlimited term, subject to certain exceptions. With certain exceptions, an employer must pay severance to an employee where a labor contract is terminated or expires. In addition, the PRC governmental authorities have continued to introduce various new labor-related regulations since the effectiveness of the Labor Contract Law. For example, there are regulations which require that annual leave ranging from five to 15 days be made available to employees and that employees be compensated for any unused annual leave days at a rate of three times their daily salary, subject to certain exceptions.

Under the *PRC Social Insurance Law* and the *Administrative Measures on Housing Fund*, employees are required to participate in pension insurance, work-related injury insurance, medical insurance, unemployment insurance, maternity insurance and housing funds and employers are required, together with their employees or separately, to pay the social insurance premiums and housing funds for their employees.

These laws designed to enhance labor protection tend to increase our labor costs. In addition, as the interpretation and implementation of these regulations are still evolving, our employment practices may not be at all times be deemed in compliance with the regulations. As a result, we could be subject to penalties or incur significant liabilities in connection with labor disputes or investigations.

*We may suffer currency exchange losses if the RMB depreciates relative to the U.S. dollar, which could reduce the value of an investment in our ADSs.*

Our reporting currency is the U.S. dollar. However, the majority of our revenues and costs are denominated in RMB and a significant portion of our assets and liabilities are denominated in RMB. If the RMB depreciates relative to the U.S. dollar, our revenues and assets as expressed in our U.S. dollar financial statements will decline in value. In addition, to the extent that we need to convert any U.S. dollars into RMB for our operations, appreciation of the RMB against the U.S. dollar would have an adverse effect on the RMB amount we would receive from the conversion. Conversely, if we decide to convert our RMB into U.S. dollars for the purpose of paying dividends on our ordinary shares or for other business purposes, appreciation of the U.S. dollar against the RMB would have a negative effect on the U.S. dollar amount available to us.

*The successful operation of our business and implementation of our growth strategies, including our ability to accommodate additional game players and advertising clients in the future, depend upon the performance and reliability of the Internet infrastructure and fixed telecommunications networks in China.*

Almost all access to the Internet in China is maintained through state-owned telecommunications operators under the administrative control and regulatory supervision of the MIIT. We rely on this national information infrastructure to provide data communications capacity, primarily through local telecommunications lines. Although the PRC government has announced plans to further develop this infrastructure, it may not be further developed as planned. In addition, we will have no access to alternative networks and services, on a timely basis if at all, in the event of any infrastructure disruption or failure. The Internet infrastructure in China may not support the demands necessary for continued growth in Internet usage.

*We may be subject to, and may expend significant resources in defending against, claims regarding the content and services we provide over our Websites.*

As our services may be used to download and distribute information to others, there is a risk that claims may be made against us for defamation, negligence, copyright or trademark infringement or based on the nature and content of such information. Furthermore, we could be subject to claims related to the online activities of our visitors and incur significant costs in our defense. In the past, claims regarding the nature and content of information that was posted online by visitors have been made in the United States against companies that provide online services. We could be exposed to liability for the selection of listings that may be accessible through our Websites or through content and materials that our visitors may post in classifieds, message boards, chat rooms or other interactive services. If any information provided through our services contains errors, third parties may make claims against us for losses incurred in reliance on the information.

We do not carry any liability insurance against of the foregoing risks.

*We do not have business insurance coverage.*

The insurance industry in China is still at an early stage of development. Insurance companies in China offer limited business insurance products, or offer them at a high price. As a result, we do not have any business liability, loss of data or disruption insurance coverage for our operations in China or the operations of our joint operators in China and overseas. Any business disruption, litigation or natural disaster might result in our incurring substantial costs and the diversion of our resources.

*We may not be able to generate sufficient cash flow in U.S. dollars in the future to service our debt obligations, which would cause us to default under our matching loans to Sohu and Fox Financial and/or under our U.S. dollar bank loan facilities.*

During 2016, certain of our subsidiaries entered into a series of matching-loans arrangements with certain subsidiaries of Sohu and certain subsidiaries of Fox Financial Technology Group Limited (“Fox Financial,” formerly known as “SoEasy Internet Finance Group Limited”), pursuant to which our subsidiaries are entitled to draw down U.S. dollar-denominated loans from the Sohu subsidiaries and the Fox Financial subsidiaries. See “Major Shareholders and Related Party Transactions – Related Party Transactions – Matching Loans Arrangement between Sohu and Changyou” and “– Matching Loans Arrangement between Changyou and Fox Financial” in Item 7 of this report. During 2018, we drew down from the offshore branches of certain banks loans in an aggregate amount of \$220 million that were secured by an equivalent amount of RMB deposits by us in the onshore branches of such banks. Since we conduct most of our business operations in Mainland China and generate most of our revenues in RMB, and our existing loans owed to the Sohu subsidiaries and the Fox Financial subsidiaries and to the offshore branches of such banks are denominated in U.S. dollars and are repayable in U.S. dollars, in order for us to make scheduled payments on those loans, we may need to rely on dividends or loans from our PRC subsidiaries, which would be subject to restrictions under PRC laws and regulations, including those regarding foreign exchange controls, and may be time-consuming. Also see “To fund any cash requirements we may have, we may need to rely on dividends, loans or advances made by our principal PRC subsidiaries AmazGame and Gamespace, which are subject to limitations and possible taxation under applicable PRC law.” If we fail to timely receive U.S. dollar-denominated cash from our PRC subsidiaries, we may default on our payment obligations with respect to those loans. In addition, the loans of \$220 million that we drew down from the offshore banks during 2018 carried floating interest rates based on the London Inter-Bank Offered Rate (the “LIBOR”); and as a result any rise in the LIBOR in the future could place further constraints on our cash flow in U.S. dollars.

*We face risks related to health epidemics and other natural disasters.*

Our business could be adversely affected by the effects of H1N1 influenza, H7N9 influenza, avian influenza or other epidemics or outbreaks. In recent years, there have been reports of occurrences of H1N1 influenza, H7N9 influenza and of avian influenza in various parts of China, including a few confirmed human cases and deaths. Any prolonged recurrence of H1N1 influenza, H7N9 influenza, avian influenza or other adverse public health developments in China may have an adverse effect on our business operations. Adverse effects could include illness and loss of our management and key employees, as well as temporary closure of our offices and related other businesses, such as server operations, upon which we rely, and a decrease in the number of our game players. Such loss of management and key employees or closures would severely disrupt our business operations. We have not adopted any written preventive measures or contingency plans to combat any future outbreak of H1N1 influenza, H7N9 influenza, avian influenza, or any other epidemics. In addition, other major natural disasters may also adversely affect our business by, for example, causing disruptions of the Internet network or otherwise affecting access to our games.

#### ***Risks Related to Our Class A Ordinary Shares and ADSs***

*We are a Cayman Islands company and, because judicial precedent regarding the rights of shareholders is more limited under Cayman Islands law than that under U.S. law, our shareholders may have less protection for their shareholder rights than they would under U.S. law.*

Our corporate affairs are governed by our memorandum and articles of association, the Companies Law of the Cayman Islands and the common law of the Cayman Islands. The rights of shareholders to take action against our directors, actions by minority shareholders and the fiduciary responsibilities of our directors to us under Cayman Islands law are to a large extent governed by the common law of the Cayman Islands. The common law of the Cayman Islands is derived in part from comparatively limited judicial precedent in the Cayman Islands as well as from English common law, which has persuasive, and in some cases binding, authority on a court in the Cayman Islands. The rights of our shareholders and the fiduciary responsibilities of our directors under Cayman Islands law are not as clearly established as they would be under statutes or judicial precedent in some jurisdictions in the United States, such as the State of Delaware, where many United States-based corporations are organized. In addition, shareholders in Cayman Islands companies may not have standing to initiate a shareholder derivative action in U.S. federal courts. As a result, our public shareholders may have more difficulty in protecting their interests through actions against us, our management, our directors or our major shareholders than would shareholders of a corporation incorporated in a jurisdiction in the United States such as Delaware.

*Holders of our ADSs may have difficulty enforcing judgments obtained against us.*

We are a Cayman Islands company and all of our assets are located outside the United States. A substantial portion of our current operations are conducted in the PRC. In addition, all of our directors and executive officers are nationals and residents of countries other than the United States. A substantial portion of the assets of these persons are located outside the United States. As a result, it may be difficult for holders of our ADSs to effect service of process within the United States upon these persons. It may also be difficult for holders of our ADSs to enforce in Cayman Islands courts or PRC courts judgments obtained in U.S. courts based on the civil liability provisions of the U.S. federal securities laws against us and our officers and directors, most of whom are not residents in the United States and the substantial majority of whose assets are located outside of the United States. In addition, there is uncertainty as to whether the courts of the Cayman Islands or the PRC would recognize or enforce judgments.

*Our operating results for a particular period could fall below our expectations or the expectations of investors or research analysts, resulting in a decrease in the price of our ADSs.*

Our operating results may vary significantly from period to period as a result of factors beyond our control, such as the slowdown in China's economic growth that occurred between the first quarter of 2010 and third quarter of 2012 and continued from 2014 through 2018, caused in part by measures adopted by the Chinese government intended to slow such growth and to temper real estate prices and inflation, and the significant instability recently experienced in the worldwide economy, and the European Community facing disruptions as a result of crises in the economies of Greece and Spain, among other countries, and such factors may be difficult to predict for any given period. Other factors also could cause significant fluctuations in our operating results, including the timing and success of our new game launches, our costs of developing and launching new games, and the level of user activity of our games in China during particular fiscal quarters. If our operating results for any period fall below our expectations or the expectations of investors or research analysts, the price of our ADSs is likely to decrease.

*Press reports in 2011 concerning possible increased scrutiny by Chinese authorities of the VIE structure used by us and various other Chinese companies publicly-traded in the United States appear to have created concern at the time among investors and to have caused the price of the ADSs of various Chinese companies, including us, that are publicly traded in the United States to drop, and similar reports in the future could have a similar adverse effect on the price of our ADSs.*

In 2011 various prominent western news outlets reported that the MOFCOM and the CSRC, among other Chinese regulatory authorities, might be considering increased scrutiny or enhanced regulation of Chinese companies that use VIE structures, such as we do, as a means of complying with Chinese laws restricting foreign ownership of certain businesses in China, including online game businesses such as ours. Some of such news reports also sought to draw a connection between accounting issues at certain Chinese companies, which were widely reported at the time, and the use of VIE structures. Such news reports appear to have had the effect of causing significant drops at the time in the market prices of the shares of many Chinese companies, including us. It is possible that in the future there will be increased scrutiny or enhanced regulation by Chinese regulatory authorities of Chinese companies, including us, that use VIE structures. See “If the PRC government determines that the VIE structure for operating our business does not comply with applicable PRC government restrictions on foreign investment in telecommunication industry, we could face severe penalties.” In addition, while we are not aware of any causal connection between the reported accounting scandals and the use of VIE structures, it is possible that holders or potential purchasers of our ADSs will believe that such a connection exists. Any of such circumstances could lead to further loss of investor confidence in Chinese companies and cause fluctuations in the market prices of our ADSs and, if such prices were to drop sharply, could subject us to shareholder litigation, which could cause the price for our shares to drop further.

*Proceedings instituted by the Securities and Exchange Commission (the “SEC”) against PRC affiliates of the “big four” accounting firms, including our independent registered public accounting firm, could result in our financial statements being determined to not be in compliance with the requirements of the Securities Exchange Act of 1934 (the “Exchange Act”).*

Starting in 2011, the PRC affiliates of the “big four” accounting firms, including our independent registered public accounting firm, were affected by a conflict between U.S. and PRC law. Specifically, for certain U.S.-listed companies operating and audited in mainland China, the SEC and the U.S. Public Company Accounting Oversight Board (the “PCAOB”) sought to obtain from the PRC big four affiliate firms access to their audit work papers and related documents. However, the firms were advised and directed that under PRC law they could not respond directly to the U.S. regulators on those requests, and that requests by foreign regulators for access to such papers in China had to be channeled through the CSRC. On December 7, 2018, the SEC and the PCAOB issued a joint statement highlighting continued challenges faced by these U.S. regulators in their oversight of financial statement audits of U.S.-listed companies with significant operations in China. However, it remains unclear what further actions the SEC and PCAOB will take to address the problem.

In late 2012, the impasse led the SEC to commence administrative proceedings under Rule 102(e) of its Rules of Practice and under the Sarbanes-Oxley Act of 2002 against the PRC big four affiliate accounting firms, including our independent registered public accounting firm. A first instance trial of the proceedings in July 2013 in the SEC’s internal administrative court resulted in an adverse judgment against the firms. The administrative law judge proposed penalties on the firms, including a temporary suspension of their right to practice before the SEC, although that proposed penalty did not take effect pending review by the Commissioners of the SEC. On February 6, 2015, before a review by the Commissioners had taken place, the firms reached a settlement with the SEC. Under the settlement, the SEC accepted that future requests by the SEC for the production of documents would normally be made to the CSRC. The firms were to receive matching requests, and were required to abide by a detailed set of procedures with respect to such requests, which in substance required them to facilitate production via the CSRC. If they failed to meet specified criteria during a period of four years starting from the settlement date, the SEC retained authority to impose a variety of additional remedial measures on the firms depending on the nature of the failure. Under the terms of the settlement, the underlying proceeding against the four China-based accounting firms was deemed dismissed with prejudice four years after entry of the settlement. The four-year mark occurred on February 6, 2019. However, we cannot predict if the SEC will further challenge the four China-based accounting firms’ compliance with U.S. law in connection with U.S. regulatory requests for audit work papers or if the results of such a challenge would result in the SEC imposing penalties such as suspensions. If additional remedial measures are imposed on the Chinese affiliates of the “big four” accounting firms, including our independent registered public accounting firm, we could be unable to timely file future financial statements in compliance with the requirements of the Exchange Act.

In the event the Chinese affiliates of the “big four” become subject to additional legal challenges by the SEC or the PCAOB, depending upon the final outcome, listed companies in the United States with major PRC operations could find it difficult or impossible to retain auditors in respect of their operations in China. If our independent registered public accounting firm was denied, even temporarily, the ability to practice before the SEC and we were unable to timely find another registered public accounting firm to audit and issue an opinion on our financial statements, our financial statements could be determined not to be in compliance with the requirements of the Exchange Act. Such a determination could ultimately lead to the delisting of our ADSs and Class A Ordinary Shares from the Nasdaq Global Select Market or termination of the registration of our ADSs and Class A Ordinary Shares under the Exchange Act, or both, which would substantially reduce or effectively terminate the trading of our ADSs in the United States.



*We are a “controlled company” within the meaning of the Nasdaq Listing Rules and as a result we are entitled to, and do, rely on exemptions from certain corporate governance requirements that provide protection to shareholders of other companies. We also have invoked one of the “home country practice” exceptions to the corporate governance requirements of the Nasdaq Listing Rules that are available to foreign private issuers such as us, and we may invoke additional such exceptions in the future.*

Because Sohu owns more than 50% of the total voting power of our ordinary shares, we are a “controlled company” under the Nasdaq Listing Rules. We rely on certain exemptions that are available to controlled companies from Nasdaq corporate governance requirements, including the following, which we do not intend to meet voluntarily:

- that we have a corporate governance and nominating committee that is composed entirely of independent directors with a written charter addressing the committee’s purpose and responsibilities;
- that we have a compensation committee that is composed entirely of independent directors with a written charter addressing the committee’s purpose and responsibilities; and
- for an annual performance evaluation of the nominating and governance committee and compensation committee.

In November 2014 our Board of Directors approved and we implemented an increase in the number of Class A ordinary shares reserved for issuance under our 2014 Share Incentive Plan without shareholder approval, which would otherwise have been required by the corporate governance requirements of the Nasdaq Listing Rules, by invoking one of the “home country” exceptions from certain of the Nasdaq Listing Rules that are available to foreign private issuers such as us, and in the future we may invoke additional home country exceptions from the Nasdaq Listing Rules’ corporate governance requirements.

As a result of our use of the “controlled company” exemptions and of a “home country” exception to these requirements of the Nasdaq Listing Rules, holders of our ADSs do not have the same protection afforded to shareholders of companies that are subject to all of Nasdaq’s corporate governance requirements.

*The market price for our ADSs has been and may continue to be volatile.*

The trading price of our ADSs has been and may continue to be subject to wide fluctuations. During the period from April 2, 2009, the first day of trading of our ADSs on the Nasdaq Global Select Market, until March 15, 2019, the trading price of our ADSs ranged from \$12.68 to \$52.00 per ADS, and the closing sale price on March 15, 2019 was \$19.25 per ADS. The market price for our ADSs may continue to be volatile and subject to wide fluctuations in response to factors including the following:

- announcements of competitive developments, including new games by our competitors;
- regulatory developments in our target markets affecting us, our customers or our competitors;
- actual or anticipated fluctuations in our quarterly operating results;
- failure of our quarterly financial and operating results to meet market expectations or failure to meet our previously announced guidance;
- changes in financial estimates by securities research analysts;
- changes in the economic performance or market valuations of other Internet or online game companies;
- additions or departures of our executive officers and other key personnel;
- announcements regarding intellectual property litigation (or potential litigation) involving us or any of our directors and officers;
- fluctuations in the exchange rates between the U.S. dollar and the RMB;
- release or expiration of transfer restrictions on our outstanding ordinary shares and ADSs; and
- sales or perceived sales of additional shares or ADSs.

In addition, the securities markets have from time to time experienced significant price and volume fluctuations that are not related to the operating performance of particular industries or companies. Such market fluctuations may have a material adverse effect on the market price of our ADSs.

*Holders of our ADSs may be subject to limitations on transfer of their ADSs.*

Our ADSs are transferable on the books of the depository. However, the depository may close its transfer books at any time or from time to time when it deems it expedient in connection with the performance of its duties. In addition, the depository may refuse to deliver, transfer or register transfers of ADSs generally when our books or the books of the depository are closed, or at any time if we or the depository deem it advisable to do so because of any requirement of law or of any government or governmental body, or under any provision of the Deposit Agreement governing our ADSs (the “Deposit Agreement”), which was filed as an exhibit to our Registration Statement on Form F-1 filed with the SEC on March 17, 2009 (File No. 333-158061), or for any other reason.

*Holders of ADSs have limited voting rights and may not receive voting materials in time to be able to exercise their right to vote.*

Except as described in this annual report and in the Deposit Agreement, holders of our ADSs will not be able to exercise voting rights attaching to the shares represented by our ADSs on an individual basis. Holders of our ADSs may instruct the depositary how to exercise the voting rights attaching to the shares represented by the ADSs. Holders may not receive voting materials in time to instruct the depositary to vote, and it is possible that direct holders of ADSs, or persons who hold their ADSs through brokers, dealers or other third parties, will not have the opportunity to exercise a right to vote. In addition, due to the different voting powers attached to the two classes of our ordinary shares, our controlling shareholder, Sohu, which holds our Class B ordinary shares, controls 95.3% of the total voting power of our ordinary shares as of the date of this report. As a result, the ability of holders of our ADSs to affect the outcome of any matter subject to shareholder vote is very limited.

*ADS holders' right to participate in any future rights offerings may be limited, which may cause dilution to their holdings and ADS holders may not receive cash dividends if it is impractical to make them available to such holders.*

We may from time to time distribute rights to our shareholders, including rights to acquire our securities. However, we cannot make rights available to ADS holders in the United States unless we register the securities to which the rights relate under the Securities Act of 1933 (the "Securities Act") or an exemption from registration requirements is available. Also, under the Deposit Agreement, the depositary bank will not make rights available to ADS holders unless the distribution to ADS holders of both the rights and any related securities are either registered under the Securities Act or exempted from registration under the Securities Act. We are under no obligation to file a registration statement with respect to any such rights or securities or to endeavor to cause such a registration statement to be declared effective. Moreover, we may not be able to establish an exemption from registration under the Securities Act. Accordingly, holders of our ADSs may be unable to participate in our rights offerings and may experience dilution in their holdings.

In addition, the depositary of our ADSs has agreed to pay to ADS holders the cash dividends or other distributions it or the custodian receives on our ordinary shares or other deposited securities after deducting its fees and expenses. ADS holders will receive these distributions in proportion to the number of ordinary shares such holders' ADSs represent. However, the depositary may, at its discretion, decide that it is inequitable or impractical to make a distribution available to any holders of ADSs. For example, the depositary may determine that it is not practicable to distribute certain property through the mail, or that the value of certain distributions may be less than the cost of mailing them, or that the distribution requires certain governmental approval, such as requirement for registration or approval for currency conversion. In these cases, the depositary may decide not to distribute that property and ADSs holders will not receive that distribution.

*Holders of our ADSs and holders of our Class A ordinary shares will experience dilution when additional Class A ordinary shares are issued in settlement of restricted share units or upon exercise of options.*

Holders of our ADSs and holders of our Class A ordinary shares will experience dilution to the extent that additional Class A ordinary shares are issued upon settlement of restricted share units or exercise of outstanding options that we may grant from time to time. As of March 15, 2019, there were outstanding options for the purchase of 860,000 Class A ordinary shares at a nominal price.

*We may need additional capital and may sell additional ADSs or other equity securities or incur indebtedness, which could result in additional dilution to our shareholders or increase our debt service obligations.*

We may require additional cash resources due to changed business conditions or other future developments, including any investments or acquisitions we may decide to pursue. If our cash resources are insufficient to satisfy our cash requirements, we may seek to sell additional equity or debt securities or obtain a credit facility. The sale of additional equity securities or equity-linked debt securities could result in additional dilution to our shareholders. The incurrence of indebtedness would result in debt service obligations and could result in operating and financing covenants that would restrict our operations. We cannot assure you that financing will be available in amounts or on terms acceptable to us, if at all.

*Substantial future sales of our ADSs or ordinary shares in the public market, or the perception that these sales could occur, could cause the price of our ADSs to decline.*

Additional sales of our ADSs or ordinary shares in the public market, or the perception that these sales could occur, could cause the market price of our ADSs to decline. As of March 15, 2019, there were 36,251,420 of our Class A ordinary shares and 70,250,000 of our Class B ordinary shares outstanding. As of March 15, 2019, there were no outstanding Class A restricted share units, with each such restricted share unit settleable upon vesting by the issuance of one Class A ordinary share, and outstanding options for the purchase of 860,000 Class A ordinary shares at a nominal price. In addition, we may grant or sell additional options, restricted shares or other share-based awards in the future under our share incentive plan to our management, employees and other persons, the settlement and sale of which may further dilute our shares and drive down the price of our ADSs.

*We believe that we may be classified as a passive foreign investment company, or PFIC, for the 2018 taxable year, which would likely result in adverse United States federal income tax consequences to U.S. holders of our ADSs or Class A ordinary shares.*

We believe that we may have been classified as a PFIC for United States federal income tax purposes for our 2018 taxable year ended November 30, 2018. There can be no assurance that we will not continue to be classified as a PFIC in the current taxable year or in any future taxable year. The determination of whether we would continue to be treated as a PFIC is based in significant part on our operations and the composition of our earnings and assets (including goodwill) for a given taxable year, including the valuation of our assets based on the market price of our ADSs.

If we are treated as a PFIC for any taxable year during which a U.S. holder (as defined under “Taxation—United States Federal Income Taxation—Passive Foreign Investment Company”) holds an ADS or a Class A ordinary share, certain adverse United States federal income tax consequences likely would apply to such U.S. holder. See “Taxation—United States Federal Income Taxation—Passive Foreign Investment Company” in Item 10 of this annual report.

If we are a PFIC, a U.S. holder of our ADSs or Class A ordinary shares could make a variety of elections that might alleviate certain of the tax consequences referred to above, and one of these elections may be made retroactively. However, it is expected that the conditions necessary for making certain of such elections will not apply in the case of our ADSs or Class A ordinary shares. See “Taxation—United States Federal Income Taxation—Passive Foreign Investment Company” in Item 10 of this annual report.

U.S. holders and prospective holders of our ADSs are urged to consult their own tax advisors regarding the application of the PFIC rules to an investment in our ADSs or Class A ordinary shares.

#### **ITEM 4. INFORMATION ON THE COMPANY**

##### ***History and Development of the Company***

We began operations as the games business unit within the Sohu Group in 2003. In May 2007, the Sohu Group launched TLBB, its first in-house developed PC game.

In 2007, the Sohu Group reorganized its online games business. As part of the reorganization, Changyou.com Limited was incorporated in the Cayman Islands on August 6, 2007 as an indirect wholly-owned subsidiary of Sohu, to hold the PC games business of the Sohu Group. Sohu transferred to us, effective December 1, 2007, all of its assets and operations relating to its PC games business unit, and we assumed all the liabilities associated with Sohu’s games business unit. On April 2, 2009, ADSs offered in our initial public offering commenced trading on the Nasdaq Global Select Market.

Our online games business has been the main driver for our revenue growth since we were incorporated. In 2010, we began engaging in the cinema advertising business, which has enjoyed the strong growth in China’s cinema and movie industry in recent years. In 2011, we began offering online advertising services on 17173.com Website, which is one of the leading game information portals in China, as a main part of our platform channel business. From 2011 to 2015, we also generated revenues from Web games operated and developed by 7Road, which we fully divested in 2015. Online games, platform channels and cinema advertising constitute our three business segments.

The majority of our revenues is derived from our business operations in China, which are conducted primarily through our direct and indirect wholly-owned subsidiaries AmazGame, Changyou Chuangxiang, Shanghai Jingmao, Gamespace and Beijing Jingmao, and our VIEs Gamease, Guanyou Gamespace and Shanghai ICE.

Our principal executive offices are located at the Changyou Building, Raycom Creative Industrial Park, No. 65 Bajiao East Road, Shijingshan District, Beijing 100043, People’s Republic of China. Our telephone number at this address is (8610) 6192-0800. Our registered office in the Cayman Islands is located at the P.O. Box 31119 Grand Pavilion, Hibiscus Way, 802 West Bay Road, Grand Cayman, KY1-1205 Cayman Islands.

The following is a summary of our significant acquisitions and divestments since our initial public offering:

In May 2010, Changyou HK acquired from ICE Entertainment Limited 100% of the equity interests in ICE Entertainment (HK) Limited (“ICE HK”). ICE HK holds 100% of the registered capital of our PRC subsidiary ICE Information.

In May 2010, AmazGame, through its wholly-owned subsidiary Beijing Yang Fan Jing He Information Consulting Co., Ltd. (“Yang Fan Jing He”), acquired 50% of the equity interests in Shanghai Jingmao, which primarily engages in the cinema advertising business. In January 2011, Yang Fan Jing He acquired the remaining 50% of the equity interests in Shanghai Jingmao. In April 2012, in connection with an internal reorganization, Yang Fan Jing He acquired 100% of the equity interests in Beijing Jingmao from Shanghai Jingmao.

In May 2011, we acquired 68.258% of 7Road, which was primarily engaged in the development and operation of Web games. In June 2012, we completed the reorganization of 7Road into a Cayman Islands holding company structure. Upon completion of the reorganization, we held 71.926% of the equity interests in 7Road. In June 2013, we acquired all of the shares of 7Road held by the non-controlling shareholders.

In August 2015, we completed the sale to (i) Shanghai Yong Chong Investment Center LP, a PRC limited partnership, of all of the equity interests in Shenzhen 7Road, and (ii) Supermax Holdings Group Limited, a British Virgin Islands company, of all of the equity capital of Changyou My Sdn. Bhd, a Malaysia company, and Changyou.com (UK) Company Limited, a United Kingdom company, which are engaged in the online game business in Malaysia and the United Kingdom, respectively. The dispositions included our Web game business and certain other assets. The aggregate consideration for these transactions was \$205 million in cash.

In December 2011, we completed the acquisition from Sohu of certain assets and business operations associated with the 17173.com Website, which is one of the leading game information portals in China, and began to operate the 17173.com Website.

In November 2013, we entered into an investment agreement with Beijing Kunlun Tech Co., Ltd. and certain of its affiliates (collectively, the “Kalends Group”), pursuant to which we acquired in December 2013 62.5% of the equity interests, and the Kalends Group held the remaining 37.5% of the equity interests, on a fully-diluted basis, in TalkTalk Limited (“TalkTalk”), a British Virgin Islands company which held all of the assets associated with RaidCall. In March 2015, the Kalends Group pursuant to the investment agreement transferred additional ordinary shares of TalkTalk held by it to us, and TalkTalk issued additional ordinary shares to us, which increased our equity interests in TalkTalk to 70% on a fully-diluted basis. On March 15, 2019, our Board of Directors approved a plan for us to cease operation of RaidCall.

In July 2014, we purchased from the existing shareholders of MoboTap, which is the mobile technology developer behind the Dolphin Browser, shares of MoboTap representing 51% of the equity interests in MoboTap on a fully-diluted basis. In addition, we had the right to purchase up to 10% of the equity interests in MoboTap from the non-controlling shareholders before a qualified IPO of MoboTap. We also acquired from MoboTap for \$30 million a zero-coupon convertible bond issued by MoboTap, due in 2019. In January 2016, MoboTap redeemed \$24 million of the convertible bond, and in December 2017, MoboTap redeemed the remaining \$6 million of the convertible bond. In March 2018, we disposed of all of the equity interests in MoboTap.

## **BUSINESS OVERVIEW**

Our three primary businesses are the online game business; the platform channel business, which consists primarily of online advertising; and the cinema advertising business. The online game business is our core business.

We are a leading online game developer and operator in China as measured by the popularity of our PC game TLBB and our mobile game Legacy TLBB Mobile. We engage in the development, operation and licensing of online games for PCs and mobile devices. This includes PC games, which are interactive online games that are accessed and played simultaneously by hundreds of thousands of game players through personal computers and require that local client-end game access software be installed on the computers used, and mobile games, which are played on mobile devices and require an Internet connection.

Our platform channel business mainly consists of the operation of the 17173.com Website, one of the leading information portals in China, which provides news, electronic forums, online videos and other information services on online games to game players.

Our cinema advertising business consists primarily of the acquisition, from operators of movie theaters, and the sale, to advertisers, of pre-film advertising slots, which are advertisements shown before the screening of a movie in a cinema theater.

Our revenues increased from \$525.4 million for the year ended December 31, 2016 to \$580.3 million for the year ended December 31, 2017, and decreased to \$485.8 million for the year ended December 31, 2018. Our net income attributable to Changyou.com Limited decreased from \$144.9 million for the year ended December 31, 2016 to \$108.8 million for the year ended December 31, 2017, and decreased to \$84.3 million for the year ended December 31, 2018.

## Online Games

### *Business model*

Our game players typically access our games through personal computers and mobile devices, such as mobile phones and tablets, connected to the Internet. In order for players to access our PC games, our game access software must be installed in the computer being used. Game players using PCs can typically download our game access software, interim updates and expansion packs directly from our main game Website. Game players access our mobile games by downloading our mobile game applications mostly from third-party mobile application stores or, to a lesser extent, from our game Website. Prior to the sale of 7Road in August 2015, our online games also included Web games, which became an insignificant part of our online games business following the sale.

Our online games include a variety of game genres, including MMORPGs and advanced casual games such as CCGs. We are also developing, and plan to expand our game portfolio with, additional types of advanced casual games, such as MOBAs and SLGs. MMORPGs are massive multiplayer online role playing games that allow a large number of players to take on the role of a character and interact with one another within a virtual world. Advanced casual games include CCGs, which are collectible card games in which players collect cards and compete to win by using card sets with different functions; MOBAs, which are multiplayer online battle arena games that allow a player to join a team and work with his or her teammates to compete in a mapped field in order to achieve a common goal; and SLGs, which are simulation games that allow players to control, manage and use game characters and items and to design and implement their own strategies to win the games.

Our games are operated under the item-based revenue model, meaning game players can play our games for free, but may choose to pay for virtual items, which are non-physical items that game players can purchase and use within a game, such as gems, pets, fashion items, magic medicine, riding animals, hieroglyphs, skill books and fireworks. Through virtual items, players are able to enhance or personalize their game environments or game characters, accelerate their progress in our games and share and trade with friends.

For players who choose to purchase virtual goods, we deliver enhanced gameplay experiences and benefits, such as:

*Accelerated Progress.* Many of our games offer players the option to purchase items that can accelerate their progress in the game and increase their capabilities, so that they level up more quickly and compete more effectively against others in the game. While we sell many items that accelerate progress in our games, we monitor and carefully balance the disparity in capabilities between paying and non-paying game players to avoid discouraging non-paying game players and to keep the game challenging and interesting for paying game players.

*Enhanced Social Interaction.* We use a variety of virtual items to promote interaction and to facilitate relationship-building among game players in our games.

*Personalized and Customized Appearance.* Many of our games offer players the option to purchase decorative and functional items to customize the appearance of their characters, pets, vehicles, houses and other in-game possessions to express their individuality.

*Gifts.* Many of our games offer players the option to purchase gift items to send to their friends. Examples of gift items include decorative items and time-limited items for special holiday events and festivals, such as Valentine's Day, Spring Festival (Chinese New Year) and Christmas.

Our online game business model includes games that we self-operate and games that we license out to third-party operators.

### Self-operated Games

For self-operated games, we determine the price of virtual items based on the demand or expected demand for such virtual items. We may change the pricing of certain virtual items based on their consumption patterns. We host the games on our own servers and are responsible for the sale and marketing of the games as well as customer service. Our self-operated games include PC games and mobile games developed in house as well as PC games and mobile games that we license from or jointly develop with third party developers.

### *Sales of Game Points and Revenue Collection*

For self-operated PC games, we collect proceeds through the sale of game points. We sell game points directly to our game players. Game players can purchase game points and charge them to their accounts directly. After logging in to their accounts, game players can choose to pay either from their bank accounts or through other payment methods, including third-party online payment platforms. We also sell prepaid game cards for our PC games to a range of regional third-party distributors in China. Regional distributors sell prepaid game cards to sub-distributors or directly to Internet cafés. Sub-distributors then sub-distribute prepaid game cards to retail outlets, including Internet cafés and various Websites, as well as through various online channels. We typically collect payment from our distributors upon delivery of our prepaid game cards.

For self-operated mobile games, we sell game points to our game players via third-party mobile application stores. Game players purchase game points and charge them to their accounts through the mobile application stores. The mobile application stores in turn pay us proceeds after deducting their pre-agreed revenue-sharing amounts.

For self-operated games that are licensed from or jointly developed with third-party developers, we pay the developers license fees for the exclusive right to operate the games domestically or globally, as well as revenue-sharing payments over the duration of the licenses.

### *Marketing*

For self-operated games, we employ a variety of innovative online and offline marketing methods, including online and offline advertising, social media, and in-game marketing. We use different methods to target different demographic groups of game players.

For online marketing, we are able to leverage our game information portal, the 17173.com Website, as well as other game Websites to promote our games. We are able to leverage our affiliation with Sohu, and target Sohu's large user base as potential players of our games, by advertising on Sohu's various Websites, which typically provide a direct link to our games. For games that we believe are likely to be successful, we may seek celebrity endorsements and work with Internet celebrities on live broadcasting platforms to create additional publicity for the games.

We access online social media by advertising in online videos and marketing our games through various social networking Websites, mobile applications and online forums to create a vital effect among game players.

For offline marketing, we promote our games through pre-film advertisements, leveraging our cinema advertising business, which covers more than 11,000 cinema screens in approximately 220 cities in China.

In addition, we launch in-game promotional events. We also create in-game events to attract existing and new game players through event-related features, such as offering special holiday-edition virtual items to enhance game player participation at holiday time.

For mobile games in particular, we work closely with Apple store and Android mobile application stores to market our games. We design and implement different marketing strategies for different game genres to attract the genres' target players. We work with performance-based online advertising platforms such as *Guang Dian Tong* and *Fen Si Tong*, where we can target different user groups by gender, region, age group and other categories. For games with a specific user group, we advertise on mobile applications, websites and other media outlets that cater to the same user group.

We are also planning to promote our games in overseas markets with a targeted marketing approach, leveraging our data collection and analysis system. Our overseas marketing strategies also include using social media platforms and search engine management to promote our games.

### *Customer Service*

For self-operated and jointly-operated games, we aim to provide quality customer service and be responsive to our game players' needs. Our game players can seek our customer service support 24 hours a day, seven days a week, either via phone or by submitting their feedback online. In addition, we have physical service centers in Beijing and Tianjin, which are open to walk-in game players during normal business hours. We currently have around 104 dedicated customer service representatives.

Feedback collected by our customer service team and by third-party operators is important to the integration of our product development and game operations teams. The information collected forms the basis of our feedback database, which helps us design change, and upgrade expansion packs for our games. See "Business Overview—Our Games."

### *Licensed-out Games*

We also authorize third parties to operate our online games. In 2016 and 2018, we entered into agreements with Tencent pursuant to which we granted an exclusive license to Tencent to distribute and operate within China our mobile games Legacy TLBB Mobile and Xuan Yuan Jian, which were launched in May 2017 and October 2018, respectively. We have also licensed other third-party operators to distribute and operate within China certain of our other mobile games, including Legend of Sword and Fairy 5. In addition, we license our PC game TLBB and mobile games Legacy TLBB Mobile, TLBB 3D and Fengyun to third-party operators in selected overseas markets outside of China, including Hong Kong, Macau, Taiwan, Singapore, Malaysia, Thailand, Vietnam and South Korea.

The licensed-out games include PC games and mobile games developed in house as well as mobile games licensed from and jointly developed with third-party developers. Under our licensing arrangements with third-party operators, the operators pay us upfront license fees and we have revenue sharing rights over the terms of the licenses. The licenses are typically for a term of one to three years. We provide updates and expansion packs for the licensed games, typically after we launch the updates and expansion packs in China.

For licensed-out games, the third-party operators are responsible for all operations and costs, including marketing and customer service, as well as the leasing and maintenance of servers.

### ***Our Games***

Our online games include games that are developed in-house and games that are licensed from or jointly developed with third-party developers. Each of our games is tested against all the criteria set by our Product Appraisal Committee, irrespective of whether the games are in-house developed or licensed from or jointly developed with third-party developers, and only those games that have successfully passed the tests can move on to the next stage.

### ***In-house Developed Games***

We have adopted an Integrated Product Development procedure where a rigorous set of testing standards set by our Product Appraisal Committee are applied to all in-house developed games at each stage of development. Our game development process generally includes the following key steps, which apply to the development of PC games and mobile games:

- *Identification and Discovery:* Identify new opportunities for innovation based on the current needs and demands of target game players. We conduct focus group sessions with our target game players to pitch our ideas and understand their thoughts. The feedback we receive from our game players helps us to generate and develop new concepts for innovative games.
- *Concept Development and Testing:* Once a concept has been selected, the design team will formulate a complete plan for the new game, which will include the choice of game titles and characters, core gameplays, artistic styles and qualities. We share the plan with a group of users to test its appeal to game players and the feedback will be reviewed by the Product Appraisal Committee.
- *Prototype and Demo Testing:* Once a new game plan passes the review of the Product Appraisal Committee, the design department creates a demo laying out preliminary artistic features and gameplay, which will be further reviewed by game players and the Product Appraisal Committee.
- *Development and Consumer Engagement:* If the demo passes a critical review process by the Product Appraisal Committee, the project enters its official development phase. A demo that allows players to play for thirty minutes will be created. At this stage, the Product Appraisal Committee mainly focuses on the game's application and server architecture, and its artistic quality, in evaluating the project. More players will also be involved to try out the game, helping us evaluate the game's technical stability and game content.
- *Testing and Improvement through Successive Versions:* If the game's thirty-minute version passes review, it will then be developed to fuller versions that can be played for a consecutive number of days. Stringent testing criteria are set for a number of important milestones, such as for the one-day version, the three-day version and the seven-day version. Further along in the game's development phase, more players are brought in to try out the game. The Product Appraisal Committee evaluates every version of the game based on user conversion rates, user retention, user satisfaction, and the game's payment system. The game will only be moved to the next stage if it passes all previous tests.
- *Open Beta Testing:* Lastly, if the game passes all of our testing standards, our Product Appraisal Committee will make the final decision to conduct open beta testing to test the new game under open market conditions and introduce the new game to players.

Our games are developed through coordination among teams of program developers, game designers, graphic artists and audio designers. We try to design each of our games to cater to different audiences to grow our overall player base rather than merely shifting players from one game to another. Throughout the development of each game, real game players are invited to give us their feedback and suggestions, which we carefully evaluate and take into account in the next stage of development. At each stage of development, before we bring in real game players for testing, we make sure all our in-house technical tests, including tests on server stress, client-end compatibility and information security, have been successful, in order to ensure optimal game performance. We also take measures throughout the whole game development process to maximize product quality and development efficiencies. For example, we have an expert team consisting of experienced art experts and technical experts who provide suggestions and solutions for each important stage of game development so as to ensure strong artistic quality; and we use basic modules of games to develop universal components such as chat systems and location-based social communities to enhance the quality and efficiency of our game development.

As of December 31, 2018, we had 1,191 product development personnel responsible for developing new games as well as game enhancements and expansion packs.

*Games Licensed from or Jointly Developed with Third-Party Developers*

We have obtained exclusive licenses to operate and further develop some of our online games from third-party developers in China. For a summary of the primary PC games and mobile games that we currently operate that are licensed from or jointly developed with third parties, see “-Tables- Games Licensed from or Jointly Developed with Third-Party Developers.”

*Existing Game Enhancement*

We derive many of our game development and enhancement ideas from our game players by maintaining multiple channels whereby we obtain our game players’ ideas and feedback. These include online surveys, online discussion forums, in-game instant messaging, online customer service and a link to a form for feedback within our games. We use this information not only to create new games with the same quality of design, content and programming, but also to enhance existing games that we have either developed in-house or licensed from third parties.

We typically release game updates for our games once or twice a week and more significant enhancements in the form of expansion packs every few months or as regularly as necessary based on game players’ feedback, market demand and other factors. Our expansion packs typically include features such as new territories, themes, tasks, characters, virtual items and other enhanced features. After testing, the game updates and expansion packs are typically distributed electronically through a game Website or mobile application stores. We have found that expansion packs effectively increase game players’ interest in the game and enhance the game-playing experience by keeping the game-playing experience fresh even for long-time game players. We believe that the expansion packs help us to maintain game player loyalty, and in turn extend the lifespans of our games.












*Rights from Third Parties to Game Titles and Characters*

We have obtained exclusive rights from third parties to develop and operate PC games and mobile games based on their titles and characters. For a summary of the license agreements, see “-Tables- Rights from Third Parties to Game Titles and Characters.”








## Tables

### Key Games in Operation

	Name	Type	Genre	Initial Launch Date	In-house developed, licensed or jointly developed	Description
	TLBB	PC game	3D martial arts MMORPG	May 2007	In-house developed	The game features a combination of martial arts-style-fighting and community-building among its game players, with a variety of interesting and interactive gameplay.
	Legacy TLBB Mobile	Mobile game	3D martial arts MMORPG	May 2017	In-house developed	Legacy TLBB Mobile is a mobile game developed on the essence of the TLBB PC game. The game features and enriches the theme of “Clans and Brotherhood,” aiming to re-create classic gaming experiences of users. We have licensed the publishing rights for Legacy TLBB Mobile to Tencent.
	Blade Online series	PC game	2.5D martial arts MMORPG	Blade Online (BO) in October 2004; Blade Hero II (Blade Hero 2) in September 2009	In-house developed	Consists of two PC games, Blade Online and its sequel Blade Hero 2. Both games are martial arts-style fighting games set to the backdrop of a Chinese myth.
	TLBB 3D	Mobile game	3D martial arts MMORPG	October 2014	In-house developed	Adapted from Louis Cha’s novel of the same name, the game re-enacts the story of the original novel and blends in some of the elements of the PC version of the game.
	Dao Jian Dou Shen Zhuan	Mobile game	2.5D martial arts MMORPG	December 2017	In-house developed	Dao Jian Dou Shen Zhuan features Chinese elements in its art style, with a rich clan battle system, social functions and hitfeel.
	Free Style 2	Mobile game	2.5D martial arts ACG	May 2017	Licensed	Free style 2, which we licensed from a Chinese developer, is a basketball-themed 3v3 advanced casual game.
	Da Hua Shui Hu	PC game	2D Q-style MMORPG	March 2010	Licensed	Based on a story from one of the four great classical novels of Chinese literature, “Outlaws of the Marsh,” which is about the adventures of 108 heroes in the Northern Song dynasty. We have a permanent license to operate this game.
	Warframe	PC game	3D TPS	September 2015	Licensed	A Sci-fi themed shooter game licensed from a company in Canada. Players fight in a galactic environment, while exploring unlimited worlds and battle scenes.
	Na Yi Jian Jiang Hu	Mobile game	3D martial arts MMORPG	September 2018	Licensed	A martial arts-style fighting game that features a unique social system.
	Legend of Sword and Fairy 5	Mobile game	3D CCG	December 2015	In-house developed	A real-time card combat game, based on a successful offline PC game.
	Xuan Yuan Jian	Mobile game	3D martial arts MMORPG	October 2018	In-house developed	A martial arts-style game based on the famous Xuan Yuan Jian PC game series. We have licensed the publishing rights for Xuan Yuan Jian to Tencent.

Games Licensed from or Jointly developed with Third-Party developers

	<u>Year</u>	<u>Games</u>	<u>Genre</u>	<u>Licensed/Jointly developed</u>	<u>Developer</u>
	2003	Blade Online*	PC game	Licensed	A Beijing game studio
	2010	Da Hua Shui Hu	PC game	Licensed	A China game studio
	2015	Warframe	PC game	Licensed	A Canadian game studio
	2017	Free Style 2	Mobile game	Licensed	A China game studio
	2018	Na Yi Jian Jiang Hu	Mobile game	Licensed	A China game studio

\* In 2007, we obtained the rights to the source code of Blade Online. We own the rights to all improvements we make to Blade Online.

Rights from Third Parties to Game Titles and Characters

<u>IP</u>	<u>Game Genre</u>	<u>Authorized Rights</u>	<u>Licensed from</u>
Blade Hero	PC game	Exclusive right to adapt and operate in mainland China	Pixel Game
TLBB	PC game	Exclusive right to adapt and operate in mainland China, Hong Kong, Macau and Taiwan	Louis Cha
Duke of Mount Deer	PC game	Exclusive right to adapt and operate in mainland China, Hong Kong, Macau and Taiwan	Louis Cha
Legend of Sword and Fairy	PC game	Exclusive worldwide right to adapt and operate	Softstar Technology
Ten of Louis Cha's martial arts novels including TLBB	Mobile game	Exclusive right to adapt and operate in mainland China	Louis Cha
Feng Yun	Mobile game	Exclusive worldwide right to adapt and operate	Jonesky (HK) Limited
Six of Huangyi's martial arts novels	Mobile game	Exclusive right to adapt and operate in mainland China, Hong Kong, Macau and Taiwan	Chinese Gamer
Xuan Yuan Jian	Mobile game	Exclusive worldwide right to adapt and operate	Softstar Technology
Xian Lu Zheng Feng	Mobile game	Exclusive right to adapt in mainland China and operate worldwide	Croton Media
Tetris	Mobile game	Exclusive Right to adapt and operate in mainland China	Tetris
Yong Ye Jun Wang	Mobile game	Exclusive worldwide right to adapt and operate	Wuxi Zuihong
Fengshen Trilogy	Mobile game	Exclusive worldwide right to adapt and operate	Shanghai Biyou

## **Platform Channel Business**

### ***17173.com Website***

The 17173.com Website was launched in 2001 as the first online game information portal in China. With over 1,000 game zones and tens of millions of monthly unique visitors, the 17173.com Website is one of the largest game information and community Websites in China, and in the Chinese online game market covers over 95% of PC games, more than 13,000 mobile games, and more than 20,000 games on the digital game distribution platform Steam. With its high brand awareness, credibility, and strong relationships with advertisers, the 17173.com Website has become one of the best marketing platforms for domestic game companies, including our own. In addition, we work with users on the 17173.com Website to evaluate and improve the quality of our games. We generate online advertising revenues from providing advertising services to third-party advertisers on the 17173.com Website.

### ***Services and Products Offered to Individual Users***

We are focused on providing players with game-related media services such as news, online communities, and video for PC games, mobile games and Web games. To cater to different viewing habits, we have also launched a variety of products on mobile applications and on HTML5. We have also built a specialized and integrated online media portal that works seamlessly across devices.

### ***Services and Products Offered to Online Advertisers***

Our offerings enable advertisers to post their advertisements in different forms, including text, rich media and video advertisements. Our online advertising products include banners, links, logos, buttons and stream advertisements placed on our Websites and sponsorships that typically focus on a particular event or a particular Website area. We charge most advertisers a fixed fee based on the length of time an advertising campaign runs, and fees vary based on whether advertisements run on PCs or mobile devices. We also use the Cost Per Impressions pricing model to cater to different advertisers, and particularly small-sized advertisers. Our standard advertising charges vary depending on the terms of the contract and the advertisement's location within the 17173.com Website. Discounts from standard rates are typically provided for higher volume, longer-term advertising contracts, and may be provided for promotional purposes. We also enter into arrangements with small-sized online game platforms and receive revenue-sharing payments from revenues collected from game players directed to such platforms through the 17173.com Website.

During the year ended December 31, 2018, there were a total of 126 companies advertising on the 17173.com Website and related applications. Our end customers include leading online game companies in China, as well as independent game studios.

### ***Other Platform Channel Products***

We offer a number of software applications for PCs and mobile devices through RaidCall. RaidCall provides online music and entertainment services, primarily in Taiwan. Revenues generated from software applications that we offer through RaidCall are included in our IVAS revenues.

## **Cinema Advertising Business**

We began engaging in the cinema advertising business, where we purchase pre-film cinema advertising slots from movie theater operators and resell them to advertisers, in 2010. These pre-film advertisements are shown before the screening of a movie in a cinema theater and are mostly in the form of video advertisements.

We charge our advertising clients fees either on a per advertising-slot basis or for a fixed amount for an agreed-upon number of slots during a specified contract period. Discounts from our standard rates are typically provided for longer-term advertising contracts, and may be provided for promotional purposes. Among our existing and potential advertising clients are automotive, FMCG, financial services and Internet companies.

We typically enter into one to three-year contracts with operators of movie theaters to acquire the rights for pre-film advertising slots for resale to our advertising clients during the contract period. The price for the rights usually consists of an upfront fee and, in some cases, committed payments during the term of the contract, which we negotiate with the operator based on the brand, size, location and box office of the movie theaters that the operator runs in our desired markets.

As of December 31, 2018, we had rights to sell pre-film advertising slots at approximately 800 cinema theaters in China.

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

We regard our intellectual property and proprietary rights as critical to our success. We rely on trademark law, copyright law, patent law and trade secret protection to protect our intellectual property rights. We enter into non-competition and confidentiality and/or license agreements with our employees, customers, partners and others to protect our intellectual property rights. Our employees are generally required to enter into agreements under which they undertake to keep confidential all information related to our methods, business and trade secrets during and for a reasonable time after their employment with us. In addition, we fragment our source codes so that no one employee, other than certain of our executive officers, has access to our entire source codes for a game. Product development personnel are only given access to the specific portions of the source codes that they need to work with at a particular time. In addition, all of the computers used by our game development personnel are closed circuit and do not have access to the Internet, so that we can protect our source codes and other proprietary information from being emailed out of our closed circuit system and misappropriated. However, we cannot guarantee that our measures to protect our intellectual property are sufficient. See “Risk Factors—Overall Risks—We may need to incur significant expenses to enforce our proprietary rights, and if we are unable to protect such rights, our competitive position and financial performance could be harmed” in Item 3.

We are the registered owner of 290 software copyrights and 422 fine arts work copyrights in China, each of which we have registered with the National Copyright Administration of the PRC or Guangdong Copyright Administration.

We are the registered owner of 151 domain names that we use in connection with the operation of our business, including our official Changyou Website, changyou.com and 17173.com.

We are the registered owner of 2,921 registered trademarks and have applied for the registration of another 311 trademarks in the PRC, including those related to our company name and our online games and other businesses. We are the registered owner of 395 registered trademarks and have also applied for 220 trademarks in countries and regions such as Taiwan, Hong Kong, the United States, Europe, Malaysia, South Korea, Indonesia, Brazil and Vietnam relating to our company name, and our online games and other businesses. We have registered eight trademarks in Taiwan, six trademarks in South Korea and fifteen trademarks in Vietnam relating to TLBB. However, we cannot assure you that we will be able to obtain the trademarks we have applied for, and if we are unable to agree on relevant renewal terms for the existing licenses from the estate of Louis Cha for our mobile games TLBB 3D and Legacy TLBB Mobile and for our PC game TLBB, we could lose the rights to trademarks related to Tian Long Ba Bu. See “Risk Factors—Overall Risks—We may need to incur significant expenses to enforce our proprietary rights, and if we are unable to protect such rights, our competitive position and financial performance could be harmed” and “—We may not have exclusive rights to trademarks, designs and technologies that are crucial to our business” in Item 3.

We have registered 50 patents and have 52 patent applications pending which are related to the design of our games and technology intended to enhance the functionality of our games, but these patent applications may not be approved. See “Risk Factors” for discussions of various risks relating to intellectual property.

## ***Technology Infrastructure***

We support our operations with a network of reliable and secure physical and cloud-based servers that have fully supported our operations for many years. As of December 31, 2018, we maintained for our online game business approximately 4,000 physical servers that are located in Internet data centers in 13 major cities in China, and 3,500 cloud-based servers that are spread across mainland China, Hong Kong, other Asia-Pacific regions, Europe and North America.

In order to enhance our game players' experience and to improve connectivity, we have located our physical game servers in a number of regions throughout China. This allows our players to connect to the nearest servers that are located in their region without exchanging data across the national backbone network. Furthermore, to ensure high-quality services for our game players, we work with leading domestic cloud technology firms to provide efficient and stable game services using cloud-based resources.

We have a professional technical support team that specializes in maintaining our quality technology infrastructure and online operating platform. We monitor the operation of our server network 24 hours a day, seven days a week. Our remote control system allows us to track our concurrent online users in real time, and discover and fix hardware or software problems on our server network in a timely fashion.

### ***Competition***

In the online game industry, we compete principally with the following three groups of competitors in China:

- online game developers and/or operators in China that are publicly traded in the US and in Hong Kong, including Tencent Holdings Limited, NetEase, Inc., Kingsoft Corporation Limited, and IGG Inc.;
- other companies in China devoted to game development and/or operation that are publicly traded in China, such as 37 Interactive Entertainment (Shanghai) Technology Co., Ltd., Perfect World Co., Ltd., Kalends Inc., YOOZOO GAMES Co., Ltd. and Giant Network Group Co., Ltd., or privately-held companies, usually backed by venture capital or private equity, including Shulong Technologies (formerly known as Shanda Games Limited); and
- international competitors.

In the online advertising industry, our game information portal operated through the 17173.com Website currently competes in China with, among others, the following game information portals:

- duowan.com, operated by YY Inc.; and
- games.sina.com.cn, operated by Sina Corporation.

In the cinema advertising industry, we compete primarily with the following competitors in China:

- Focus Film, operated by Focus Media Group.
- China Movie Media Group, operated by Wanda Cinema Line, a Wanda Group company; and

Our existing and potential competitors in the online games industry compete with us for talent, game player spending, time spent on game playing, marketing activities, quality of games, and distribution network. Our existing and potential competitors in the online advertising industry compete with us for talent, advertiser spending, number of unique visitors, number of page views, visitors' time spent on Website, and quality of service. Our existing and potential competitors in the cinema advertising industry compete with us for cooperative relationships with operators of movie theaters that are popular among movie-goers, market share of quality pre-film advertisement slots, advertiser spending, and experienced sales and marketing personnel.

### ***Facilities***

Our principal offices are located in several office buildings in Beijing and Fuzhou in China, which comprise an aggregate of approximately 65,005 square meters, including 8,456 square meters of leased properties. Our leases for those leased properties expire between April 2019 and October 2020.

In August 2009, we purchased an office building of approximately 14,950 square meters in Beijing, for consideration of approximately \$33.4 million. Since January 1, 2016, we have leased out this building to third-party business tenants. In August 2010, we entered into a contract for the purchase and development of an office building of approximately 56,549 square meters in Beijing to serve as our headquarters, for consideration of approximately \$171 million. We occupied the office building in December 2013. As of December 31, 2018, we leased additional office space in Beijing of approximately 782 square meters. We also leased office space of approximately 8,035 square meters in other cities in the PRC and in other countries.

### ***Legal Proceedings***

We may be subject to legal proceedings, investigations and claims incidental to the conduct of our business from time to time. We are not currently a party to, nor are we aware of, any legal proceeding, investigation or claim which, in the opinion of our management, is likely to have a material adverse effect on our business, financial condition or results of operations.

### ***PRC Regulation***

The following description of PRC regulation is based upon the opinion of Haiwen & Partners, our PRC counsel. For a description of legal risks relating to our ownership structure and business, see “Risk Factors”.

### ***Regulatory Authorities***

PRC law, including regulations and interpretations issued by various PRC governmental authorities, covers extensively areas related to the Internet, such as telecommunications, Internet information services, international connections to computer information networks, information security and censorship, that affect our business. PRC governmental authorities which have issued such regulations and interpretations include:

- the State Council;
- the State Administration of Press, Publication, Radio, Film and Television (the “SAPPRFT”). The SAPPRFT was reorganized into three separate governmental authorities, the National Radio and Television Administration (“NRTA”), the National Film Administration (the “NFA”), and the State Press Publication Administration (the “SPPA”), in March 2018. The SAPPRFT had resulted from the merger of the former General Administration of Press and Publication with the former State Administration of Radio, Film and Television in March 2013. The “NRTA,” the “NFA,” and the “SPPA” as used in this report refer to the respective governmental authorities after the reorganization; the “SAPPRFT” as used in this report refers to the governmental authority that resulted from the merger for the period after the merger and prior to the reorganization;
- the Ministry of Culture and Tourism of the People’s Republic of China (the “MCT”), which was established in March 2018 and resulted from the merger of the former Ministry of Culture (the “MOC”) and the former China National Tourism Administration (“CNTA”). The “MCT” as used in this report refers to the governmental authority that resulted from the merger, as well as to the MOC and the CNTA separately for periods prior to the merger;
- the Ministry of Industry and Information Technology (the “MIIT”);
- the Ministry of Commerce (the “MOFCOM”);
- the Ministry of Public Security (the “MPS”);
- the State Administration of Foreign Exchange (the “SAFE”);
- the State Administration of Market Regulation (the “SAMR”), which resulted from the merger of, and has undertaken the responsibilities previously held by, the State Administration for Industry and Commerce (the “SAIC”); the General Administration of Quality Supervision, Inspection and Quarantine (the “AQSIQ”); the Certification and Accreditation Administration; the Standardization Administration of China (the “SAC”); and the State Food and Drug Administration (the “SFDA”). The “SAMR” as used in this report refers to the governmental authority that resulted from the merger, as well as to the SAIC, the AQSIQ, the SAC, and the SFDA separately for periods prior to the merger; and
- the State Council Information Office (the “SCIO”).

### ***Regulation of Value-Added Telecommunication Services in General***

The *Telecommunications Regulations of the People’s Republic of China*, or the Telecom Regulations, implemented in September 2000 and amended in July 2014 and February 2016, are the primary PRC regulation governing telecommunications, and set forth the general framework for the provision of telecommunication services by domestic PRC companies. The Telecom Regulations include a requirement that telecommunications service providers procure operating licenses prior to commencing operations. The Telecom Regulations draw a distinction between “basic telecommunications services” and “value-added telecommunications services.” Value-added telecommunications services are defined as telecommunications and information services provided through public networks. The *Catalog of Telecommunications Business*, or the Catalog, was originally issued as an attachment to the Telecom Regulations and updated in 2001, 2003 and 2016. The Catalog as updated categorized online data and transaction processing, domestic Internet virtual private networks, Internet data centers, and Internet access search as value-added telecommunications services. Key aspects of our business fall within the definition of value-added telecommunications services under the Telecom Regulations and the Catalog.

The MIIT promulgated the *Administration Measures for Telecommunications Business Operation*, or the Telecom License Measures, in April 2009 and amended the Telecom License Measures in September, 2017. The Telecom License Measures include requirements and procedures for obtaining licenses for value-added telecommunications services and provide for a distinction between such a license granted solely for operations within a particular province and such a license granted for “trans-regional” (or multiple-province) activities. In September 2000, the State Council promulgated the *Administrative Measures on Internet Information Services*, or the Internet Measures, and amended them in January 2011. Under the Internet Measures, providers of Internet content services, or ICPs, must obtain a value-added telecommunications license, or ICP license, from governmental authorities before engaging in any commercial ICP operations within the PRC. Each of Gamease, Guanyou Gamespace and Shanghai ICE has obtained an ICP license.

In 2000, the MIIT promulgated the *Internet Electronic Bulletin Service Administrative Measures*, or the BBS Measures. The BBS Measures required ICPs to obtain specific approvals before they provided BBS services, which included electronic bulletin boards, electronic forums, message boards and chat rooms. In September 2014, the MIIT revoked the BBS Measures by the *Decision on Revocation and Amendment Certain Regulations and Rules*. However, in practice certain local authorities still require operating companies to obtain approvals or make filings for the operation of BBS services. The ICP licenses held by Gamease and Guanyou Gamespace include such specific approval of the BBS services that they provide.

#### *Restrictions on Foreign Ownership of Value-Added Telecommunication Services*

Various PRC regulations currently restrict foreign-invested entities from engaging in value-added telecommunication services, including operating online games and providing Internet information services. Foreign direct investment in telecommunication companies in China is regulated by the *Regulations for the Administration of Foreign-Invested Telecommunications Enterprises*, or the FITE Regulations, issued by the State Council, which became effective in January 2002 and were amended in September 2008 and February 2016. The FITE Regulations stipulate that telecommunications enterprises in the PRC with foreign investors, or FITEs, must be established as Sino-foreign equity joint ventures. Under the FITE Regulations and in accordance with WTO-related agreements, FITEs may provide value-added telecommunications services, but the foreign party to a FITE engaging in such services may hold no more than 50% of the equity of the FITE.

For a FITE to acquire any equity interest in a value-added telecommunications business in China, it must satisfy a number of stringent performance and operational experience requirements, including demonstrating a track record and experience in operating a value-added telecommunications business overseas. Moreover, FITEs that meet these requirements must obtain approvals from the MIIT and the MOFCOM or their authorized local counterparts, which retain considerable discretion in granting approvals.

In July 2006, the MIIT released a *Notice on Strengthening the Administration of Foreign Investment in Operating Value-added Telecommunications Business*, or the MIIT Notice, which reiterates certain provisions under the FITE Regulations. Under the MIIT Notice, if a FITE intends to invest in a PRC value-added telecommunications business, the FITE must apply for a telecommunications business license applicable to its business. Under the MIIT Notice, a domestic company that holds a license for the provision of Internet content services, or an ICP license, is considered to be a type of value-added telecommunications business that is prohibited from leasing, transferring or selling the license to foreign investors in any form, and from providing any assistance, including providing resources, sites or facilities, to foreign investors to conduct value-added telecommunications businesses in China. Trademarks and domain names that are used in the provision of Internet content services must be owned by the ICP license holder. The MIIT Notice requires each ICP license holder to have appropriate 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 standards set forth in relevant PRC regulations.

In view of the restrictions on foreign direct investment in the telecommunications sector, we established or acquired our principal VIEs Gamease, Guanyou Gamespace and Shanghai ICE to engage in value-added telecommunications services. Our VIEs, rather than our subsidiaries, hold ICP licenses, own our domain names, and hold or have applied for registration in the PRC of trademarks related to our games and our 17173.com Website and own and maintain facilities that we believe are appropriate for our business operations. For a detailed discussion of our VIEs, please refer to “Organizational Structure” in Item 4. Due to a lack of interpretative materials from the relevant PRC authorities, there are uncertainties regarding whether PRC authorities would consider our corporate structure and contractual arrangements to be a kind of foreign ownership of value-added telecommunications services. See “Risk Factors—Risks Related to Our Corporate Structure and Corporate Governance—If the PRC government determines that the VIE structure for operating our business does not comply with applicable PRC government restrictions on foreign investment in telecommunication industry, we could face severe penalties.”

On October 1, 2004, the *Administrative Rules on the Filing of Commercial Websites*, or the Websites Rules, were promulgated by the Beijing Administration of Industry and Commerce (the “Beijing AIC”) to replace the *Detailed Implementing Rules for the Measures for the Administration of Commercial Website Filings for the Record* promulgated by the Beijing AIC on September 1, 2000. The Websites Rules state that operators of Websites must comply with the following requirements:

- file with the Beijing AIC and obtain electronic registration marks for the Websites;
- place the registration marks on the Websites’ homepages; and
- register the Website names with the Beijing AIC.

On November 27, 2017, the MIIT promulgated the *Notice of Regulating the Use of Domain Names in Providing Internet-based Information Services*, or Domain Names Notice, which became effective January 1, 2018. Under the Domain Names Notice, a domain name used by a provider of Internet-based information services must be registered and owned by the provider or, if the provider is an entity, by a shareholder or senior manager of the provider.

We have registered our Websites [www.changyou.com](http://www.changyou.com) and [www.cy.com](http://www.cy.com) with the Beijing AIC and an electronic registration mark for each of these Websites is prominently placed on its homepage.

#### *Unfair Competition*

An amendment adopted on November 4, 2017 by the Standing Committee of the National People's Congress of the *Unfair Competition Law of the PRC*, or the Unfair Competition Law, effective January 1, 2018, stipulates, among other things, that, without the other Internet business operator's consent, an Internet business operator may not insert links into Internet products or services of another Internet business operator in order to re-direct user traffic; may not mislead or compel users to modify, terminate, or un-install any Internet products or services of another Internet business operator; and may not take actions in bad faith to cause an Internet product or service of another Internet business operator to be unusable by users of the other business operator's properties.

#### *Internet Privacy*

The PRC Constitution states that PRC law protects the freedom and privacy of the communications of citizens and prohibits infringement of such rights. In recent years, PRC government authorities have issued various regulations on the use of the Internet that are designed to protect personal information from unauthorized disclosure. For example, the Internet Measures prohibit an Internet information services provider from insulting or slandering a third party or infringing upon the lawful rights and interests of a third party. In addition, PRC regulations authorize PRC telecommunication authorities to demand rectification of unauthorized disclosure by ICPs.

The MIIT promulgated the *Several Provisions on Regulating the Market Order of Internet Information Services*, which became effective as of March 15, 2012. This regulation stipulates that ICPs must not, without users' consent, collect information on users that can be used, alone or in combination with other information, to identify the user, or User Personal Information, and may not provide any User Personal Information to third parties without prior user consent. ICPs may only collect User Personal Information necessary to provide their services and must expressly inform the users of the method, content and purpose of the collection and processing of such User Personal Information. In addition, an ICP may use User Personal Information only for the stated purposes under the ICP's scope of services. ICPs are also required to ensure the proper security of User Personal Information, and take immediate remedial measures if User Personal Information is suspected to have been disclosed. If the consequences of any such disclosure are expected to be serious, the ICP must immediately report the incident to the telecommunications regulatory authorities and cooperate with the authorities in their investigations. However, the PRC government has the power and authority to order ICPs to submit personal information of an Internet user if such user posts any prohibited content or engages in any illegal activity on the Internet. We require our users to accept a user agreement whereby they agree to provide certain personal information to us. If we violate these regulations, the MIIT or its local bureaus may impose penalties and we may be liable for damages caused to our users.

On December 28, 2012, the Standing Committee of the National People's Congress enacted the *Decision to Enhance the Protection of Network Information*, or the Information Protection Decision, to further enhance the protection of User Personal Information in electronic form. The Information Protection Decision provides that ICPs must expressly inform their users of the purpose, manner and scope of the ICPs' collection and use of User Personal Information, publish the ICPs' standards for their collection and use of User Personal Information, and collect and use User Personal Information only with the consent of the users and only within the scope of such consent. The Information Protection Decision also mandates that ICPs and their employees must keep strictly confidential User Personal Information that they collect, and that ICPs must take such technical and other measures as are necessary to safeguard the information against disclosure.

On July 16, 2013, the MIIT issued the *Order for the Protection of Telecommunication and Internet User Personal Information* or the Order. Most requirements under the Order that are relevant to ICP operators are consistent with the requirements already established under the MIIT provisions as discussed elsewhere in this annual report. Under the Order, these requirements are often stricter and have a wider scope. If an ICP operator wishes to collect or use personal information, it may do so only if such collection is necessary for the services it provides. Further, the operator must disclose to its users the purpose, method and scope of any such collection or use, and must obtain consent from its users whose information is being collected or used. ICP operators are also required to establish and publish their rules relating to personal information collection or use, keep any collected information strictly confidential, and take technological and other measures to maintain the security of such information. ICP operators are required to cease any collection or use of the user personal information, and de-register the relevant user account, when a given user stops using the relevant Internet service. ICP operators are further prohibited from divulging, distorting or destroying any such personal information, or selling or providing such information unlawfully to other parties. In addition, if an ICP operator appoints an agent to undertake any marketing or technical services that involve the collection or use of personal information, the ICP operator is still required to supervise and manage the protection of the information. The Order states that violators may face penalties that include warnings, fines, and disclosure to the public and, in severe cases, criminal liability.



On August 21, 2014, the Supreme People’s Court promulgated *the Provisions of the Supreme People’s Court on Several Issues Concerning the Application of Law to Trial of Civil Dispute Cases over Infringement Upon Personal Rights and Interests by Using Information Networks*, pursuant to which if an ICP operator discloses online genetic information, medical records, health examination data, criminal records, home addresses, private events or other private personal information of a natural person, and such disclosure causes damage to a natural person, the aggrieved person will be entitled to hold the ICP operator liable. It also specifies that an ICP operator will not be liable for the disclosure of such personal information if: (i) the information is made public with the written consent of the person; (ii) the information is made public for the purpose of promoting the public interest and the information disclosed is limited to the scope necessary for such purpose; (iii) the information is made public by schools or scientific research institutions; (iv) the information has been made public by the person himself; or (v) the personal information was obtained through legal channels.

The *Measures on Punishment for Infringement of Consumer Rights* promulgated by SAIC, which became effective in March, 2015, stipulate that business operators collecting and using personal information of consumers must comply with the principles of legitimacy, propriety and necessity, specify the purpose, method and scope of collection and usage of information, and obtain the consent of consumers. Business operators may not: (i) collect or use personal information of consumers without their consent; (ii) illegally divulge, sell or provide personal information of consumers to others; or (iii) send commercial information to consumers without their consent or request, or when a consumer has explicitly declined to receive such information.

The Standing Committee of the National People’s Congress issued *Amendment (IX) to the Criminal Law of the People’s Republic of China*, which came into effect in November 2015, to strengthen the protection of personal information and Internet security. Under certain circumstances, providers of services over Internet networks who do not perform their duties of safety management on information networks as required by laws and administrative regulations, and who do not correct their conduct after regulatory authorities order them to correct their non-compliance, may be subject to imprisonment for up to three years, criminal detention or public surveillance in addition to fines.

On November 7, 2016, the Standing Committee of the National People’s Congress issued the *Internet Security Law of the People’s Republic of China*, or the Internet Security Law, which took effect on June 1, 2017. The Internet Security Law requires providers of services over Internet networks to keep user information that they have collected in strict confidence and to establish improved systems for the protection of user information. Such service providers must provide notice of the purpose, methods and scope of their collection and use of user information, and obtain the consent of each person whose personal information will be collected. Providers of services over Internet networks may not collect any personal information that is not related to the services they provide, or disclose or tamper with personal information that they have collected, unless such information is encoded to prevent identification of individuals whose information is so disclosed or tampered with. Service providers who do not comply with the Internet Security Law may be subject to fines, suspension of their businesses, shutdown of their websites, and revocation of their business licenses.

On March 15, 2017, the National People’s Congress issued the *General Rules of the Civil Law of the PRC* that require entities and individual to maintain the security of personal information of third-party natural persons and prohibit the illegal collection, sale, use, processing, or other publication of such information.

On May 8, 2017, the Supreme People’s Court of the PRC and the Supreme People’s Procurator of the PRC issued the *Interpretation of the Supreme People’s Court and the Supreme People’s Procurator on Several Issues Concerning the Applicable Law for Criminal Cases With Respect to Infringement of Citizen’s Personal Information*, which defines and clarifies the meanings of “personal information,” “the provision of personal information,” and “the illegal collection of personal information.”

Our current security measures and those of the third parties with whom we transact business may not be adequate for the protection of User Personal Information. In addition, we do not have control over the security measures of our third-party online payment vendors. Security breaches of our system and the online payment systems that we use could expose us to litigation and liability for failing to secure confidential customer information and could harm our reputation, ability to attract customers and ability to encourage customers to purchase virtual items.

The SAMR issued the *Information Security Technology – Personal Information Security Specification* effective on May 1, 2018. The specification includes a recommendation as to nationwide standards for the protection and processing of personal information, and provides definitions and data processing, disclosure, and protection requirements regarding personal information.

#### *Online Games and Cultural Products*

In September 2009, the SAPPFRFT, together with the National Copyright Administration and the National Office of Combating Pornography and Illegal Publications, jointly issued a *Notice on Further Strengthening on the Administration of Pre-examination and Approval of Online Games and the Examination and Approval of Imported Online Games*, or the SAPPFRFT Online Game Notice. The SAPPFRFT Online Game Notice states that foreign investors are not permitted to invest in online game operating businesses in China via wholly foreign-owned entities, China-foreign equity joint ventures or cooperative joint ventures or to exercise control over or participate in the operation of domestic online game businesses through indirect means, such as other joint venture companies or contractual or technical arrangements. If our VIE structure were deemed under the SAPPFRFT Online Game Notice to be an “indirect means” for foreign investors to exercise control over or participate in the operation of a domestic online game business, our VIE structure might be challenged by the SPPA, as a successor agency to the SAPPFRFT. We are not aware of any online game companies which use the same or similar VIE contractual arrangements as those we use having been challenged by the SAPPFRFT or the SPPA as using those VIE arrangements as an “indirect means” for foreign investors to exercise control over or participate in the operation of a domestic online game business or having been penalized or ordered to terminate operations since the SAPPFRFT Online Game Notice first became effective. However, it is unclear whether and how the SAPPFRFT Online Game Notice might be interpreted or implemented in the future.

On February 21, 2008, the SAPPRFT issued *the Rules for the Administration of Electronic Publications*, or the Electronic Publication Rules, which were amended on August 28, 2015. The Electronic Publication Rules regulate the production, publishing and importation of electronic publications in the PRC and outline a licensing system for business operations involving electronic publishing. Under the Electronic Publication Rules and other related regulations issued by the SAPPRFT, online games are classified as a type of electronic publication or Internet publication that may only be provided by a licensed electronic publishing entity with a standard publication code, and the establishment of an electronic publishing entity must be approved by the SAPPRFT. Electronic publishing entities are responsible for assuring that the content of electronic publications comply with relevant PRC law and regulations, and must obtain the approval of the SPPA, as a successor agency to the SAPPRFT, before publishing foreign electronic publications. The New Internet Publication Measures, which became effective on March 10, 2016 and replaced the *Temporary Measures for Internet Publication Administration* that had become effective in 2002, require that entities in the Internet publishing business apply for an online publishing service license, instead of an Internet publishing license, that entities holding an Internet publishing license apply for an online publishing service license within a specified period of time to replace their Internet publishing license, and that all such entities obtain approval from the SAPPRFT or the SPPA prior to the publication of new online games. In addition, under the New Internet Publication Measures, Sino-foreign joint ventures and foreign-invested entities are not permitted to engage in Internet publication services, and the legal representative of an entity providing Internet publication services may not be a foreigner.

Gamease, which is the operator of TLBB, BO, BH2 and certain other licensed PC games, and Guanyou Gamespace, which provides online game services, obtained Internet publishing licenses on December 10, 2010 and October 13, 2011, respectively and Gamease and Guanyou Gamespace have obtained online publishing services licenses under the New Internet Publication Measures to replace the Internet publishing licenses previously held by them. TLBB, BO, BH2 and some of our other games were historically published through third parties that were licensed electronic publishing entities, because Gamease had not obtained an Internet publishing licenses at the time those online games were made publicly available. TLBB, BO and BH2 and certain of our other existing games are currently published under an Internet publishing license held by Gamease. Current PRC regulations are not clear as to the consequences of obtaining authorization codes through third-party electronic publishing entities. While we believe that arrangements like ours are acknowledged by the SAPPRFT or SPPA, in view of the lack of formal interpretation regarding this issue, the SPPA might challenge our current and past practices and could subject us to various penalties, including fines, confiscation of publishing equipment and the revenues generated from the publishing activities, the revocation of our business license, or the forced discontinuation of or restrictions on our operations.

On May 24, 2016, the SAPPRFT issued the Mobile Game Notice, which became effective on July 1, 2016, and sets forth requirements for the publication and operation of mobile games online, including requiring that mobile game publishers and operators, including joint operators, review the content of the games that they publish and operate, and apply for publication and authorization codes at least 20 business days before first publishing and operating domestic recreational and educational mobile games through open beta testing. The Mobile Game Notice, as updated by a subsequent notice, specifies that game publishers and game operators were required to review the content of mobile games that were published and were operated online before July 1, 2016, and to complete approval procedures for those games before December 31, 2016, or to cease operating the games. We completed prior to December 31, 2016 all of the approval procedures required by the SAPPRFT for our mobile games that were in operation before July 1, 2016.

The MCT issued the *New Provisional Regulations for the Administration of Online Culture*, or the Online Culture Regulations, which took effect on April 1, 2011 and was amended on December 15, 2017 and replaced the *Provisional Regulations for the Administration of Online Culture*. The Online Culture Regulations apply to entities engaging in activities related to “Internet cultural products,” which include cultural products that are produced specifically for Internet use, such as online music and entertainment, online games, online plays, online performances, online works of art and Web animation, and other online cultural products that through technical means, produce or reproduce music, entertainment, games, plays and other art works for Internet dissemination. Under the New Online Culture Regulations, commercial entities are required to apply to the relevant local branch of the MCT for an Online Culture Operating Permit if they engage in the production, duplication, importation, release or broadcasting of Internet cultural products; the dissemination of online cultural products on the Internet or the transmission of such products via Internet or mobile phone networks to user terminals, such as computers, phones, television sets and gaming consoles, or Internet surfing service sites such as Internet cafés; or the holding or exhibition of contests related to Internet cultural products. Gamease obtained an Online Culture Operating Permit in January 2008, which was re-certified in October 2015 and December 2017; Guanyou Gamespace obtained an Online Culture Operating Permit in June 2011, which was re-certified in October 2015 and December 2017; and Shanghai ICE obtained an Online Culture Operating Permit in December 2010, which was re-certified in January 2014. Shanghai ICE plans to apply for re-certification of its Online Culture Operating Permit in March 2018.

The Online Game Measures issued by the MCT, which took effect on August 1, 2010 and was amended on December 15, 2017, regulate a broad range of activities related to the online games business, including the development, production and operation of online games, the issuance of virtual currencies used for online games, and the provision of virtual currency trading services. The Online Game Measures provide that any entity that is engaged in online game operations must obtain an Online Culture Operating Permit, and require the content of an imported online game to be examined and approved by the MCT prior to the game's launch and a domestic online game to be filed with the MCT within 30 days after its launch. The *Notice of the Ministry of Culture on the Implementation of the Interim Measures for the Administration of Online Games*, which was issued by the MCT on July 29, 2010 to implement the Online Game Measures (i) requires online game operators to protect the interests of online game users and specifies certain terms that must be included in service agreements between online game operators and the users of their online games, (ii) specifies content review of imported online games and filing procedures for domestic online games, (iii) emphasizes the protection of minors playing online games and (iv) requests online game operators to promote real-name registration by their game users. On December 1, 2016, the MCT issued the Online Game Operation Notice, which became effective on May 1, 2017. The Online Game Operation Notice includes clarification of products and services that will be considered to be within the scope of the operation of online games, enhanced standards for the issuance of and payment for virtual items used in online games and enhanced protection of online games users, and announces more stringent supervision of the operation of online games and penalties for violations by online game operators of regulations with respect to the operation of online games. The Online Game Operation Notice stipulates that game operators are prohibited from providing lucky draws or lotteries that are conducted on the condition that participants contribute cash or virtual currency in exchange for virtual items and services; must timely publish the name, properties, description, amount, and probability of winning for such lucky draws or lotteries on either the Website of the game or the Web page on which such lucky draws or lotteries are provided; must require real-name registration of game players who wish to enter such lucky draws or lotteries; and must publish the results of such lucky draws or lotteries on the Website of or other conspicuous location in the game; and must maintain all relevant records for at least 90 days. The Online Game Operation Notice also stipulates that online game operators must require real-name registration of online game players and may sell game points and virtual items only to real-name registered game players, must set limits on the maximum amount of game points for a particular game that game players may purchase in a single transaction, must require confirmation of transaction information by game players placing orders and maintain all relevant records for at least 180 days. We filed our games TLBB, BO, BH2, and certain of our other existing games with the MCT. If we fail to maintain any of our permits, approvals, or registrations; make any necessary filings; apply for and obtain any required new permits, approvals, or registrations; make any new filings on a timely basis; or comply with the requirements under the Online Game Operation Notice and other laws and regulations, we may be subject to various penalties, including fines and a requirement that we discontinue or limit our operations.

The *Notice on Strengthening the Approval and Administration of Imported Online Games*, or the Imported Online Game Notice, which was issued by the SAPPRFT and took effect in July 2009, states that the SAPPRFT was, and the SPPA as a successor to the SAPPRFT is, the only governmental department authorized by the State Council to approve the importation of online games from offshore copyright owners, and that any enterprise which engages in online game publication and operation services within China must have the game examined and approved by the SAPPRFT or the SPPA and receive from the SAPPRFT or the SPPA an Internet publishing license (or after the New Internet Publication Measures became effective on March 10, 2016, an online publishing service license). Our VIEs Gamease and Guanyou Gamespace obtained Internet publishing licenses from the SAPPRFT and they have obtained online publishing services licenses under the New Internet Publication Measures to replace the Internet publishing licenses previously held by them. In addition, the Imported Online Game Notice states that activities which involve the showing, exhibition, trading and promotion of offshore online games in China must be examined and approved by the SAPPRFT or the SPPA.

The *Notice Regarding Improving and Strengthening the Administration of Online Game Content*, or the Online Game Content Notice, issued by the MCT in November 2009, calls for online game operators to improve and adapt their game models by (i) mitigating the predominance of the "upgrade by monster fighting" model, (ii) limiting the use of the "player kill" model (where one player's character attempts to kill another player's character), (iii) limiting in-game marriages among game players, and (iv) improving their compliance with legal requirements for the registration of minors and game time-limits.

The *Administrative Measures for Content Self-review by Internet Culture Business Entities*, or the Content Self-review Administrative Measure, which took effect in December 2013, require Internet culture business entities to review the content of products and services to be provided prior to providing such content and services to the public. The content management system of an Internet culture business entity is required to specify the responsibilities, standards and processes for content review as well as accountability measures, and is required be filed with the local provincial branch of the MCT.

In January 2014, the SAIC promulgated the *Administrative Measures for Online Trading*, or the Online Trading Measures, which took effect on March 15, 2014, and replaced the Interim Measures for the *Administration of Online Commodities Trading and Relevant Services*, issued by the SAIC, which had taken effect on July 1, 2010. The Online Trading Measures regulate online commodity trading and related activities. The Online Trading Measures require that commodities or services transacted online comply with the provisions of all applicable laws, regulations and rules. When selling commodities or providing services to consumers, online operators must comply with all applicable laws with respect to the protection of consumer rights and interests, the protection of intellectual property rights of others and the prevention of unfair competition. Information provided with respect to commodities and services provided by online commodity operators or related service operators must be authentic and accurate. If we fail to comply with all requirements of the Online Trading Measures, the local branch of the SAIC or SAMR or another governmental authority with jurisdiction might impose penalties on us, such as fines.

### *Copyright Protection*

The *PRC Copyright Law*, which was adopted by the Standing Committee of the National People's Congress in 1990 and subsequently amended in 2001 and 2010, extends copyright protection to Internet activities, products disseminated over the Internet and software products. In addition, there is a voluntary registration system administered by the China Copyright Protection Center.

*The Rules of Protection on Information Network Dissemination Rights*, promulgated by the State Council in May 2006 and amended in January 2013, address copyright issues relating to the Internet. In addition, on December 17, 2012, the Supreme People's Court promulgated *the Provisions on Several Issues Concerning the Application of Law for Trial of Civil Dispute Cases Involving Infringement of the Right to Network Dissemination of Information*, which stipulate that the dissemination by network users or providers of services over Internet networks of works, performance or audio or video recordings without the permission of the holder of the rights to such dissemination will constitute infringement of such rights, and that service providers that aid or abet any network user's infringement of the rights of another to network dissemination of any works or recordings may be liable for such network user's infringing activities.

### *Registration of Software Copyrights*

The *Measures Concerning Registration of Computer Software Copyright*, or the Software Copyright Measures, issued by the National Copyright Administration, which became effective in February 2002, encourage the registration of software and afford greater protection to registered software than that afforded to unregistered software. We have registered software copyrights covering all of our significant copyrightable products and enhancements.

### *Regulation of Internet Content*

The PRC government has promulgated measures relating to Internet content through a number of government authorities, including but not limited to the MIIT, the MCT, the SPPA, the NRTA and the MPS. These measures specifically prohibit certain Internet activities, including the operation of online games that result in the publication of any content which is found to, among other things, propagate obscenity, gambling or violence, instigate crimes, undermine public morality or the cultural traditions of the PRC, or compromise State security or secrets. If an ICP license holder violates these measures, the PRC government may revoke its ICP license and shut down its Websites.

On May 2, 2017, the Cyberspace Administration of China (the "CAC") issued the *Administrative Enforcement Procedures for the Administration of Internet-based Information Content*, or the Enforcement Procedures, effective June 1, 2017. Pursuant to the Enforcement Procedures, the CAC and its local branch offices have the authority to enforce, and impose administrative sanctions on activities prohibited by, applicable administrative laws and regulations concerning Internet-based information content.

### *Protection of Minors*

On April 15, 2007, the SAPPRFT and several other governmental authorities issued a circular requiring the implementation of an "anti-fatigue system" and a real-name registration system by all PRC online game operators, in an effort to curb addictive online game play behaviors of minors. Under the anti-fatigue system, three hours or less of continuous play by minors is considered to be "healthy," three to five hours to be "fatiguing," and five hours or more to be "unhealthy." Game operators are required to reduce the value of in-game benefits to a game player by half if the game player has reached "fatiguing" level, and to zero in the case of "unhealthy" level.

To identify whether a game player is a minor and thus subject to the anti-fatigue system, there was adopted a real-name registration system, which requires online game players to register their real identity information before they play online games and requires us to submit the identity information of game players to the public security authorities for verification. On July 1, 2011, the SAPPRFT, the MIIT, the Ministry of Education and five other governmental authorities issued a *Notice on Initializing the verification of Real-name Registration for Anti-Fatigue System on Internet Games*, or the Real-name Registration Notice, to strengthen the implementation of the anti-fatigue system and real-name registration, which took effect on October 1, 2011. The Real-name Registration Notice's main focus is to prevent minors from using an adult's ID to play Internet games and, accordingly, the notice imposes stringent punishments on online game operators that do not implement the required anti-fatigue and real-name registration measures properly and effectively. The most severe punishment contemplated by the Real-name Registration Notice is to require termination of the operation of the online game if it is found to be in violation of the Anti-Fatigue Notice, the Monitor System Circular or the Real-name Registration Notice. We developed our own anti-fatigue and real-name registration systems for our games, and implemented them beginning in 2007. Under our system, game players must use real identification in order to create accounts, and in this way we are able to tell which of our game players are minors and thus subject to these regulations. For game players who do not register, we assume that they are minors. As required by the anti-fatigue rules, we reduce the value of in-game benefits of game players under 18 years based on the amount of their continuous play.

On January 15, 2011, the MCT, the MIIT and six other central government authorities jointly issued a circular entitled *Implementation of Online Game Monitor System of the Guardians of Minors*, or the Monitor System Circular, aiming to provide specific protection measures to monitor the online game activities of minors and curb addictive online game playing behaviors of minors. Under the Monitor System Circular, online game operators are required to adopt various measures to maintain a system to communicate with the parents or other guardians of minors playing online games and online game operators are required to monitor the online game activities of minors, and must suspend the account of a minor if so requested by the minor's parents or guardians. The monitor system was formally implemented commencing March 1, 2011.

In February 2013, 15 PRC government authorities, including the SAPPRFT, the Ministry of Education, the MCT and the MIIT, jointly issued the Work Plan implementing integrated measures by different authorities to prevent minors from being addicted to online games. Under the Work Plan, the current relevant regulations regarding online games will be further clarified and additional implementation rules will be issued; and as a result, online game operators will be required to implement measures to protect minors.

On July 25, 2014, the SAPPRFT promulgated a *Notice on Further Carrying out the Verification of Real-name Registration for Anti-Fatigue System on Internet Games*, or the Verification of Real-name Registration Notice, which took effect on October 1, 2014. The Verification of Real-name Registration Notice requires local press and publication administrative departments to strengthen their administration over enterprises engaged in online game publication and operations, and requires such enterprises to strictly abide by anti-fatigue and real-name registration requirements when developing and promoting online games, excluding, at present, mobile games.

### *Information Security and Censorship*

Internet content in China is also regulated and restricted from a State security standpoint. The Standing Committee of the National People's Congress enacted the *Decision on Internet Security Protection* in 2000, and amended it in August, 2009. The decision makes it unlawful to: (i) gain improper entry into a computer or system of strategic importance; (ii) disseminate politically disruptive information; (iii) leak State secrets; (iv) spread false commercial information; or (v) infringe intellectual property rights. The MPS has promulgated measures that prohibit the use of the Internet in ways which, among other things, result in a leakage of State secrets or distribution of socially destabilizing content. The MPS has supervision and inspection rights in this regard, and we may be subject to the jurisdiction of local security bureaus. If an ICP license holder violates these measures, the PRC government may revoke its ICP license and shut down its Websites. On November 7, 2016, the Standing Committee of the National People's Congress issued the Internet Security Law, which took effect on June 1, 2017. The Internet Security Law requires providers of services over Internet networks to keep user information that they have collected in strict confidence and to establish improved systems for the protection of user information. Such service providers must provide notice of the purpose, methods and scope of their collection and use of user information, and obtain the consent of each person whose personal information will be collected. Service providers may not collect any personal information that is not related to the services they provide, or disclose or tamper with personal information that they have collected, unless such information is encoded to prevent identification of individuals whose information is so disclosed or tampered with. Service providers who do not comply with the Internet Security Law may be subject to fines, suspension of their businesses, shutdown of their websites, and revocation of their business licenses.

In 2004, the MCT issued a *Notice Regarding the Strengthening of Online Game Censorship*. This notice mandates the establishment of a new committee under the MCT that will screen the content of imported online games. In addition, all imported and domestic online games are required to be filed with the MCT. We have submitted the relevant filing documents to the MCT for the filing of all of our online games in operation.

In 2005, the MCT and the MIIT promulgated the *Opinions on the Development and Administration of Online Games* emphasizing the PRC government's intent to foster and control the development of the online game industry in China and providing that the MCT will censor online games that "threaten state security," "disturb the social order," or contain "obscenity" or "violence."

In April, 2009, the MCT issued a *Public Announcement on Regulating Applications for the Examination of the Content of Imported Online Games*, or the Announcement. The Announcement emphasizes that enterprises operating imported online games must have the content of those games examined and approved by the MCT.

In November, 2018, the MPS issued the *Regulations for Internet Security Supervision and Inspection by Public Security Authority*, which specifies standards for the inspection of network operators and the legal responsibility of network operators for content.

### *Mobile Internet Applications*

The CAC issued the *Regulations for the Administration of Mobile Internet Application Information Services*, effective August 1, 2016, which require providers of information services through mobile Internet applications, or "Apps," to (i) verify the true identities of registered users through mobile phone numbers and similar channels, (ii) establish procedures for the security of user information; (iii) establish procedures for information censorship, (iv) ensure that users are given adequate information concerning an App, and are able to choose whether an App is installed and whether or not to use an installed App, (v) respect and protect intellectual property rights, and (vi) keep records of user log-in information for 60 days. If we, as a provider of information services through Apps, violate these regulations, mobile application stores through which we distribute our Apps may issue warnings to us, suspend the release, or terminate the sale, of our Apps, and/or report our violations to governmental authorities.

### *Online Live Streaming Services*

On July 1, 2016, the MCT issued the *Notice of MCT on Strengthening the Administration of Online Performance*, which became effective on the same day and makes operators of online performances as well as performers in online performances responsible for the content of online performances, calls for supervision of online performances by relevant governmental cultural administrative departments and law enforcement agencies and for enhanced focus on investigating and punishing disseminators of online performances with illegal content.

The CAC issued the *Regulations for the Administration of Online Live Streaming Services*, or the Online Live Streaming Regulations, effective December 1, 2016. The Online Live Streaming Regulations emphasize that approval is required to provide online live streaming services, and that providers of online live streaming services must have a level of professional staffing that is suitable for the scale of the online live streaming services provided, and adequate systems for censorship of information, for information security, and for protection of the identities and privacy of users. The Online Live Streaming Regulations also require providers of online live streaming services to enter into agreements with the users of the online live streaming services requiring the users to comply with applicable laws and regulations.

On July 12, 2017, the CAC issued a *Notice concerning the Filing of Information by Online Live Streaming Services Enterprises*, or the Live Streaming Notice. The Live Streaming Notice requires online live streaming services enterprises to promptly file information concerning their online live streaming services at the request of relevant local branches of the CAC.

On August 1, 2018, the MIIT and several other governmental authorities issued a *Notice on Strengthening the Administration of Live Online Social Video Services*, which stipulates that providers of Internet access services and APP stores that distribute online interactive broadcasting services are required to obtain permits from, or complete relevant filing procedures with, specified governmental agencies in order to provide the services.

### *Online Audiovisual Transmission*

On April 25, 2016, the SAPPRFT issued the *Regulations on the Administration of Private Network and Directional Transmission of Audiovisual Program Services*, which were effective in June 1, 2016 and replaced the *Measures for the Administration of the Transmission of Audiovisual Programs over Internet and Other Information Networks*, which had been adopted in 2004 and had last been amended on August 28, 2015. Under these rules, providers of audiovisual program dissemination services over local area networks, virtual private networks and directional transmission channels are required to obtain a permit from the SPPA, as a successor agency to the SAPPRFT.

The SAPPRFT and the MIIT jointly issued the *Rules for the Administration of Internet Audiovisual Program Services*, or Document 56, which went into effect in January 2008 and was amended on August 28, 2015. Under Document 56, all online audio and video service providers must be either state-owned or state-controlled. However, at a press conference held on February 3, 2008, the SAPPRFT and the MIIT clarified that online audio-visual service providers that had been lawfully conducting the business prior to the issuance of Document 56 may re-register and continue to operate without becoming state-owned or controlled, provided that such providers do not engage in any unlawful activities. This exemption will not be granted to service providers set up after the issuance of Document 56. We provide online audio and video services primarily through the 17173.com Website, which was conducting business prior to the issuance of Document 56.

On March 16, 2018, the SAPPRFT issued a *Notice on Further Regulating the Distribution Order of Internet Audiovisual Programs*, which prohibits a provider of audiovisual programs from unauthorized appropriation or adaptation of audiovisual programs.

### *Advertisings Services*

The New Advertising Law provides that advertisements posted or published through the Internet may not affect users' normal usage of a network, and advertisements published in the form of pop-up windows on the Internet must display the "close" sign prominently and ensure one-key closing of the pop-up windows. The SAIC issued the *Interim Measures for Administration of Internet Advertising* (the "Interim Measures for Internet Advertising"), effective September 1, 2016, which define the scope of services included within Internet advertising; specify the respective obligations of Internet advertisers, advertising agencies, advertising publishers and Internet information service providers; and provide penalties for violations. The Interim Measures for Internet Advertising forbid luring users to click on the content of Internet advertisements by any fraudulent means and attaching advertisements or advertising links to emails sent by users without their permission. Under the Interim Measures for Internet Advertising, Internet advertisers are responsible for the authenticity of the contents of online advertisements, and Internet advertising publishers and advertising agencies are required to verify the content of advertisements, and employ inspectors who are familiar with PRC laws and regulations governing online advertising. Under the *Notice on Strengthening the Administration of Cinema Advertising* and the *Notice on Further Regulating the Administration of the Cinema Advertising*, effective on July 2004 and February 2009, respectively, cinema advertising operators and the content of cinema advertisements must comply with the New Advertising Law and other relevant laws and regulations. Both Guanyou Gamespace, which is the operator of our online advertisement business, and Shanghai Jingmao, which primarily engages in the cinema advertising business, have business licenses that include advertising services. The Standing Committee of the National People's Congress promulgated the FIPL effective March 1, 2017. Among other things, the FIPL forbids the displaying of advertisements during the presentation of a feature film.

### *Employment Contracts*

The Standing Committee of the National People's Congress promulgated the *Employment Contract Law of PRC* (the "ECL"), which became effective as of January 1, 2008 and was amended on December 28, 2012. The ECL requires employers to provide written contracts to their employees, restricts the use of temporary workers and aims to give employees long-term job security.

Pursuant to the ECL, employment contracts lawfully concluded prior to the implementation of the ECL and continuing as of the date of its implementation shall continue to be performed. Where an employment relationship was established prior to the implementation of the ECL but no written employment contract was concluded, a contract must be concluded within one month after its implementation.

Our standard employment contract complies with the requirements of the ECL and its implementing regulations.

### *Regulation of Foreign Currency Exchange and Dividend Distribution*

*Foreign Currency Exchange.* The principal regulations governing foreign currency exchange in China are the *Foreign Exchange Administration Regulations*, as amended in August 2008. Under the Foreign Exchange Administration Regulations, the RMB is freely convertible for current account items, including the distribution of dividends, interest payments, trade and service-related foreign exchange transactions, but not for capital account items, such as direct investments, loans, repatriation of investments and investments in securities outside of China, unless the prior approval of the SAFE is obtained and prior registration with the SAFE is made.

Dividends paid by a subsidiary to its overseas shareholder are deemed income of the shareholder and are taxable in China. Pursuant to the *Administration Rules of the Settlement, Sale and Payment of Foreign Exchange* (1996), foreign-invested enterprises in China may purchase or remit foreign currency, subject to a cap approved by the SAFE, for settlement of current account transactions without the approval of the SAFE. Foreign currency transactions under the capital account are still subject to limitations and require approvals from, or registration with, the SAFE and other relevant PRC governmental authorities.

*Circular 37.* In July 2014, SAFE promulgated the *Circular on Issues Concerning Foreign Exchange Administration Over the Overseas Investment and Financing and Roundtrip Investment by Domestic Residents Via Special Purpose Vehicles*, or (together with its appendices) Circular 37, which replaced *Relevant Issues Concerning Foreign Exchange Control on Domestic Residents' Corporate Financing and Roundtrip Investment through Offshore Special Purpose Vehicles*, or Circular 75, which had been promulgated by SAFE in October 2005. Circular 37 requires PRC residents to register with local branches of SAFE in connection with their direct establishment or indirect control of an offshore entity, referred to in Circular 37 as a "special purpose vehicle," for the purpose of holding domestic or offshore assets or interests. Circular 37 further requires amendment to a PRC resident's registration in the event of any significant changes with respect to the special purpose vehicle, such as an increase or decrease in the capital contributed by PRC individuals, share transfer or exchange, merger, division or other material event. In the event that a PRC shareholder holding interests in a special purpose vehicle fails to fulfill the required SAFE registration, the PRC subsidiaries of that special purpose vehicle may be prohibited from making profit distributions to the offshore parent and from carrying out subsequent cross-border foreign exchange activities, and the special purpose vehicle may be restricted in its ability to contribute additional capital to its PRC subsidiary. Moreover, failure to comply with these SAFE registration requirements could result in liability under PRC law for evasion of foreign exchange controls. PRC residents who control our company from time to time are required to register with the SAFE in connection with their investments in us. See "Risk Factors—Regulations relating to offshore investment activities by PRC residents may limit our ability to acquire PRC and foreign companies and could adversely affect our business."

*Share Option Rules.* On December 25, 2006, the PBOC issued the *Administration Measures on Individual Foreign Exchange Control*, its implementation rules were issued by SAFE on January 5, 2007 and both became effective on February 1, 2007. Under these regulations, all foreign exchange transactions involving an employee share incentive plan, share option plan or similar plan participated in by onshore individuals may be conducted only with the approval from the SAFE or its authorized branch. Under the Offshore Share Incentives Rules, PRC citizens who are granted share options, restricted share units or restricted shares by an overseas publicly-listed company are required to register with the SAFE or its authorized branch and to comply with a series of other requirements. On February 21, 2012, the SAFE approved our application to designate our PRC subsidiary AmazGame to handle registrations and other procedures required by the Offshore Share Incentives Rules. If we and our PRC employees who hold options, restricted share units or restricted shares fail to comply with these registration or other procedural requirements, we and such employees may be subject to fines and other legal sanctions.

Under Circular 37, if a non-listed special purpose vehicle uses its own equity to grant equity incentive awards to directors, supervisors, members of senior management or employees directly employed by a domestic enterprise that is directly or indirectly controlled by such special purpose vehicle, or with which such employee has established an employment relationship, any of such directors, supervisors, members of senior management or employees who are PRC residents must, prior to exercising their rights, file an application with the SAFE for the foreign exchange registration for such special purpose vehicle. If PRC residents fail to make such registration before exercising their rights, the special purpose vehicle could be subject to fines and legal penalties, and the SAFE could restrict cross-border investment and foreign exchange activities of the special purpose vehicle or related companies, including limiting the special purpose vehicle's or related companies' ability to distribute dividends to, or obtain loans denominated in foreign currencies from, offshore companies, or preventing the special purpose vehicle or related companies from paying dividends.

*Distribution of Dividends.* The principal regulations governing distribution of dividends of foreign holding companies include the *Foreign Investment Enterprise Law* (1986), as amended in October 2000 and September 2016, and the *Administrative Rules under the Foreign Investment Enterprise Law* (1990), as amended in April 2001 and February 2014.

Under these regulations, foreign investment enterprises in China may pay dividends only out of their accumulated profits, if any, determined in accordance with PRC accounting standards and regulations. In addition, foreign investment enterprises in China are required to allocate at least 10% of their respective accumulated profits each year, if any, to fund certain reserve funds unless these reserves have reached 50% of the registered capital of the enterprises. These reserves are not distributable as cash dividends. Under the CIT Law, effective January 1, 2008 and amended on February 24, 2017 and December 29, 2018, the maximum tax rate for the withholding tax imposed on dividend payments from PRC foreign invested companies to their overseas investors that are not regarded as "resident" for tax purposes is 10%. The rate is reduced to 5% under tax treaties and arrangements between the PRC and certain other countries and administrative regions.

#### *M&A Regulations and Overseas Listings*

On August 8, 2006, six PRC regulatory agencies, consisting of the MCT, the State Assets Supervision and Administration Commission, the SAT, the SAIC, the CSRC, and the SAFE, jointly issued the M&A Rules, which became effective on September 8, 2006 and were amended on June 22, 2009. The M&A Rules, among other things, include provisions that purport to require that an offshore special purpose vehicle formed for purposes of overseas listing of equity interests in PRC companies and controlled directly or indirectly by PRC companies or individuals obtain the approval of the CSRC prior to the listing and trading of such special purpose vehicle's securities on an overseas stock exchange.

On September 21, 2006, the CSRC published on its official Website procedures regarding its approval of overseas listings by special purpose vehicles. The CSRC approval procedures require the filing of a number of documents with the CSRC. The application of this PRC regulation remains unclear, with no consensus currently existing among leading PRC law firms regarding the scope of the applicability of the CSRC approval requirement.

The M&A Rules also establish procedures and requirements that could make some acquisitions of Chinese companies by foreign investors more time-consuming and complex, including requirements in some instances that the MOFCOM be notified in advance of any change-of-control transaction in which a foreign investor takes control of a Chinese domestic enterprise.

In February 2011, the General Office of the State Council promulgated Circular 6, which established a security review system for mergers and acquisitions of domestic enterprises by foreign investors. Under Circular 6, a security review is required for mergers and acquisitions by foreign investors having "national defense and security" concerns and mergers and acquisitions by which foreign investors may acquire "de facto control" of domestic enterprises with "national security" concerns. In August 2011, the MOFCOM promulgated the *Rules on Implementation of Security Review System*, or the MOFCOM Security Review Rules, to replace the *Interim Provisions of the Ministry of Commerce on Matters Relating to the Implementation of the Security Review System Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* promulgated by the MOFCOM in March 2011. The MOFCOM Security Review Rules, which came into effect on September 1, 2011, provide that the MOFCOM will look into the substance and actual impact of a transaction and prohibit foreign investors from bypassing the security review requirement by structuring transactions through proxies, trusts, indirect investments, leases, loans, control through contractual arrangements or offshore transactions.

#### *Virtual Currency*

On February 15, 2007, the MCT, the PBOC and other relevant government authorities jointly issued the *Notice on the Reinforcement of the Administration of Internet Cafés and Online Games*, or the Internet Cafés Notice. Under the Internet Cafés Notice, the PBOC is directed to strengthen the administration of virtual currency in online games to avoid any adverse impact on the economy and financial system. The Internet Cafés Notice limits the total amount of virtual currency that may be issued by online game operators and the amount that may be purchased by individual game players, and includes a clear division between virtual transactions and real transactions carried out by way of electronic commerce. The Internet Cafés Notice also provides that virtual currency may only be used to purchase virtual items.



On June 4, 2009, the MCT and the MOFCOM jointly issued the Virtual Currency Notice, to regulate the trading of online game virtual currencies. The Virtual Currency Notice defines the meaning of virtual currency and places a set of restrictions on the trading and issuance of virtual currency. The Virtual Currency Notice also states that online game operators are not allowed to give out virtual items or virtual currency through lottery-based activities, such as lucky draws, betting or random computer sampling, in exchange for user's cash or virtual money. The Virtual Currency Notice is mainly targeted at lottery-based activities relating to the "treasure boxes" found in some online games.

On July 20, 2009, the MCT promulgated the *Filing Guidelines on Online Game Virtual Currency Issuing Enterprise and Online Game Virtual Currency Trading Enterprise*, which defines the terms "issuing enterprise" and "trading enterprise" and stipulates that the same enterprise may not be both an issuing enterprise and a trading enterprise.

On December 1, 2016, the MCT issued the Online Game Operation Notice, which became effective on May 1, 2017. The Online Game Operation Notice standardizes rules regarding the issuance of virtual items used for online games. The Online Game Operation Notice provides that the issuance and exchange of virtual items issued by online game operators must be administered in accordance with the regulations applicable to virtual currency; that online game operators may not allow online game virtual currency to be exchanged for real currency or physical items, except that, when online game operators cease offering their online game products and services to users, the operators may repay the users with real currency or other actual physical or intangible assets for unused virtual currency; requires that, when online game operators allow users to exchange small-value physical items for virtual items, the content and value of such physical items must comply with applicable laws and regulations; and stipulates that online game operators are prohibited from providing lucky draws or lotteries that are conducted on the condition that participants contribute cash or virtual currencies in exchange for virtual items and services, must publish the results of such lucky draws or lotteries on the Website of or other conspicuous location in the game and must maintain all relevant records for at least 90 days.

#### *Import and Export of Software Technology*

China imposes controls on the import and export of technology and software products. Under the *Regulations on Administration of Import and Export of Technologies* promulgated by the State Council, the term "technology import and export" is defined to include, among other things, the transfer or licensing of patents and know-how, and the provision of services related to technology. Depending on the nature of the relevant technology, the import and export of technology require either approval by or registration with the relevant PRC governmental authorities. Under the *Software Export Management and Statistics Measures* promulgated in October 2001, if a company is classified as a software enterprise and has a minimum of RMB1 million in registered capital, it may engage in an export business after being registered with the relevant PRC governmental authorities. All contracts which relate to the export of software products, transfer of technology or provision of related services must be filed with the relevant PRC governmental authorities. The *Measures for the Administration of Registration of Technology Import and Export Contracts*, issued by the MOFCOM in February 2009, specify registration requirements related to the import and export of technology.

We have entered into license agreements with third parties outside of China to license our games, which may be deemed to constitute the export of technology under the regulations. As a result, such licenses are required to be registered with applicable PRC governmental authorities. Although there are no explicit penalties set forth in these regulations for lack of such registration, failure to register an agreement where such registration is required may result in restrictions concerning foreign exchange, banking and taxation matters relating to such agreements. We have not registered all of the game license agreements under which we authorize overseas third-party online game operators to operate our online games, and so far we have not encountered any problems with respect to foreign exchange, banking or taxation matters relating to our license agreements, nor have we received any notice from any governmental authority requiring us to complete the registration of our game license agreements.

#### **Organizational Structure**

Changyou.com Limited is an indirect subsidiary of Sohu.com Limited. As of the date of this report, Sohu held through subsidiaries approximately 67.4% of the combined total of our outstanding Class A and Class B ordinary shares and controlled approximately 95.3% of the total voting power in us.

As of the date of this annual report, the following are our principal wholly-owned subsidiaries:

- Changyou.com (HK) Limited, or Changyou HK, incorporated in Hong Kong on August 13, 2007. Changyou HK is our intermediate offshore holding company for our operations in China and overseas.
- Beijing AmazGame Age Internet Technology Co., Ltd., or AmazGame, incorporated in the PRC on September 26, 2007.

- Shanghai Jingmao Culture Communication Co., Ltd., or Shanghai Jingmao, incorporated in the PRC on April 30, 2009 and acquired by us on January 25, 2011.
- Beijing Changyou Gamespace Software Technology Co., Ltd., or Gamespace, incorporated in the PRC on October 29, 2009.
- Beijing Yang Fan Jing He Information Consulting Co., Ltd., or Yang Fan Jing He, incorporated in the PRC on April 22, 2010.
- Beijing Changyou Jingmao Film & Culture Communication Co., Ltd., or Beijing Jingmao, incorporated in the PRC on November 16, 2010 and acquired by us on January 25, 2011.
- 7Road.com Limited, or 7Road, incorporated in the Cayman Islands on June 15, 2011.
- 7Road.com HK Limited, or 7Road HK, incorporated in Hong Kong on July 6, 2011.
- Changyou.com Webgames (HK) Limited, or Changyou HK Webgames, incorporated in Hong Kong on September 21, 2011.
- Shenzhen Brilliant Imagination Technologies Co., Ltd., or Brilliant Imagination, incorporated in the PRC on April 18, 2014.
- Beijing Changyou Chuangxiang Software Technology Co., Ltd., or Changyou Chuangxiang, incorporated in the PRC on November 8, 2016.

In order to comply with PRC law restricting foreign ownership in the online game business and platform channel business in China, we conduct the operations of our online game business and our platform channel business in China through our principal VIEs.

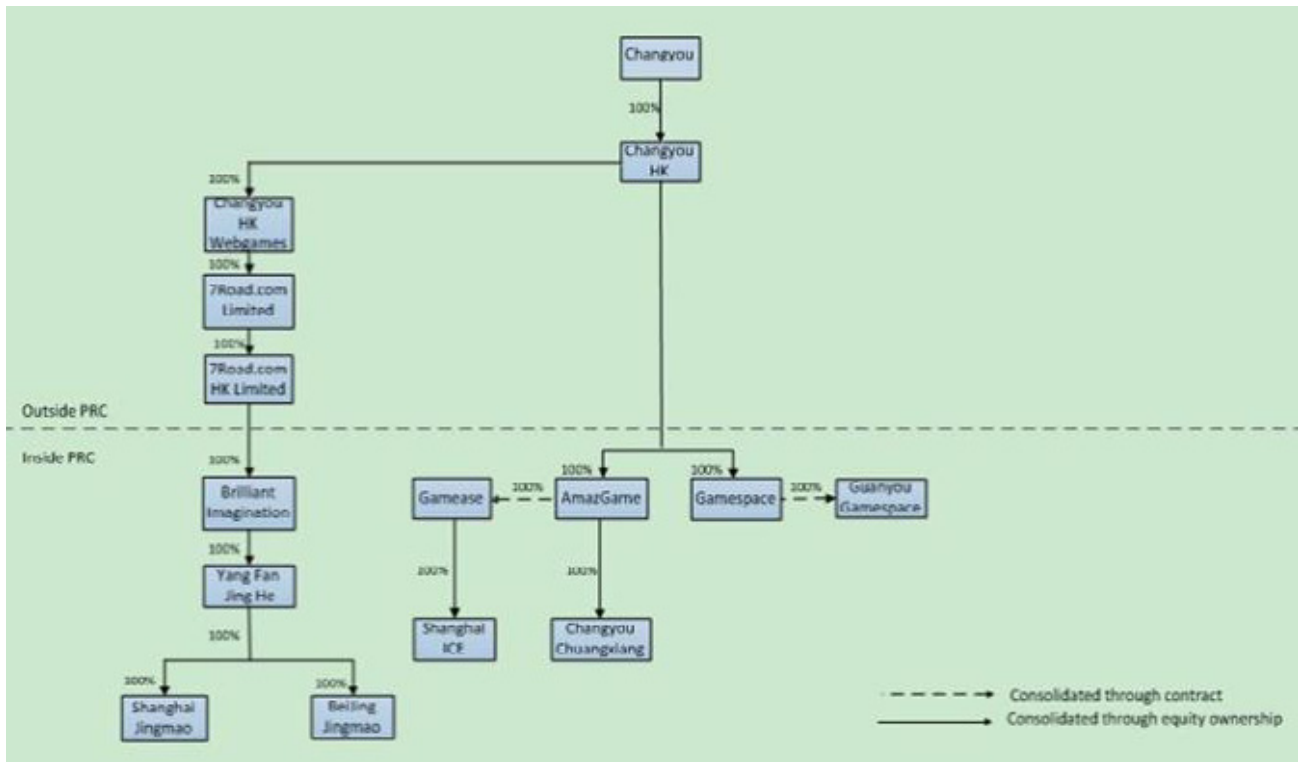
The following is a summary of our principal VIEs as of the date of this report:

- Gamease
  - Gamease was incorporated in 2007 and is a wholly-owned subsidiary of Beijing Century High Tech Investment Co., Ltd., or High Century, which is a PRC company and a VIE of Sohu.com Limited that is held 80% by Charles Zhang, our Chairman of the Board, and 20% Wei Li, an employee of Sohu.
- Shanghai ICE
  - Shanghai ICE is a wholly-owned subsidiary of Gamease that was acquired by Changyou in 2010.
- Guanyou Gamespace
  - Guanyou Gamespace was incorporated in 2010 and is a wholly-owned subsidiary of Beijing Changyou Star Digital Technology Co., Ltd., or Changyou Star, which is owned 50% by Dewen Chen, Changyou's Chief Executive Officer, and 50% by Jie Liu, a Changyou employee.

Gamease, Guanyou Gamespace and Shanghai ICE hold the key licenses and permits required to operate our business. Gamease and Shanghai ICE are controlled by AmazGame, and Guanyou Gamespace is controlled by Gamespace, through a series of contractual arrangements. AmazGame and Gamespace perform substantially all of our product development and technical support functions, which they provide to Gamease and Guanyou Gamespace pursuant to contractual arrangements.

In the opinion of Haiwen & Partners, our PRC counsel, subject to the uncertainties and risks disclosed elsewhere in this annual report under the heading "Risk Factors" the ownership structures of our principal PRC subsidiaries and our principal VIEs comply with all existing laws, rules and regulations of the PRC and each of such companies has the full legal right, power and authority, and has been duly approved, to carry on and engage in the business described in its business license.

The following diagram presents our principal consolidated entities as of the date of this annual report.



#### ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

#### ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

##### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*You should read the following discussion and analysis of our financial condition and results of operations in conjunction with the section entitled "Selected Consolidated Financial Data" and our consolidated financial statements and the related notes included elsewhere in this annual report. The discussion in this section contains forward-looking statements that involve risks and uncertainties. As a result of various factors, including those set forth under "Item 3. Key Information—Risk Factors" and elsewhere in this annual report on Form 20-F, our actual future results may be materially different from what we expect.*

##### **Overview**

Our three primary businesses are the online game business; the platform channel business, which consists primarily of online advertising; and the cinema advertising business.

We are a leading online game developer and operator in China as measured by the popularity of TLBB and our mobile game Legacy TLBB Mobile. We engage in the development, operation and licensing of online games for PCs and mobile devices. This includes PC games, which are interactive online games that are accessed and played simultaneously by hundreds of thousands of game players through personal computers and require that local game client-end access software be installed on the computers used, and mobile games, which are played on mobile devices and require an Internet connection. For the three months ended December 31, 2018, the online games that we operate had approximately 4.9 million total average monthly active accounts and 1.6 million total active paying accounts. The revenues generated from the online games are classified as online game revenues.

Our platform channel business consists primarily of the operation of the 17173.com Website, one of the leading information portals in China, which provides news, electronic forums, online videos and other information services on online games to game players.

Our cinema advertising business consists primarily of the acquisition, from operators of movie theaters, and the sale, to advertisers, of pre-film advertising slots, which are advertisements shown before the screening of a movie in a cinema theater.

Our revenues increased from \$525.4 million for the year ended December 31, 2016 to \$580.3 million for the year ended December 31, 2017, and decreased to \$485.8 million for the year ended December 31, 2018. We had net income attributable to Changyou.com Limited of \$144.9 million for the year ended December 31, 2016, net income attributable to Changyou.com Limited of \$108.8 million for the year ended December 31, 2017, and net income attributable to Changyou.com Limited of \$84.3 million for the year ended December 31, 2018.

##### **Factors Affecting Our Results of Operations**

Our results of operations are affected by several key factors, including the following:

##### *General economic conditions affecting our business*

We have benefited from general conditions typically affecting the online game, online advertising and cinema advertising industries in China, including overall economic growth, which has resulted in increases in disposable income and discretionary consumer spending and increases in advertising spending; the increasing use of the Internet with the growth of personal computers, mobile phones and broadband penetration; and the growing popularity of online games and cinema movies in comparison with other forms of entertainment.

However, we cannot assure you that the Chinese economy will continue to grow, or that if there is growth, such growth will be steady and uniform and that any such growth will lead to growth in our online game business, our online advertising, or our cinema advertising business or that if there is a slowdown, such slowdown will not have a negative effect on those businesses. Our future operating results will depend on numerous factors affecting the online game, online advertising and cinema advertising industries in China, many of which are beyond our control, including general economic conditions in China, particularly economic conditions adversely affecting discretionary consumer spending, such as the slowdown in China's economic growth that occurred between the first quarter of 2010 and the third quarter of 2012 and from 2014 through 2018.

### *Our ability to maintain popular online games*

The popularity of our games drives the growth of our game player base, which is the key component driving the sales and consumption of our virtual items and thus our revenues. To maintain and grow the popularity of our games, we must diligently maintain the quality of the games and continually enhance the games to meet game player demands and preferences. We solicit feedback from our game players and have a dedicated product development team that helps us to identify market trends and user preferences. For PC games such as TLBB, we typically provide weekly updates and more substantial enhancements in the form of expansion packs every few months. For mobile games such as Legacy TLBB Mobile, we provide updates and expansion packs on a more frequent basis. If we fail to meet game player demands and maintain their satisfaction from playing our games, game players may leave the game, which would have an adverse effect on our revenues.

### *The shift away from PC games to new game products and services, and to mobile games in particular*

For several years we have relied, and currently rely, on our popular game TLBB for a substantial portion of our revenues. However, the popularity of PC games continues to decline and an increasing number of online game developers are delaying or suspending their plans to develop and launch new PC games, as game players increasingly switch to mobile devices to access online games. As a result, we consider it to be essential to the prospects for the growth of our online game business that we shift considerable resources to the development of mobile games. Mobile games, even if successful, tend to have shorter lifespans than PC games, as the attention of users tend to shift rapidly away from existing mobile games, even those that are initially very successful, to mobile games that are new to the market. For example, our mobile game Legacy TLBB Mobile was quite popular upon its launch in May 2017, but declined in popularity through 2018. We therefore consider it to be important for us to create a substantial pipeline of mobile games, either through in-house development, or through the licensing of rights from third-party developers. We also must anticipate that a number of our mobile games will not be accepted by the game-player market, even upon initial launch. Further, we generally operate, and expect that we will continue to operate, mobile games primarily through third-party platforms that require that we enter into revenue-sharing arrangements that provide for significant revenue-sharing payments to the operators of the platforms, and that, accordingly, our profit margins from mobile games are, and are likely to be, lower than those that we enjoy from PC games.

### *Product development and sales and marketing expenses*

Developing and marketing a new online game and maintaining its popularity in the market requires a commitment of significant resources, including product development and sales and marketing expenses. We typically incur such expenses several quarters before such games generate any revenues. If such games are not popular and do not generate substantial revenues, we may not be able to recover our product development and sales and marketing expenses. In addition, because our product development strategy is to focus on a limited number of high-quality games, the failure of a small number of these games could adversely impact our growth rate.

### *The cost of attracting and retaining game development personnel*

Competition in the online game industry in China is intense, making it increasingly costly to retain and motivate existing talent and to attract new talent necessary for the growth of our business. Many of our competitors have been aggressively hiring game development personnel. If we are unable to retain our current talent and to attract new talent, we may have difficulty developing new games or enhancements for our existing games or meeting our development schedule, which could have an adverse impact on our business, financial condition and results of operations. See “Risk Factors—Our business may not succeed in a highly competitive market.” in Item 3.

### *Attempted monetization of platform channel business*

Through 2014 we made significant investments in acquiring assets and marketing, including both domestic and overseas marketing, and spent considerable sums to increase our staffing levels, with the goal of expanding and promoting our platform channels, including our acquisitions of RaidCall, MoboTap and several other entities offering Internet software products and services. However, we had limited success in generating revenues from such products and services and recognized impairment losses. See “— Results of Operations – Operating Expenses – Goodwill impairment and impairment of intangible assets acquired as part of acquisition of a business.”

### *Any restrictions imposed by PRC law on payments from our principal VIEs to our principal subsidiaries pursuant to contractual arrangements and any increase in the amount of PRC taxes applicable to such payments may adversely affect our business.*

We conduct a substantial portion of our operations through our principal VIEs Gamease, Guanyou Gamespace and Shanghai ICE, which generate nearly all of our revenues. As our principal VIEs are not owned by our subsidiaries, they are not able to make dividend payments to our subsidiaries. Instead, our principal PRC subsidiaries AmazGame and Gamespace entered into a number of contracts with their corresponding VIEs, pursuant to which the VIEs pay the PRC subsidiaries for certain services that the PRC subsidiaries provide to their corresponding VIEs. However, depending on the nature of services provided, certain of these payments are subject to PRC taxes, which effectively reduce the amount that we receive from the VIEs. We cannot assure you that the PRC government will not impose restrictions on such payments or increase the tax rates applicable to such payments. Any such restrictions on such payments or increases in the applicable tax rates may adversely affect our ability to receive payments from the VIEs or the amount of such payments.

### *Impact of fluctuations in the exchange rate between the RMB and the U.S. dollar*

Although our reporting currency is the U.S. dollar, the majority of our revenues and costs are denominated in RMB and a significant portion of our assets and liabilities are denominated in RMB. As a result, we are exposed to foreign exchange risk, as our revenues and results of operations may be affected by fluctuations in the exchange rate between the U.S. dollar and the RMB. If the RMB depreciates against the U.S. dollar, the value of our RMB revenues and assets as expressed in our U.S. dollar financial statements will decline. Conversely, if the RMB appreciates against the U.S. dollar, the value of our RMB revenues and assets as expressed in our U.S. dollar financial statements will increase. In 2018, the RMB appreciated against the U.S. dollar by approximately 2.1% compared to 2017. Calculated based on the average U.S. dollar to RMB exchange rate for 2017, our non-GAAP total revenues for 2018 expressed in U.S. dollars would have been \$10.3 million lower than the revenues we reported, representing a decrease of 18.1% year-over-year, rather than 16.3%. In addition, as a substantial portion of our cash is denominated in RMB, the depreciation of the RMB against the U.S. dollar reduced our ability to make U.S. dollar-denominated payments. See “Risk Factors—Risks Related to Doing Business in China—We may suffer currency exchange losses if the RMB depreciates relative to the U.S. dollar, which could reduce the value of an investment in our ADSs” in Item 3.

### *Government regulation of the online game industry*

PRC regulatory authorities have issued a series of new regulations affecting the online game industry. For example, the Mobile Game Notice issued by the SAPPRFT, which became effective on July 1, 2016, provides that mobile game publishers and operators must apply for publishing and authorization codes. In addition, the SPPA, as a successor agency to the SAPPRFT, may delay or temporarily suspend its review of, and issuance of publishing and authorization codes for, online games, as was the case between April 2018 and December 2018. These may delay our game publishing process. For another example, the Online Game Operation Notice issued by the MCT, which became effective on May 1, 2017, affects certain game features in mobile games, and is likely to have an adverse impact on the way we design our games and game features, which may in turn make the games less attractive to game players. These regulations also may increase our compliance costs, delay the release of our new games and expansion packs for existing games, and restrict the access of certain groups of players, such as minors, to our games, which in turn may significantly affect our operating results. See “Risks Related to Doing Business in China” in Item 3 of this report.

### *Critical Accounting Policies and Management Estimates*

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”). We have identified below the accounting policies that reflect our more significant estimates and judgments, and those that we believe are the most critical to fully understanding and evaluating our consolidated financial statements.

When reviewing our financial statements, you should consider (i) our selection of critical accounting policies, (ii) the judgment and other uncertainties affecting the application of such policies and (iii) the sensitivity of reported results to changes in conditions and assumptions.

### *Basis of presentation and consolidation*

Our consolidated financial statements have been prepared on a historical cost basis to reflect our financial position and results of operations in accordance with U.S. GAAP and on a going concern basis. Our consolidated financial statements include the financial statements of Changyou.com Limited and its controlled operating entities, including subsidiaries and VIEs. All inter-company balances and transactions within the Changyou group have been eliminated on consolidation.

We have adopted the guidance of accounting for VIEs, which requires VIEs to be consolidated by the primary beneficiary of the entity. Our management made evaluations of the relationships between us and our VIEs and the economic benefit flow of contractual arrangements with the VIEs. In connection with such evaluation, our management also took into account the fact that, as a result of such contractual arrangements, we control the shareholders’ voting interests in the VIEs. As a result of such evaluation, management concluded that Changyou.com Limited, through its indirect PRC subsidiaries, is the primary beneficiary of its VIEs. As a result, we consolidate all of our VIEs in our consolidated financial statements.

### *Use of estimates*

The preparation of our financial statements requires our management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

### ***Fair value measurement***

U.S. GAAP establishes a three-tier hierarchy to prioritize the inputs used in the valuation methodologies in measuring the fair value of financial instruments. This hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The three-tier fair value hierarchy is:

Level 1—observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2—other inputs that are directly or indirectly observable in the marketplace.

Level 3—unobservable inputs which are supported by little or no market activity.

Our financial instruments consist primarily of cash equivalents, accounts receivable, short-term investments, matching loans to related parties, loans between Changyou and Sohu, prepaid and other current assets, restricted time deposits, other non-current assets, accounts payable, receipts in advance and deferred revenue, accrued liabilities to suppliers, matching loans from related parties and other short-term liabilities.

### ***Cash and cash equivalents***

Cash and cash equivalents consist of cash on hand, time deposits with original maturities of three months or less and highly-liquid investments that are readily convertible to known amounts of cash.

In November 2016, the FASB issued new guidance related to the classification of restricted cash in the statement of cash flows. The new standard requires that a statement of cash flows explain any change during the year in total cash, cash equivalents, and restricted cash. The new standard is effective for fiscal years beginning after December 15, 2017, and should be applied retrospectively. We adopted the new standard during the beginning of 2018 and applied the standard retrospectively for all periods presented.

### ***Restricted time deposits—Loans from offshore banks, secured by time deposits***

Loans from offshore branches of lending banks are classified as short-term bank loans or long-term bank loans based on their repayment periods. The rates of interest under the loan agreements with the lending banks were determined based on the prevailing interest rates in the market. The RMB onshore deposits securing the offshore loans are treated as restricted time deposits in our consolidated balance sheets. Restricted time deposits are valued based on the prevailing interest rates in the market.

### ***Short-term investments***

In accordance with Accounting Standards Codification (“ASC”) 825, for investments in financial instruments with a variable interest rate indexed to the performance of underlying assets, we elected the fair value method at the date of initial recognition and carried these investments subsequently at fair value. Changes in the fair value are reflected in our consolidated statements of comprehensive income. To estimate fair value, we refer to the quoted rate of return provided by banks at the end of each period using the discounted cash flow method. Since these investments’ maturity dates are within one year, they are classified as short-term investments.

### ***Accounts receivable, net***

The carrying value of accounts receivable is reduced by an allowance that reflects our best estimate of the amounts that will not be collected. We make estimates of the collectability of accounts receivable. Many factors are considered in estimating the general allowance, including reviewing delinquent accounts receivable, performing aging analyses and customer credit analyses, and analyzing historical bad debt records and current economic trends. Additional allowance for specific doubtful accounts might be made if our customers are unable to make payments due to their deteriorating financial condition.

### ***Fixed assets and depreciation***

Fixed assets, mainly comprising office buildings, leasehold improvements, building improvements, office furniture, vehicles, and computer equipment (including servers), are stated at cost less accumulated depreciation and impairment. Fixed assets are depreciated at rates sufficient to write off their costs less impairment, if any, over the estimated useful lives of the assets on a straight-line basis, with no residual value. The estimated useful lives are as follows:

	<u>Estimated useful life</u>
Office buildings	36-47 years
Leasehold improvements	Lesser of the term of the lease or the estimated useful lives of the assets
Building improvements	10 years
Office furniture	5 years
Vehicles	4 years
Computer equipment (including servers)	3-5 years

Repairs and maintenance costs are recorded as expenses as incurred, whereas the costs of renewals and betterments that extend the useful lives of fixed assets are capitalized as additions to the related assets. Retirements, sales and disposals of assets are recorded by removing the costs, accumulated depreciation and impairments with any resulting gain or loss recognized in the consolidated statements of comprehensive income.

### ***Intangible assets***

Intangible assets mainly comprise operating rights for licensed games, computer software, developed technologies, and trademarks and domain names. Intangible assets are recorded at cost less accumulated amortization and impairments. Amortization is computed using the straight-line method over the estimated useful lives of assets with no residual value. The estimated useful lives are as follows:

	<u>Estimated useful life</u>
Operating rights for licensed games	Contract terms
Computer software	1-5 years
Developed technologies	3-5 years
Trademarks and domain names	5-30 years

### ***Long-term investments***

#### Equity investments

In January 2016, the FASB issued ASU 2016-01 (“ASU 2016-01”), Recognition and Measurement of Financial Assets and Financial Liabilities, which, among other things, generally requires companies to measure investments in other entities, except those accounted for under the equity method, at fair value and to recognize any changes in fair value in net income. ASU 2016-01 also simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. ASU 2016-01 is effective for fiscal years beginning after December 15, 2017, and the guidance should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The guidance related to equity investments without readily determinable fair values (including disclosure requirements) is applied prospectively to equity investments that exist as of the date of adoption. ASU 2016-01, which we adopted on January 1, 2018, did not have a material impact on our consolidated financial statements.

Investments in entities over which we do not have significant influence are recorded as equity investments and are accounted for either at fair value with any changes recognized in net income or, for those without readily determinable fair values, at cost less impairment, adjusted for subsequent observable price changes. Under the equity method, our share of the post-acquisition profits or losses of the equity investment is recognized in our consolidated statements of comprehensive income; and our share of post-acquisition movements in equity is recognized in equity in our consolidated balance sheets. Unrealized gains on transactions between us and an entity in which we have recorded an equity investment are eliminated to the extent of our interest in the entity. To the extent of our interest in the investment, unrealized losses are eliminated unless the transaction provides evidence of an impairment of the asset transferred. When our share of losses in an entity in which we have recorded an equity investment equals or exceeds our interest in the entity, we do not recognize further losses, unless we have incurred obligations or made payments on behalf of the equity investee.

### ***Goodwill***

Goodwill represents the excess of the purchase price over the fair value of the identifiable assets and liabilities acquired as a result of our acquisitions of interests in our subsidiaries and VIEs.



We test goodwill for impairment at the reporting unit level on an annual basis as of October 1, and between annual tests when an event occurs or circumstances change that could indicate that the asset might be impaired. In accordance with the FASB guidance on “Testing of Goodwill for Impairment,” a company has the option to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. For those reporting units where it is determined that it is more likely than not that their fair values are less than the units’ carrying amounts, we perform the first step of a two-step quantitative goodwill impairment test. In the first step, we determine the fair values of the individual reporting units using the income approach and the market approach. After performing the assessment, if the carrying amounts of the reporting units were higher than their fair values, we perform the second step of the two-step quantitative goodwill impairment test. In the second step, the implied fair value of the goodwill is estimated as the fair value of the reporting unit determined in the first step less the fair values of all other net tangible and intangible assets of the reporting unit. If the carrying amount of the goodwill exceeds its implied fair market value, an impairment loss is recognized in an amount equal to that excess, not to exceed the carrying amount of the goodwill.

The quantitative impairment test consists of a comparison of the fair value of goodwill with its carrying value. Application of a goodwill impairment test requires significant management judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value of each reporting unit. We estimate the fair value using the income approach and the market approach, both of which are typically used under ASC 350. The judgment in estimating the fair value of reporting units includes estimating future cash flows, determining appropriate discount rates, control premium, comparable companies’ multipliers and making other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value for each reporting unit.

#### ***Impairment of long-lived assets and intangible assets***

The carrying amounts of long-lived assets and intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amounts of the assets may not be recoverable. Recoverability of assets to be held and used is evaluated by a comparison of the carrying amounts of the assets to future undiscounted net cash flows expected to be generated by the assets. If such assets are considered to be impaired, where the undiscounted cash flows are less than the carrying amounts of the assets, the impairment to be recognized is measured by the amount by which the carrying amounts of the assets exceed the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less cost to sell. We test impairment of long-lived assets and intangible assets at the asset group level when impairment indicators appear and recognize impairment in the event that the carrying value exceeds the fair value of each reporting unit.

#### ***Receipts in advance and deferred revenues***

For our operation of PC games, the proceeds received from sales of prepaid game cards are initially recorded as receipts in advance. For online advertising and cinema advertising services, cash payments, which are received in advance of the delivery of services pursuant to applicable advertising contracts, are recorded as receipts in advance.

For self-operated games, deferred revenues are recognized when the game points are sold through our online payment platform or when prepaid game cards are charged by the players to their respective game accounts. The deferred revenues are amortized when virtual items are consumed. For our licensed out games, deferred revenues represent the unamortized balance of license fees paid by third-party operators, and the deferred revenues are amortized on a straight-line basis through the service period.

#### ***Non-controlling interest***

Non-controlling interests are recognized to reflect the portion of the equity of majority-owned subsidiaries and VIEs which is not attributable, directly or indirectly, to the controlling shareholder. The non-controlling interests in our consolidated financial statements consist primarily of the non-controlling interests in RaidCall; the non-controlling interests in Beijing Changmica Culture Co., Ltd., which is a joint venture that operates Korean comics online in China; and, for periods prior to the Company’s sale of MoboTap in March 2018, the non-controlling interests in MoboTap.

#### ***Treasury shares***

On July 27, 2013, our Board of Directors authorized a share repurchase program of up to \$100 million of the outstanding ADSs of Changyou over a two-year period from July 27, 2013 to July 26, 2015. We accounted for those shares repurchased as treasury shares at cost in accordance with ASC 505-30. The treasury shares acquired are shown separately in shareholders’ equity, as we have not yet decided on the ultimate disposition of those shares. If and when we cancel the treasury shares, the difference between the original issuance price and the repurchase price will be debited into additional paid-in capital.

## ***Functional currency and foreign currency translation***

### **Functional currency**

An entity's functional currency is the currency of the primary economic environment in which it operates, and normally is the currency of the environment in which the entity primarily generates and expends cash. Our management's judgment is essential to determine our functional currency by assessing various indicators, including cash flows, sale prices, market prices, expenses, financing and inter-company transactions and arrangements. The functional currency of Changyou.com Limited and our subsidiaries in the United States, the Cayman Islands, the British Virgin Islands and Hong Kong is the U.S. dollar. The functional currencies of our subsidiaries and VIEs in other countries are the national currencies of those countries, rather than the U.S. dollar.

### **Foreign currency translation**

Financial statements of entities with functional currencies other than the U.S. dollar are translated into the U.S. dollar, which is the reporting currency. Assets and liabilities are translated at the current exchange rate in effect at the balance sheet date, and revenues and expenses are translated at the average exchange rates in effect during the reporting period. Shareholders' equity accounts are translated using the historical exchange rates at the date the entry to shareholders' equity was recorded, except for the change in retained earnings during the year, which is translated using the historical exchange rates used to translate each period's income statement. Differences resulting from the translation of foreign currency to the reporting currency are recorded in accumulated other comprehensive income/(loss) in the consolidated balance sheets.

Foreign currency transactions denominated in currencies other than the functional currency are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are re-measured at the applicable rates of exchange in effect at that date. Gains and losses resulting from foreign currency re-measurement are included in the consolidated statements of comprehensive income.

## ***Revenue recognition***

In May 2014, the FASB issued ASC Topic 606, Revenue From Contracts with Customers (the "New Revenue Standard" or "ASC 606"), which replaced ASC Topic 605, Revenue Recognition (the "Old Revenue Standard" or "ASC 605"), including industry-specific requirements, and provided companies with a single principles-based revenue recognition model for recognizing revenue from contracts with customers. The core principle of the New Revenue Standard is that a company should recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. We adopted ASC 606 on January 1, 2018, applying the modified retrospective method to contracts that were not completed as of January 1, 2018. Adoption had no significant impact on our consolidated financial statements. We have updated significant accounting policy and relevant disclosure hereinafter.

Effective January 1, 2018, we evaluated and recognized revenue based on the criteria set forth in ASC 606 by:

- identifying the contract(s) with the customer;
- identifying the performance obligations in the contract;
- determining the transaction price;
- allocating the transaction price to performance obligations in the contract; and
- recognizing revenue as each performance obligation is satisfied through the transfer of a promised good or service to a customer (i.e., "transfer of control").

### **Online game revenues**

Our online game revenues are generated primarily from our self-operated and licensed-out PC games and mobile games. Prior to the sale of the MoboTap business in 2018, we also generated a small amount of revenues from online card and board games. All of our games are operated under the item-based revenue model, where the basic game play functions are free of charge and players are charged for purchases of in-game virtual items, including those with a predetermined expiration time and perpetual virtual items. Revenues that we generate from self-operated and licensed out online games are included in online game revenues.

### ***Self-Operated Games***

We are the principal of our self-operated games. We host the games on our own servers and are responsible for the sale and marketing of the games as well as the customer services. Accordingly, revenues are recorded gross of revenue-sharing payments to third-party developers and/or mobile application stores, but are net of value-added tax and discounts to game card distributors where applicable. We obtain revenues from the sale of in-game virtual items. Revenues are recognized over time for virtual items with estimated lives and upon use for items that are consumed immediately. If different assumptions were used in deriving the estimated lives of the virtual items, the timing of the recording of the revenues would be impacted.

## PC games

Proceeds from self-operated PC games are collected from players and third-party game card distributors through sales of our game points on online payment platforms and prepaid game cards. We apply the portfolio approach in determining the commencement date of consumption and the estimated lives of virtual items for the recognition of the game revenues, given that the effect of applying a portfolio approach to the behaviors of game players as a group would not differ materially from considering each of them individually.

Self-operated PC games are either developed in house or licensed from third-party developers. For licensed PC games, we remit a pre-agreed percentage of the proceeds to the third-party developers, and keep the balance pursuant to revenue-sharing agreements. Such revenue-sharing amounts paid to third-party developers are included in our cost of revenues.

## Mobile games

For self-operated mobile games, we sell game points to our game players via third-party mobile application stores. The mobile application stores in turn pay us proceeds after deducting their share of pre-agreed revenue-sharing amounts.

Self-operated mobile games are either developed in house or licensed from or jointly developed with third-party developers. For licensed and jointly developed mobile games, we remit a pre-agreed percentage of the proceeds to the third-party developers, and keep the balance pursuant to revenue-sharing agreements. Such revenue-sharing amounts paid to mobile application stores and third-party developers are included in our cost of revenues.

## *Licensed Out Games*

We also authorize third-parties to operate our online games. The licensed out games include PC games and mobile games developed in house and mobile games jointly developed with third-party developers. We receive monthly revenue-based royalty payments from the third-party licensee operators. We receive additional up-front license fees from certain third-party licensee operators who are entitled to an exclusive right to operate our games in specified geographic areas. Since we are obligated to provide post-sale services (“PCS”), the initial license fees are allocated between the license and PCS based on relative standalone selling prices. The amount allocated to the license is recognized as revenue upon the commencement of the license period, given that our intellectual property rights subject to the license are considered to be functional and the licensee has the right to use such intellectual property rights as they exist at the point when the license is granted, and the amount allocated to PCS is recognized as revenue ratably over the license period. Monthly revenue-based royalty payments are recognized when the relevant services are delivered, provided that collectability is reasonably assured. We view the third-party licensee operators as our customers and recognize revenues on a net basis, as we do not have the primary responsibility for fulfillment and acceptability of the game services. We remit to the third-party developers a pre-agreed percentage of revenues and keep the balance pursuant to revenue-sharing agreements. Such revenue-sharing amounts paid to third-party developers are included in our cost of revenues or product development expenses.

## Online advertising revenues

### *17173.com Website*

Our online advertising revenues are mainly generated from the 17173.com Website. We sign contracts with advertisers to fix the advertising services to be provided and the prices for the services. Based on the contracts, we provide advertisement placements on the 17173.com Website in different forms, including text, rich media and video advertisements. Currently the main type of pricing model of the 17173.com Website is the Fixed Price Model, under which a contract is signed to establish a fixed price for the advertising services to be provided.

To determine the method of recognition of online advertising revenues, prior to entering into contracts, management makes a credit assessment of customers to assess the collectability of amounts due under the contracts. For those contracts for which collectability is determined to be reasonably assured, revenues are recognized ratably over the period during which the advertising services are provided and when all revenue-recognition criteria have been met. For those contracts for which collectability is determined to be not reasonably assured, revenues are recognized only when the cash is received and all other revenue-recognition criteria have been met.

We treat advertising contracts for the 17173.com Website with multiple deliverable elements as separate units of accounting for revenue recognition purposes and recognize revenues on a periodic basis during the contract periods when each deliverable service was provided. Since the contract price is for all the deliverables under one advertising contract, we allocate the contract price among all the deliverables at the inception of the arrangement on the basis of their relative selling prices according to the selling price hierarchy established by ASU No. 2009 -13. We first use vendor-specific objective evidence of selling price, if it exists. If vendor-specific objective evidence of selling price does not exist, we use third-party evidence of selling price. If neither vendor-specific objective evidence of selling price nor third-party evidence of selling price exists, we use management’s best estimate of the selling price for the deliverables.

## Cinema advertising revenues

Revenues generated from the cinema advertising business is classified as cinema advertising revenues. We provide clients advertising placements in slots that are shown in theaters before the screening of movies. The rights to place advertisements in such advertising slots are granted under contracts we sign with different theaters. We charge our advertising clients fees either on a per advertising-slot basis or a fixed amount for an agreed-upon number of slots during a specified contract period. When delivery of the advertising service is confirmed by the customers by their signing a form, revenues from cinema advertising are recognized based on a percentage of the advertising slots actually delivered or on a straight-line basis over the contract period.

### IVAS revenues

Our IVAS revenues are derived primarily from software applications for PCs and mobile devices offered by RaidCall. Prior to March 2018, IVAS revenues also included revenues generated from the Dolphin Browser operated by MoboTap. Revenues from IVAS are recognized during the period the services are rendered or items are consumed under the gross method, as we are the principal obligor for provision of the services.

### Significant judgments

#### *Estimate of the lives of virtual items*

Our self-operated game revenues are generated through direct online sale of game points and prepaid game cards, and recognition of these revenues depends on such factors as whether the virtual items purchased by game players are considered consumable or perpetual. Our revenue recognition policy with respect to perpetual virtual items is based on our best estimate of the lives of the items. We consider the average period that paying players typically play games and other player behavior patterns to arrive at the best estimate of the lives of these perpetual items.

#### *Allocating the transaction price for contracts with multiple deliverables*

Part of our revenue from licensed out games is received pursuant to license contracts. The contracts often include multiple performance obligations, including obligations characterized as license obligations and PCS obligations. Determining how to allocate the transaction prices between license obligations and PCS obligations may require significant judgments. Certain of our games may contain licenses of our right to distribute and operate games to the third-party operators and requirements for the provision by us of a significant level of upgrade and maintenance. In these cases, significant judgment is required to determine whether the license should be considered distinct and accounted for separately, or not distinct and accounted for together with the PCS provided and recognized over time. Generally, for cases in which the license is functional without the PCS, we believe there are separate performance obligations for the license of the right to distribute and operate games and the PCS. Significant judgment is also required to determine the standalone selling price for each distinct performance obligation and to determine whether there is a discount that needs to be allocated based on the relative standalone selling price of the license and the PCS. To estimate the standalone selling price, we consider market data, including our pricing strategies for the products being evaluated and other similar products we offer, competitor pricing to the extent data is available, and costs to determine whether the estimated selling price yields an appropriate profit margin.

### Contract balances

The timing of revenue recognition may differ from the timing of invoicing to customers. Accounts receivable represent amounts invoiced and revenue recognized prior to invoicing, when we have satisfied our performance obligations and have the unconditional right to payment. The allowance for doubtful accounts and authorized credits is estimated based upon our assessment of various factors, including historical experience, the age of the accounts receivable balances, current economic conditions and other factors that may affect our customers' ability to pay. Contract assets as of December 31, 2018 were not material.

Receipts in advance and deferred revenues related to unsatisfied performance obligations at the end of an applicable reporting period consist of fees received from game players in the online game business and from advertisers in the online advertising and cinema advertising businesses. Due to the generally short-term duration of the relevant contracts, a majority of the performance obligations are satisfied in the following reporting period.

### Practical expedients

We have used the following practical expedients as allowed under ASC 606:

- The transaction price allocated to the performance obligations that are unsatisfied, or partially unsatisfied, has not been disclosed, as substantially all of the contracts have a duration of one year or less;
- Payment terms and conditions vary by contract types, although terms generally include a requirement of prepayment or payment within one year or less. In instances where the timing of revenue recognition differs from the timing of invoicing, we have determined that the contracts generally do not include a significant financing component;
- We generally expense sales commissions when incurred, because the amortization period would be one year or less. These costs are recorded within sales and marketing expenses.

### Sales rebates

In the online advertising and cinema advertising businesses, certain customers may receive sales rebates, which are accounted for as variable consideration. We estimate the annual expected revenue volume from each individual agent with reference to the agent's historical results. The sales rebates reduce the amount of revenues recognized. We recognize revenue for the amount of fees we receive from our advertisers after deducting sales rebates, and net of VAT and related surcharges. We believe that there will not be significant changes to our estimates of variable consideration.

### Principal/agent considerations

An entity is the principal if it controls a good or service before it is transferred to the end customer. Key indicators that we evaluate in determining gross treatment, which applies if the entity is determined to be the principal, versus net treatment, which applies if the entity is determined to be an agent, include the following:

- which party is primarily responsible for fulfilling the promise to provide the specified good or service to the end customer;
- which party has inventory risk before the specified good or service has been transferred to the end customer; and
- which party has discretion in establishing the price for the specified good or service.

Based on evaluation of the above indicators, we have determined that generally we are considered to be the principal to end customers, except in the case of licensed out games, where we are not the primary obligor and are not entitled to establish the price.

### ***Cost of revenues***

Cost of online game revenues consists primarily of revenue-sharing payments, salary and benefits expense, bandwidth leasing costs, content and license fees, tax surcharges, depreciation and amortization expenses, and other direct costs.

Cost of online advertising revenues consists primarily of salary and benefits expense, bandwidth leasing costs, depreciation and amortization expenses, and advertising design costs.

Cost of cinema advertising revenues consists primarily of payments to theaters for pre-film screening advertising slots.

Cost of IVAS revenues consists primarily of revenue-sharing payments to third-party developers and service providers, bandwidth leasing costs, and salary and benefits expense.

### ***Product development expenses***

Product development expenses include costs incurred for the development of products prior to the establishment of technological feasibility and maintenance costs incurred after the establishment of technological feasibility. During the fiscal years ended December 31, 2016, 2017 and 2018, we did not capitalize any product development expenses.

### ***Advertising expenses***

Advertising expenses, which generally represent the cost of promotions to create or stimulate a positive image of us or a desire to buy our products and services, are expensed as incurred.

### ***Government grants***

A government grant is recognized when the grant is received and the relevant requirements have been complied with. Government grants are generally recorded as other income, and grants for which the government stipulates specified uses are recorded as a reduction in operating expenses and cost of revenues.

### ***Operating leases***

Leases for which substantially all of the risks and rewards of ownership of assets remain with the leasing company are accounted for as operating leases. Payments made under operating leases net of any incentives received by us from the leasing company are charged to our consolidated statements of comprehensive income on a straight-line basis over the lease periods.

### ***Share-based compensation expense***

Share-based compensation expense is for share awards, including ordinary shares, share options, restricted shares and restricted share units, granted by us to employees and directors. For share-based awards for which a grant date has occurred, share-based compensation expense is recognized as costs and expenses in our consolidated statements of comprehensive income based on the fair values of the related share-based awards on their grant dates. For share-based awards for which the service inception date precedes the grant date, share-based compensation expense is recognized as costs and expenses in our consolidated statements of comprehensive income beginning on the service inception date and is re-measured on each subsequent reporting date before the grant date, based on the estimated fair values of the related share-based awards. The fair value is estimated based on the public market price of the underlying shares.

We have used two share incentive plans, our 2008 Share Incentive Plan and our 2014 Share Incentive Plan, for the granting of share-based awards, including share options, restricted shares and restricted share units, to our employees and directors. Our 2008 Share Incentive Plan expired in August 2018 and is no longer available for granting new share-based awards.

Share-based compensation expense for share options, restricted shares and restricted share units granted is recognized on an accelerated basis over the requisite service period, net of estimated forfeitures. Forfeiture rates are estimated at the time of grant and revised in the subsequent periods if actual forfeitures differ from the initial estimates.

Options for the purchase of our Class A ordinary shares contractually granted under the Changyou 2014 Share Incentive Plan are subject to vesting in four equal installments over a period of four years, with each installment vesting upon satisfaction of a service period requirement and certain subjective performance targets. Under ASC 718-10-25, no grant date can be established until a mutual understanding is reached between us and the recipients clarifying the subjective performance requirements. In accordance with ASC 718-10-55, as the service inception date preceded the grant date, compensation expense was accrued beginning on the service inception date and will be re-measured on each subsequent reporting date before the grant date is established, based on the then-current fair value of the awards. The estimates of the awards' fair values will be fixed in the period in which the grant date occurs, and cumulative compensation expense will be adjusted based on the fair values at the grant date. In determining the fair values of our share options granted, the public market price of the underlying shares at each reporting date was used, and a binomial valuation model was applied.

### ***Income taxes***

Current income taxes are provided on the basis of income for financial reporting purposes, adjusted for income and expense items which are not assessable or deductible for income tax purposes, in accordance with regulations of the relevant tax jurisdictions. Deferred income taxes are provided using the liability method. Under this method, deferred income taxes are determined based on the differences between the financial reporting and tax bases of assets and liabilities and are measured using the currently enacted tax rates and laws. The deferred tax assets are reduced by a valuation allowance if it is considered based on available evidence more likely than not that some portion, or all, of the deferred tax assets will not be realized. Deferred tax liability is not recognized for undistributed earnings of a PRC subsidiary if the subsidiary has invested or will invest the undistributed earnings indefinitely.

### ***Uncertain tax positions***

In order to assess uncertain tax positions, we apply a more likely than not threshold and a two-step approach for tax position measurement and financial statement recognition. For the two-step approach, the first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon settlement.

### ***Earnings (Losses) per share***

Basic earnings (losses) per share are computed using the weighted average number of ordinary shares outstanding during the year. Diluted earnings (losses) per share are computed using the weighted average number of ordinary shares and, if dilutive, potential ordinary shares outstanding during the year. Potential ordinary shares consist of shares issuable upon the exercise of share options and shares issuable upon the settlement of restricted share units. Potential ordinary shares are accounted for in the computation of diluted earnings (losses) per share using the treasury stock method. Potential ordinary shares are not included in the denominator of the diluted earnings (losses) per share calculation when inclusion of such shares would be anti-dilutive, such as in a period in which a net loss is recorded. Earnings (losses) per share are computed on Class A ordinary shares and Class B ordinary shares together, because both classes have the same dividend rights and the same participation rights in our undistributed earnings (losses).

### ***Comprehensive income (loss)***

Comprehensive income (loss) is defined as the change in equity of a company during a period from transactions and other events and circumstances excluding transactions resulting from investments from owners and distributions to owners. Accumulated other comprehensive income (loss), as presented on the accompanying consolidated balance sheets, consists of the cumulative foreign currency translation adjustment.

### Segment reporting

Operating segments are defined as components of an enterprise about which separate financial information is available and is evaluated regularly by the chief operating decision maker (“CODM”), or a decision making group, in deciding how to allocate resources and in assessing performance. From November 2, 2014 to July 31, 2016 the CODMs were our former Co-Chief Executive Officers, and since August 1, 2016 the CODM has been our current Chief Executive Officer.

Our organizational structure is based on a number of factors that the CODM uses to evaluate, view and run our business operations, which include, but are not limited to, customer base, homogeneity of products and technology. Our operating segments are based on our organizational structure and information reviewed by the CODM to evaluate the operating segment results.

As of December 31, 2016 and December 31, 2017, the business segments that constituted our reportable segments were the Online Game segment, which consisted primarily of PC games and mobile games; the Platform Channel segment, which consisted primarily of online advertising services offered on the 17173.com Website, and also included IVAS offered on the Dolphin Browser, which was operated by MoboTap, and by RaidCall and online card and board games offered by MoboTap; and the Cinema Advertising segment.

We disposed of the MoboTap business in March 2018 and, as a result, as of December 31, 2018 the business segments that constituted our reportable segments were the Online Game segment, which consisted primarily of PC games and mobile games; the Platform Channel segment, which consisted primarily of online advertising services offered on the 17173.com Website, and also included IVAS offered by RaidCall; and the Cinema Advertising segment.

### Foreign exchange forward contracts

Foreign exchange forward contracts are initially recognized on the date a foreign exchange forward contract is entered into and are subsequently measured at fair value. We entered into such foreign exchange forward contracts in compliance with our risk management policy for the purpose of eliminating the negative impact on earnings and equity resulting from fluctuations in the exchange rate between the U.S. dollar and the RMB. The instruments are marked-to-market at each period-end, with the associated changes in fair value recognized in the line item “Other income, net” in our consolidated statements of comprehensive income and “Prepaid and other current assets” or “Other short-term liabilities” in our consolidated balance sheets. The net cash inflow and outflow related to the settlement of the forward contracts are recorded in the line item “Other investing activities” under “Cash flows from investing activities” in our consolidated statements of cash flows.

### Results of Operations

#### Our Revenues

Our total revenues for 2018 were \$485.8 million, which included online game revenues of \$389.8 million, online advertising revenues of \$19.7 million, cinema advertising revenues of \$70.2 million and IVAS revenues of \$6.1 million.

The following table sets forth our revenues generated from online games, online advertising, cinema advertising and IVAS, in absolute amounts and as a percentage of total revenues for the periods indicated:

	For the Year Ended December 31,					
	2016		2017		2018	
	Amount	% of Total Revenues	Amount	% of Total Revenues	Amount	% of Total Revenues
<b>Revenues:</b>						
Online games	395,708	75.3%	449,533	77.5%	389,790	80.2%
Online advertising	39,409	7.5%	25,129	4.3%	19,697	4.0%
Cinema advertising	68,542	13.1%	91,419	15.8%	70,202	14.5%
IVAS	21,726	4.1%	14,180	2.4%	6,074	1.3%
Total revenues	<u>525,385</u>	<u>100.0%</u>	<u>580,261</u>	<u>100.0%</u>	<u>485,763</u>	<u>100.0%</u>

### Online Game Revenues

Online game revenues were \$389.8 million for 2018, compared to \$449.6 million and \$395.7 million, respectively, for 2017 and 2016.

#### *PC games and mobile games*

Revenues generated by our PC games were \$236.7 million for 2018, compared to \$239.2 million and \$274.6 million, respectively, for 2017 and 2016, representing 60.7%, 53.2% and 69.4%, respectively, of our online game revenues for 2018, 2017 and 2016. The dominant PC game operated by us is TLBB. The year-over-year decrease in PC games revenues for 2018 of \$2.5 million was mainly due to the natural decline in revenues generated by our PC games other than TLBB. The year-over-year decrease in PC games revenues for 2017 of \$35.4 million was mainly due to the natural decline in revenues generated by TLBB, which is an older game. For 2018, our revenues for TLBB were \$200.9 million, accounting for approximately 51.6% of our online game revenues and approximately 41.4% of our total revenues.

Revenues generated from mobile games were \$151.7 million for 2018, compared to \$208.4 million and \$116.8 million, respectively, for 2017 and 2016. The dominant mobile game operated by us was Legacy TLBB Mobile after the game was launched in May 2017; and before our launch of Legacy TLBB Mobile, the dominant mobile game operated by us was TLBB 3D. The year-over-year decrease in mobile games revenues for 2018 was \$56.7 million, mainly due to the natural decline in revenues of Legacy TLBB Mobile. The year-over-year increase in mobile games revenues for 2017 was \$91.6 million, mainly due to the revenue contribution of Legacy TLBB Mobile, which was launched in May 2017.

The following table sets forth certain operating data for our PC games and mobile games in China for the periods indicated:

Average Monthly Active Accounts <sup>(1)</sup> (in millions)	For the Three Months Ended							
	March 31		June 30		September 30		December 31	
	PC games	mobile games	PC games	mobile games	PC games	mobile games	PC games	mobile games
2016	3.0	3.2	2.9	2.4	2.7	2.8	2.5	1.6
2017	2.4	1.1	2.4	7.4	2.3	5.2	2.4	3.1
2018	2.5	2.6	2.3	3.2	2.3	3.7	2.0	2.9

Quarterly Aggregate Active Paying Accounts <sup>(2)</sup> (in millions)	For the Three Months Ended							
	March 31		June 30		September 30		December 31	
	PC games	mobile games	PC games	mobile games	PC games	mobile games	PC games	mobile games
2016	1.1	0.8	1.0	0.6	1.0	0.7	1.0	0.4
2017	0.9	0.3	0.9	2.5	0.8	1.4	0.8	1.2
2018	0.8	0.8	0.7	0.7	0.8	0.7	0.9	0.7

- (1) Average Monthly Active Accounts for a given period refers to the number of registered accounts that were logged in to these games at least once during the period.
- (2) Quarterly Aggregate Active Paying Accounts for a given period refers to the number of accounts from which game points are utilized at least once during the quarter.

### Online Advertising Revenues

Online advertising revenues, which consist mainly of revenues generated from the 17173.com Website, were \$19.7 million for 2018, compared to \$25.1 million and \$39.4 million, respectively, for 2017 and 2016. The year-over-year decreases in online advertising revenues for 2018 and 2017 were \$5.4 million and \$14.3 million, respectively, mainly due to fewer Web games and PC games being marketed on the 17173.com Website.

### Cinema Advertising Revenues

Cinema advertising revenues, which we identified as “Others” revenues prior to 2016, were \$70.2 million for 2018, compared to \$91.4 million and \$68.5 million, respectively, for 2017 and 2016. The year-over-year decrease in cinema advertising revenues for 2018 was \$21.2 million, mainly due to a strategy adjustment related to the acquisition and sale of advertising resources during the second quarter of 2018. The year-over-year increase in cinema advertising revenues for 2017 was \$22.9 million mainly due to strong growth in China’s movie and cinema industry in general, as well as increased customer orders that resulted from our having increased our advertising resources.



### IVAS Revenues

Our IVAS revenues were \$6.1 million for 2018, compared to \$14.2 million and \$21.7 million, respectively, for 2017 and 2016. The year-over-year decrease in IVAS revenues for 2018 was \$8.1 million, mainly due to the disposition of all of our equity interests in MoboTap in 2018 and lower revenues from both PC and mobile Internet products. The year-over-year decrease for 2017 was \$7.5 million, mainly due to lower revenues from both PC and mobile Internet products.

### **Cost of Revenues**

The following table presents our cost of revenues for online games, online advertising, cinema advertising and IVAS revenues, in absolute amounts and as a percentage of total revenues for the periods indicated:

	For the Year Ended December 31,					
	2016		2017		2018	
	Amount	% of Total Revenues	Amount	% of Total Revenues	Amount	% of Total Revenues
<b>Cost of Revenue:</b>	(US\$ in thousands except percentages)					
Online game	96,171	18.3%	62,774	10.8%	60,983	12.6%
Online advertising	10,104	1.9%	6,660	1.2%	5,204	1.1%
Cinema advertising	45,959	8.7%	84,944	14.6%	89,233	18.4%
IVAS	13,576	2.6%	9,408	1.6%	5,408	1.0%
Total cost of revenues	<u>165,810</u>	<u>31.5%</u>	<u>163,786</u>	<u>28.2%</u>	<u>160,828</u>	<u>33.1%</u>

Cost of online game revenues was \$61.0 million for the year ended December 31, 2018, compared to \$62.8 million and \$96.2 million, respectively, for the year ended December 31, 2017 and 2016. The cost of online game revenues for 2018 was consistent with the cost of online game revenues for 2017, with a relatively minor decrease of \$1.8 million. The year-over-year decrease in cost of online game revenues for 2017 was \$33.4 million. The decrease mainly consisted of a \$16.3 million decrease in revenue-sharing payments to mobile application stores, a \$5.7 million decrease in bandwidth leasing costs, a \$4.9 million decrease in salary and benefits expense, a \$2.9 million decrease in revenue-sharing payments to third-party developers and a \$1.0 million decrease in content and license fees.

Cost of online advertising revenues was \$5.2 million for the year ended December 31, 2018, compared to \$6.7 million and \$10.1 million, respectively, for the year ended December 31, 2017 and 2016. The year-over-year decrease in cost of online advertising revenues for 2018 was \$1.5 million. The decrease mainly consisted of a \$0.4 million decrease in salary and benefits expense, a \$0.4 million decrease in depreciation and amortization expense, a \$0.2 million decrease in revenue-sharing payments, and a \$0.2 million decrease in bandwidth leasing costs. The year-over-year decrease in cost of online advertising revenues for 2017 was \$3.4 million. The decrease mainly consisted of a \$1.5 million decrease in salary and benefits expense, a 0.4 million decrease in advertising design costs and a \$0.4 million decrease in bandwidth leasing costs.

Cost of cinema advertising revenues were \$89.2 million for the year ended December 31, 2018, compared to \$84.9 million and \$46.0 million, respectively, for the years ended December 31, 2017 and 2016. The year-over-year increase in cost of pre-film advertising revenues for 2018 and 2017 was \$4.3 million and \$38.9 million, respectively. The increase for 2018 was mainly due to our purchases of more high quality advertising resources. The increase for 2017 was mainly due to an increase in purchases of pre-film advertising slots.

Cost of IVAS revenues was \$5.4 million for the year ended December 31, 2018, compared to \$9.4 million and \$13.6 million, respectively, for the year ended December 31, 2017 and 2016. The year-over-year decrease in cost of IVAS revenues for 2018 was \$4.0 million. The decrease mainly consisted of a \$2.5 million decrease in revenue-sharing payments to third-party developers and service providers, a \$0.9 million decrease in salary and benefits expense, and a \$0.5 million decrease in bandwidth leasing costs. The year-over-year decrease in cost of IVAS revenues for 2017 was \$4.2 million. The decrease mainly consisted of a \$2.2 million decrease in revenue-sharing payments to third-party developers and service providers and a \$1.7 million decrease in bandwidth leasing costs.

### **Gross Profit**

As a result of the foregoing, our gross profit was \$324.9 million for the year ended December 31, 2018, compared to \$416.5 million and \$359.6 million, respectively, for the years ended December 31, 2017 and 2016. Our gross margin was 66.9%, 71.8% and 68.4%, respectively, for the years ended December 31, 2018, 2017 and 2016.

### Operating Expenses

Our operating expenses consist of product development expenses, sales and marketing expenses, general and administrative expenses, and goodwill impairment and impairment of intangibles acquired as part of the acquisition of a business.

The following table sets forth our product development expenses, sales and marketing expenses, general and administrative expenses, and goodwill impairment and impairment of intangibles acquired as part of the acquisition of a business, both in absolute amount and as a percentage of total revenues for the periods indicated:

	For the Year Ended December 31,					
	2016		2017		2018	
	Amount	% of Total Revenues	Amount	% of Total Revenues	Amount	% of Total Revenues
	(US\$ in thousands, except percentages)					
Product development	121,619	23.1%	131,032	22.6%	124,166	25.6%
Sales and marketing	56,543	10.8%	60,917	10.5%	54,303	11.2%
General and administrative	50,560	9.6%	47,163	8.1%	30,116	6.1%
Goodwill impairment and impairment of intangibles as part of acquisition of a business	—	0%	86,882	15.0%	16,369	3.4%
<b>Total</b>	<b>228,722</b>	<b>43.5%</b>	<b>325,994</b>	<b>56.2%</b>	<b>224,954</b>	<b>46.3%</b>

### Product Development Expenses

Our product development expenses consist primarily of salary and benefits expense for personnel engaged in the development of our game development platform and our games, and content and license expenses relating to our games. Product development expenses was \$124.2 million for the year ended December 31, 2018 compared to \$131.0 million and \$121.6 million, respectively, for the years ended December 31, 2017 and 2016. The decrease in product development expenses for 2018 was mainly due to a decrease in share-based compensation expense as a result of decreases in the market price of our ADSs during 2018. The increase in product development expenses for 2017 was mainly due to an increase in expenses associated with the development of Legacy TLBB Mobile. Product development expenses constituted 25.6%, 22.6% and 23.1%, respectively, of our total revenues for the years ended December 31, 2018, 2017 and 2016.

### Sales and Marketing Expenses

Our sales and marketing expenses consist primarily of salary and benefits expense for our sales and marketing personnel and expenses for advertisement and promotion. Sales and marketing expense was \$54.3 million for the year ended December 31, 2018 compared to \$60.9 million and \$56.5 million, respectively, for the years ended December 31, 2017 and 2016. The decrease in sales and marketing expenses for 2018 was mainly due to a decrease in salary and benefit expenses of \$2.8 million as a result of a reduction in marketing headcount, as well as a decrease in share-based compensation expense of \$1.7 million due to decreases in the market price of our ADSs during 2018. The increase in sales and marketing expenses for 2017 was mainly due to an increase in sales and marketing expense for the online game and cinema advertising businesses in 2017. Sales and marketing expenses constituted 11.2%, 10.5% and 10.8%, respectively, of our total revenues for the years ended December 31, 2018, 2017 and 2016.

### General and Administrative Expenses

Our general and administrative expenses consist primarily of salary and benefits expense for management, finance and administrative personnel, and professional service fees. General and administrative expenses decreased to \$30.1 million for the year ended December 31, 2018 compared to \$47.2 million and \$50.6 million, respectively, for the years ended December 31, 2017 and 2016. The decrease in general and administrative expenses for 2018 was primarily due to a decrease in share-based compensation expense as a result of decreases in the market price of our ADSs during 2018. The decrease in general and administrative expenses for 2017 was primarily due to a decrease in salary and benefit expenses as a result of a reduction in workforce in 2017, which was partially offset by an increase in share-based compensation expense resulting from an increase in the market prices for our ADSs in 2017. General and administrative expenses constituted 6.1%, 8.1% and 9.6%, respectively, of our total revenues for the years ended December 31, 2018, 2017 and 2016.

### *Goodwill impairment and impairment of intangible assets acquired as part of acquisition of a business*

In 2018, we recognized \$16.4 million of goodwill impairment relating to the 17173.com Website. The \$16.4 million of goodwill impairment was primarily due to (i) the launch of new initiatives for the 17173.com Website having fallen behind schedule in the fourth quarter of 2018, and the profit outlook of the business remaining uncertain, and (ii) the relevant Chinese authority's suspension between April and December of 2018 of its review of, and issuance of publishing and authorization codes for, online games, which resulted in declines in the number of new games launched and the related demand from game developers and operators for online advertising services on the 17173.com Website. Our management determined that, as a result, there was a material adverse impact on our ability to generate revenues from the 17173.com Website.

In 2017, we recognized \$86.9 million of goodwill impairment and impairment of intangible assets acquired as part of the acquisition of a business. This \$86.9 million impairment loss consisted primarily of a \$83.5 million impairment loss for goodwill and a \$3.4 million impairment loss for intangible assets related to the Dolphin Browser, as a result of our management's assessment that it was unlikely to gain users and grow its revenues in China.

In 2016, there was no goodwill impairment or impairment of intangible assets acquired as part of acquisition of a business.

### *Share-based Compensation Expense/(Benefit)*

Share-based compensation expense/(benefit) was recognized in costs and expenses for the years ended December 31, 2018, 2017 and 2016 as follows (in thousands):

	For the Year Ended December 31,		
	2016	2017	2018
	Amount	Amount	Amount
	(US\$ in thousands)		
Cost of revenues	31	73	(31)
Product development	2,881	6,163	(2,427)
Sales and marketing	572	1,212	(497)
General and administrative	4,918	9,945	(3,506)
Total	<u>8,402</u>	<u>17,393</u>	<u>(6,461)</u>

There was a share-based compensation benefit recognized in 2018 due to a decrease in the market price of our ADSs during 2018. As of December 31, 2018, unrecognized share-based compensation expense was \$0.4 million.

### *Operating Profit/(Loss)*

As a result of the foregoing, we had an operating profit of \$100.0 million for the year ended December 31, 2018, compared to operating profits of \$90.5 million and \$130.9 million, respectively, for the years ended December 31, 2017 and 2016.

### *Foreign Currency Exchange Gain/(Loss)*

For the year ended December 31, 2018, foreign currency exchange gain was \$1.3 million, compared to foreign currency exchange loss of \$5.2 million for the year ended December 31, 2017 and foreign currency exchange gain of \$5.1 million for the year ended December 31, 2016.

### *Interest Income*

For the year ended December 31, 2018, interest income was \$34.4 million, compared to \$32.3 million and \$21.5 million, respectively, for the years ended December 31, 2017 and 2016. The increases in both 2018 and 2017 were primarily due to increases in average cash balances.

### *Interest Expense*

For the year ended December 31, 2018, interest expense was \$10.2 million, compared to \$4.4 million and \$4.3 million, respectively, for the years ended December 31, 2017 and 2016. The increase in interest expense in 2018 was primarily due to an increase in the total outstanding principal balance of matching loans from related parties.

### ***Other Income***

For the year ended December 31, 2018, other income was \$22.9 million, which primarily consisted of interest income on short-term investments and rental income, compared to other income of \$9.4 million and \$15.5 million, respectively, for the years ended December 31, 2017 and 2016. Both year-over-year increase and decrease in other income for 2018 and 2017, respectively, were mainly due to a loss recognized in 2017 related to a forward contract.

### ***Income Tax Expense***

Income tax expense was \$64.5 million for the year ended December 31, 2018, compared to \$40.8 million and \$21.6 million, respectively, for the years ended December 31, 2017 and 2016. The increase in 2018 was mainly due to our accrual of \$47 million for additional income tax withholding in the first quarter of 2018, as we revised our policy for our PRC subsidiaries with respect to their distribution of cash dividends. The additional income tax withholding was partially offset by a tax benefit of \$24.9 million recognized in the third quarter of 2018 as a result of the preferential enterprise income tax rates that applied to some of our subsidiaries upon their receipt of 2017 Key National Software Enterprise status or 2017 Software Enterprise status. The increase in 2017 was mainly due to an increase in our effective tax rate due to our introduction during 2017 of Legacy TLBB Mobile, the income from which was subject to the full PRC enterprise income tax rate of 25% during 2017.

### ***Net (Loss)/Gain Attributable to Non-controlling Interests***

Net loss attributable to non-controlling interests was \$0.4 million for the year ended December 31, 2018. Non-controlling interests consist primarily of the non-controlling interests in RaidCall; the non-controlling interests in Beijing Changmica Culture Co., Ltd., which is a joint venture that operates Korean comics online in China; and, for periods prior to the Company's sale of MoboTap in March 2018, the non-controlling interests in MoboTap.

### ***Net Income/(Loss) Attributable to Changyou.com Limited***

As a result of the foregoing, we had net income attributable to Changyou.com Limited of \$84.3 million for the year ended December 31, 2018, compared to a net income of \$108.8 million and \$144.9 million, respectively, for the years ended December 31, 2017 and 2016.

### ***Liquidity and Capital Resources***

#### **Significant Cash-Related Activities**

We have financed our operations primarily through cash flows from operations.

During 2016, our wholly-owned subsidiary AmazGame entered into a loan agreement with Sohu's wholly-owned subsidiary Beijing Sohu New Media Information Technology Co., Ltd. ("Sohu Media"), pursuant to which AmazGame agreed to loan to Sohu Media from time to time up to RMB1.0 billion (or approximately \$148.64 million). As of December 31, 2016, we had outstanding loans to Sohu Media in an aggregate principal amount of RMB500 million (or approximately \$72.1 million).

During 2017, AmazGame lent the remaining RMB500 million (or approximately \$76.5 million) to Sohu Media pursuant to the loan agreement. As of December 31, 2017, we had outstanding loans to Sohu Media in an aggregate principal amount of RMB1.0 billion (or approximately \$153.0 million).

During 2018, we drew down loans from offshore banks in an aggregate amount of \$220 million. The loans were secured by RMB deposits totaling RMB1.7 billion (or \$244 million) in onshore branches of those banks. As of December 31, 2018, the loan amounts carried floating rates of interest based on the LIBOR. All of the loans will be repaid, and accordingly all of the restricted time deposits will be released, in 2021. In January 2019, a total of \$80.0 million of outstanding principal of the loans was repaid, and corresponding restricted time deposits were released accordingly.

#### **Liquidity Sources and Balances**

We had cash and cash equivalents, restricted cash and short-term investments of approximately \$649.4 million, \$977.7 million, and \$830.7 million, respectively, as of December 31, 2018, 2017, and 2016. Cash equivalents primarily consist time deposits with maturities of three months or less and highly-liquid investments that are readily convertible into known amounts of cash.

We believe our current liquidity and capital resources are sufficient to meet anticipated working capital needs (net cash used in operating activities), commitments and capital expenditures over the next twelve months.

#### **Cash-Generating Ability**

The following table sets forth a summary of our cash flows for the periods indicated:

	For the Year Ended December 31,		
	2016	2017	2018
	(US\$ in thousands)		
Net cash provided by operating activities	205,662	200,795	199,512
Net cash used in investing activities	(230,178)	(256,426)	(25,066)
Net cash provided by/(used in) financing activities	(147,459)	15,013	(42,624)
Effect of exchange rate changes on cash, cash equivalents, restricted cash and restricted time deposits	(14,563)	4,905	(1,762)
Net increase/(decrease) in cash, cash equivalents, restricted cash and restricted time deposits	(186,538)	(35,713)	130,060
Cash reclassified (to)/from held for sale	(11,684)	11,684	—
Cash, cash equivalents, restricted cash and restricted time deposits, beginning of year	795,410	597,188	573,159
Cash, cash equivalents, restricted cash and restricted time deposits, end of year	<u>597,188</u>	<u>573,159</u>	<u>703,219</u>

#### *Operating Activities*

Net cash provided by operating activities for the year ended December 31, 2018 was \$199.5 million, which was primarily attributable to our net income of \$83.9 million, adjusted by non-cash items consisting of changes in deferred tax expense of \$50.0 million, accounts receivable of \$28.2 million, depreciation and amortization of \$18.2 million, goodwill impairment as part of the acquisition of a business of \$16.4 million, accrued salary and benefits of \$12.0 million, and other short term liabilities of \$5.9 million, offset by changes in the fair values of financial instruments of \$17.5 million.

Net cash provided by operating activities for the year ended December 31, 2017 was \$200.8 million, which was primarily attributable to our net income of \$81.8 million, adjusted by non-cash items consisting of goodwill impairment and impairment of intangible assets acquired as part of the acquisition of a business of \$86.9 million, depreciation and amortization of \$19.8 million, share-based compensation expense of \$17.4 million, changes in other receivables of \$27.1 million and tax payable of \$10.1 million, offset by a change in accounts receivable of \$40.4 million and receipts in advance and deferred revenue of \$3.3 million.

Net cash provided by operating activities for the year ended December 31, 2016 was \$205.7 million, which was primarily attributable to net income of \$147.1 million, adjusted by non-cash items consisting of depreciation and amortization of \$26.0 million, share-based compensation expense of \$8.4 million and changes in accounts receivable of \$14.8 million and other receivables of \$11.7 million.

#### *Investing Activities*

For the year ended December 31, 2018, net cash used in investing activities was \$25.1 million, which was primarily attributable to matching loans made to Sohu of \$237.0 million and purchase of intangible assets and other assets of \$14.2 million, offset by proceeds from financial instruments (net of purchases of financial instruments) of \$222.2 million.

For the year ended December 31, 2017, net cash used in investing activities was \$256.4 million, which was primarily attributable to purchases of financial instruments (net of cash proceeds) of \$170.2 million, a loan to Sohu of \$72.5 million and matching loans to Sohu of \$15.1 million.

For the year ended December 31, 2016, net cash used in investing activities was \$230.2 million and was primarily attributable to matching loans to Sohu and Fox Financial of \$210.8 million and a loan to Sohu of \$72.1 million, offset by cash proceeds (net of purchases) relating to financial instruments of \$ 48.0 million.

#### *Financing Activities*

For the year ended December 31, 2018, net cash used in financing activities was \$42.6 million, which was primarily attributable to a dividend distribution of \$499.7 million, offset by matching loans from related parties of \$237.0 million and loan proceeds from offshore banks of \$220.0 million.

For the year ended December 31, 2017, net cash provided by financing activities was \$15.0 million, which was primarily due to matching loans from related parties of \$15.0 million.

For the year ended December 31, 2016, net cash used in financing activities was \$147.5 million, which was primarily due to repayments to offshore banks of loans of \$344.5 million and repayments of matching loans of \$12.9 million, offset by matching loans from related parties of \$209.9 million.

#### PRC Restrictions Related to Our VIE Structure

To fund any cash requirements from time to time, we may need to rely on dividends, loans or advances made by our principal PRC subsidiaries. We conduct most of our operations in PRC through our principal VIEs Gamease, Guanyou Gamespace, and Shanghai ICE, which generate most of our operating revenues. As our VIEs are not owned by our subsidiaries, they are not able to make dividend payments to our subsidiaries. Instead, our subsidiaries AmazGame and Gamespace have entered into a number of contracts with their corresponding VIEs to provide services to such VIEs in return for cash payments. In order for us to receive any dividends, loans or advances from AmazGame and Gamespace, or to distribute any dividends to our shareholders and ADS holders from operating income sources, we will need to rely on these payments made from our principal VIEs to these principal PRC subsidiaries. Depending on the nature of services provided by these PRC subsidiaries to their corresponding VIEs, certain of these payments are subject to PRC taxes, including business taxes and VAT, which effectively reduce the amount that a PRC subsidiary receives from its corresponding VIE. In addition, the PRC government could impose restrictions on such payments or change the tax rates applicable to such payments.

#### PRC Profit Appropriation, Withholding Tax on Dividends and Regulation of Foreign Currency Exchange

Regulations in the PRC currently permit payment of dividends of a PRC company, only out of accumulated profits as determined in accordance with accounting standards and regulations in China. Our China-based WFOEs are also required to set aside at least 10% of its after-tax profit, determined in accordance with PRC accounting standards, each year to its general reserves until the cumulative amount reaches 50% of its registered capital. These reserves are not distributable as cash dividends, or as loans or advances. Our WFOEs may also allocate a portion of their after-tax profits, as determined by its Board of Directors, to their staff welfare and bonus funds, which may not be distributed to us.

Furthermore, under regulations of the SAFE, the RMB is not convertible into foreign currencies for capital account items, such as loans, repatriation of investments and investments outside of China, unless the prior approval of the SAFE is obtained and prior registration with the SAFE is made.

Any dividends paid by any of our PRC subsidiaries to its direct holding company in Hong Kong will be subject to a withholding tax at a rate of at least 5% and could be as high as 10%, which will reduce the amount of cash available for distribution to us. See “Risk Factors—Risks related to Doing Business in China—There are significant uncertainties under the Corporate Income Tax Law of the PRC (the “CIT Law”) regarding our PRC enterprise income tax liabilities, such as tax on dividends paid to us by our PRC subsidiaries. The CIT Law also contains uncertainties regarding possible PRC withholding tax on any dividends we pay to our overseas corporate shareholders and gains realized from the transfer of our shares by our overseas corporate shareholders.” in Item 3.

We do not expect any of such restrictions or taxes to have a material impact on our ability to meet our cash obligations.

We believe that our existing cash is sufficient to sustain our operations for at least the next twelve months.

#### Capital Expenditures

Our capital expenditures include the purchase of fixed assets, intangible assets and other assets. Our capital expenditures were \$16.9 million, \$3.6 million and \$13.0 million, respectively, for the years ended December 31, 2018, 2017 and 2016.

#### Research and Development, Patents and Licenses, etc.

Our research and development efforts are primarily to keep pace with technological advances in order to make our online game development capabilities and our games competitive in the market. Moreover, we also focus on the improvement of our licensed games. We intend to further expand our internal game development capabilities and license more new games that are attractive to users.

#### Off-balance Sheet Arrangements

We have not entered into any financial guarantees or other commitments to guarantee the payment obligations of third parties. We have not entered into any derivative contracts that are indexed to our shares and classified as shareholder’s equity, or that are not reflected in our consolidated financial statements. Furthermore, we do not have any retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity. We do not have any variable interest in any unconsolidated entity that provides financing, liquidity, market risk or credit support to us or that engages in leasing, hedging or product development services with us.

## Contractual Obligations

The following table sets forth our contractual obligations as of December 31, 2018 (US\$ in thousands):

	<u>Total</u>	<u>Less than 1 Year</u>	<u>1-3 Years</u>	<u>More than 3 Years</u>
Repayment of principal of offshore loans	220,000	—	220,000	—
Interest payment commitments	23,900	8,419	15,481	—
Cinema advertisement slot rights	125,161	56,396	58,643	10,122
Expenditures for operating rights of licensed games with technological feasibility	20,573	19,475	1,098	—
Expenditures for rights to titles and characters of games in development	7,715	6,990	725	—
Fees for office rental and property management	2,862	2,088	774	—
Bandwidth leasing charges	2,375	2,303	72	—
Fees for operating rights of licensed games in development	585	585	—	—
Others	240	240	—	—
Total	<u>403,411</u>	<u>96,496</u>	<u>296,793</u>	<u>10,122</u>

Other than the obligations set forth above, we did not have any material capital commitments, long-term debt obligations, operating lease obligations, purchase obligations or other long-term liabilities as of December 31, 2018.

## IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

*Leases.* On February 25, 2016, the FASB issued Accounting Standards Update (“ASU”) No. 2016-02 (“ASU 2016-02”), Leases, which specifies the accounting for leases. For operating leases, ASU 2016-02 requires a lessee to recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in its balance sheet. The standard also requires a lessee to recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term, generally on a straight-line basis. In addition, this standard requires both lessees and lessors to disclose certain key information about lease transactions. The only exceptions are short-term leases, whose periods are one year or less. ASU 2016-02 is effective for publicly-traded companies for annual reporting periods, and interim periods within those years, beginning after December 15, 2018. Early adoption is permitted. Based on our preliminary assessment, we expect to record a right-of-use asset of approximately \$2.6 million and a lease liability of approximately \$2.4 million on our adoption date of January 1, 2019, primarily related to our leased office space. We will use an additional transition method (“ASU 2018-11”) and will not restate prior periods. We expect to implement new accounting policies as well as to elect certain practical expedients available to us under ASU 2016-02, including those related to leases with terms of less than 12 months. The implementation of the amended lease guidance is subject to the same internal controls over financial reporting that we apply to our consolidated financial statements.

*Financial Instruments-Credit Losses.* In June 2016, the FASB issued ASU 2016-13, Financial Instruments-Credit Losses (Topic 326), which requires entities to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. This replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. We are currently evaluating the impact of adopting this standard on our consolidated financial statements.

*Simplifying the Test for Goodwill Impairment.* In January 2017, the FASB issued ASU 2017-04, “Simplifying the Test for Goodwill Impairment.” The guidance removes Step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation. A goodwill impairment will now be the amount by which a reporting unit’s carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The guidance should be adopted on a prospective basis for the annual or any interim goodwill impairment tests beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. Based on management’s preliminary assessment, we believe that the change will not have a material impact on our consolidated financial statements.

## ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

### *Directors and Senior Management*

The following table sets forth information regarding our directors and executive officers as of the date of this annual report. The business address of each of our directors and executive officers is Changyou Building, Raycom Creative Industrial Park, No. 65 Bajiao East Road, Shijingshan District, Beijing 100043, People's Republic of China.

<b>Directors and Executive Officers</b>	<b>Age</b>	<b>Position</b>
Charles Zhang	54	Chairman of the Board of Directors
Dewen Chen	43	Chief Executive Officer and Director
Xiaojian Hong	41	Chief Operating Officer
Yaobin Wang	46	Chief Financial Officer
Dave De Yang <sup>(1)</sup>	53	Independent Director
Xiao Chen <sup>(1)</sup>	55	Independent Director
Charles Chan <sup>(1)</sup>	65	Independent Director

(1) Member of the audit committee of our Board of Directors.

*Dr. Charles Zhang* is the Chairman of our Board of Directors. Dr. Zhang is the founder of Sohu and has been Chairman of the Board and CEO of Sohu since August 1996. Prior to founding Sohu, Dr. Zhang worked for Internet Securities Inc. ("ISI") and helped establish its China operations. Prior to joining ISI, he worked as Massachusetts Institute of Technology's liaison officer with China. Dr. Zhang has a Ph.D. in Experimental Physics from the Massachusetts Institute of Technology and a Bachelor of Science degree from Tsinghua University in Beijing.

*Dewen Chen* is our Chief Executive Officer and was one of the principal founders of our online game business. Mr. Chen joined Sohu in 2005 as a business manager, responsible for building our sales team for games products and starting May 2006, Mr. Chen was in charge of the overall marketing, promotion, sales and channel distribution of Sohu's games products. Prior to our carveout from Sohu, Mr. Chen was the Director of Marketing & Operations of the client-end installed MMORPG business of Sohu. From April 2000 to April 2005, Mr. Chen worked at Shanghai Hua Teng Software System Co. Ltd. as a pre-sale technology consultant and sale manager of its business with banks. Prior to that, Mr. Chen had worked with Fujian Shi Da Computer Group as a software engineer, project manager and later the Director of the Technology Department at its Shanghai branch office. Mr. Chen received a bachelor's degree in Computer Engineering from Xi'an Jiaotong University.

*Xiaojian Hong* is our Chief Operating Officer and was one of the principal founders of our MMORPG business. Mr. Hong has significant experience in the security, efficiency and stability of online games software and operations. Prior to our carve-out from Sohu, Mr. Hong was a Senior Manager of Sohu and played a key role in building Sohu's MMORPG software development division and was responsible for strategic planning for technology framework design and module development for our MMORPG business. From 2004 to 2005, Mr. Hong worked at Sina and was a research and development manager of its iGAME project. From 2001 to 2004, Mr. Hong was the Manager of Research and Development of Beijing Tian Ren Interactive Software Technologies Co. Ltd., responsible for in-house digital games design and development and introduction, distribution and localization of popular overseas games products. From 1999 to 2001, Mr. Hong was a project manager of Object Software (Beijing) Limited. Mr. Hong received a bachelor's degree in Engineering from Beijing Technology University.

*Yaobin Wang* has been our Chief Financial Officers since September 29, 2017. Mr. Wang has held many senior management positions previously in a number of Internet companies, including Sohu, Changyou, and Kaixin001, where he oversaw finance, legal, and M&A functions. Mr. Wang served as our financial director between 2008 and 2010 and served as Sohu's financial director and internal audit director between 2005 and 2008. Mr. Wang worked for Deloitte from 1999 to 2005. Mr. Wang holds a master's degree in Business Administration from Renmin University of China. He is a certified public accountant, a certified tax agent, and a certified internal auditor.

*Dave De Yang* has served as an independent director and a member of our audit committee since April 2009. Mr. Yang has served as the Chief Financial Officer and a Partner of Dalton International, an investment firm based in Chicago, since 2017. From 2012 through 2016, Mr. Yang also served as CFO for Reckitt Benckiser's North Asia region, including China, Hong Kong, Taiwan, Japan and Korea. Prior to this role, Mr. Yang had worked for McDonald's Corporation as a senior financial director, including an international assignment as the Corporate Controller of McDonald's China for three and half years. Prior to such role, he served as acting controller of McDonald's India and Indonesia and as a senior director of McDonald's Corporation in Asia Pacific, Middle East and Africa division where he oversaw the development and supervision of financial strategy and policy. Prior to joining McDonald's Corporation, Mr. Yang worked in the U.S. business unit of Ernst & Young LLP for seven years in various positions, including as a group manager. During Mr. Yang's tenure at Ernst & Young LLP, he focused on business risk management consultation, corporate M&A, restructuring of corporate internal management processes, internal audits, risk assessment, control system designs, and auditing of corporate financial statements, primarily for Fortune 500 companies. Mr. Yang has a master of business administration degree from the City University of New York, a master's degree in Management and Engineering from the Graduate School of the Chinese Academy of Sciences in Beijing, and a bachelor's degree in Physics from the University of Science and Technology of China. Mr. Yang is a member of the U.S. Institute of Certified Internal Auditors, the Institute of Certified Public Accountants and the Institute of Certified Management Accountants.



*Dr. Xiao Chen* has served as an independent director and a member of our audit committee since August 2012. Dr. Chen has been an accounting professor at the School of Economics and Management at Tsinghua University since 1997. For the past 20 years, he has been teaching and conducting academic research in the fields of accounting and taxation at Tsinghua University. From August 2007 to April 2013, Dr. Chen served on the Board of Directors and as the chairman of the audit committee of Noah Education Holdings Ltd, a public company listed on the New York Stock Exchange. During the past 10 years, he also served as an independent director of eight other public companies listed on the Shanghai Stock Exchange, the Shenzhen Stock Exchange and the Hong Kong Stock Exchange. Dr. Chen received a Ph.D. in economics from Tulane University in 1996.

*Mr. Charles Chan* has served as an independent director and a member of our audit committee since September 2013. Beginning in February 2019, Mr. Chan has served as an independent director of Maoyan Entertainment, a company listed on the Hong Kong Stock Exchange. Mr. Chan joined Arthur Andersen Canada in 1977 and was admitted to the AA Worldwide Partnership in 1988. Transferred to Arthur Andersen Hong Kong/China in 1994, Mr. Chan was Head of Audit and Business Advisory Service for Greater China. After Arthur Andersen merged with PricewaterhouseCoopers (“PwC”) in 2002, Mr. Chan assumed management positions at PwC, including as a partner and as a member of various committees. Mr. Chan qualified as a Chartered Accountant in Canada in 1980 and as a Certified Public Accountant in Hong Kong in 1995. He has extensive experience in serving major clients listed in various major capital markets through the IPO process, conducting annual audits, providing business advice with respect to M&A activities and various types of capital and debt financing transactions. Mr. Chan has served as a member of professional, government and regulatory committees, including the Hong Kong Stock Exchange Listing Committee, the Selection Committee for the first Legislative Council of the Hong Kong SAR and the Hong Kong Society of Certified Public Accountants. For the Hong Kong Society of Certified Public Accountants, he served as a member of its council, accounting standards committee and auditing standards committee, and was chairman of its China technical committee. Mr. Chan retired from PwC on June 30, 2012.

### ***Compensation of Directors and Executive Officers***

During the year ended December 31, 2018, we paid an aggregate of approximately \$5.0 million in cash compensation to our executive officers. We paid an aggregate of \$225,000 in cash compensation to our non-executive directors other than Dr. Charles Zhang. In 2018, the total compensation expense for our non-executive directors and executive officers recorded in our consolidated statements of comprehensive income was \$5.1 million. None of our directors have service contracts that provide for benefits upon termination of employment. For information regarding share-based compensation paid to officers and directors, see Item 6, “Directors, Senior Management and Employees—Compensation of Directors and Executive Officers—Share Incentive Plan.”

### ***Employment Agreements with Executive Officers***

We have entered into employment agreements with each of our executive officers. Under these agreements we may terminate an executive officer’s employment for cause, at any time, for certain acts of such officer such as willful misconduct or gross negligence, repeated failure to perform substantially his duties, indictment or conviction for or confession of a felony, or any crime involving moral turpitude. In any such case, such officer will not be entitled to receive payment of any severance benefits or other amounts by reason of termination other than accrued salary and vacation through the date of termination and such officer’s right to all other benefits will terminate, except as required by applicable law.

We may also terminate our employment agreements with our executive officers without cause upon thirty days’ advance written notice. In such case of termination by us and also in a case where an executive officer voluntarily terminates his employment with us upon thirty-days’ advance written notice for “good reason,” we are required to provide him with severance benefits equal to an amount up to six (6) months of his monthly base salary, provided that the executive officer complies during the severance period with the non-competition, non-solicitation, confidential information and work product provisions discussed below, which are incorporated into the employment agreement, and executes a release agreement in a form requested by us. “Good reason” includes (i) any significant change in the executive officer’s duties and responsibilities inconsistent in any material and adverse respect with his title and position, and (ii) any material breach of the employment agreement by us, including any reduction in the executive officer’s base salary or our failure to pay to him any portion of his compensation.

Each of our executive officers has entered into an employee non-competition, non-solicitation, confidential information, and work product agreement with us. Under these agreements, each of our executive officers has agreed to be bound by (i) non-competition restrictions during his employment and for one year after the termination of his employment or for such longer period during which we pay him any severance benefits, and (ii) non-solicitation restrictions during the non-competition period. Each executive officer has agreed to hold, both during and after the termination or expiry of his employment agreement, in strict confidence and not to use, except as required in the performance of his duties in connection with the employment, any of our confidential information or trade secrets, any confidential information or trade secrets of our clients or customers, and the confidential or proprietary information of any third party held by us in confidence. The executive officers have also agreed to disclose to us all inventions which they conceive and develop during the employment and to assign all right, title and interest in them to us and have agreed not to assert any such rights against us.

## **Share Incentive Plan**

### *Changyou.com Limited 2008 Share Incentive Plan*

In December 2008, our Board of Directors and our shareholders adopted our 2008 Share Incentive Plan to attract, motivate and retain the best available personnel, provide additional incentives to our employees, directors and consultants and promote the success of our business. Our 2008 Share Incentive Plan provides for the issuance of up to 20,000,000 ordinary shares, of which 17,740,000 are Class B ordinary shares and 2,260,000 are Class A ordinary shares. Our 2008 Share Incentive Plan expired in August 2018, and is no longer available for granting new share-based awards.

### *Changyou.com Limited 2014 Share Incentive Plan*

In June 2014, our Board of Directors and our shareholders adopted our 2014 Share Incentive Plan. In November 2014, our Board of Directors approved an increase in the number of Class A ordinary shares reserved for issuance under our 2014 Share Incentive Plan and invoked the “home country practice” exception to the Nasdaq Listing Rules to approve such increase without shareholder approval. See “Risk Factors—Risks Related to Our Class A Ordinary Shares and ADSs —” in Item 3 of this annual report. Our 2014 Share Incentive Plan provides for the issuance of up to 6,000,000 Class A ordinary shares.

*Plan Administration.* Our compensation committee, or our Board of Directors in the absence of such a committee, administers our 2014 Share Incentive Plan. The compensation committee or the Board of Directors, as appropriate, will determine the provisions and terms and conditions of our awards.

*Types of Awards.* The following briefly describes the principal features of the various awards that may be granted under our 2014 Share Incentive Plan.

- *Options.* Options provide for the right to purchase our Class A ordinary shares at a specified exercise price subject to vesting according to a vesting schedule determined by our board or our compensation committee and provided in an award agreement.
- *Restricted Shares.* A restricted share award is the sale of Class A ordinary shares at a price determined by our board or our compensation committee or a grant of our ordinary shares, in each case subject to vesting terms.
- *Restricted Share Units.* Restricted share units represent the right to receive our Class A ordinary shares, subject to vesting. Restricted share units will be settled upon vesting, subject to the terms of the award agreement, either by our delivery to the holder of the number of Class A ordinary shares that equals the number of the vested restricted share units or by a cash payment to the holder that equals the then fair market value of the number of underlying Class A ordinary shares. We expect that in most cases restricted shares units will be settled by delivery of ordinary shares.

*Award Document.* Awards granted under our 2014 Share Incentive Plan are evidenced by an award document that sets forth the terms and conditions applicable to each of these awards, as determined by our board or compensation committee in its sole discretion.

*Termination of the Share Incentive Plan.* Without further action by our Board of Directors, our 2014 Share Incentive Plan will terminate in June 2024. Our Board of Directors may amend, suspend, or terminate our 2014 Share Incentive Plan at any time; provided, however, that our Board of Directors must first seek the approval of the participants of our share incentive plan if such amendment, suspension or termination would adversely affect the rights of participants with respect to any of their existing awards.

### **Issuance of Restricted Shares and Restricted Share Units to Executive Officers**

On November 2, 2014, we granted to Dewen Chen, our Chief Executive Officer, and Xiaojian Hong, our Chief Operating Officer, an aggregate of 1,200,000 of our Class A restricted share units under our 2014 Share incentive Plan. These restricted share units are subject to vesting over a four-year period and will be forfeited to us if the vesting conditions are not met. On February 16, 2015, our Board of Directors approved the conversion of 2,400,000 Class A restricted share units into options for the purchase of Class A ordinary shares at an exercise price of \$0.01. See “Operating and Financial Review and Prospects—Share-based Compensation Expense.”

As of December 31, 2018, we had granted the following share options to our executive officers pursuant to our 2014 Share Incentive Plan.

<u>Executive Officers</u>	<u>Share Options</u>	<u>Exercise Price (US\$)</u>	<u>Date of Grant</u>	<u>End of Vesting Period</u>	<u>Expiration Date</u>
Dewen Chen	600,000 <sup>(1)</sup>	0.01	November 2, 2014	November 2, 2018	November 1, 2024
Xiaojian Hong	600,000 <sup>(1)</sup>	0.01	November 2, 2014	November 2, 2018	November 1, 2024

(1) Originally granted in the form of restricted share units settleable in Class A ordinary shares, which were subject to vesting over a four-year period and would be forfeited to us if the vesting conditions were not met. On February 16, 2015, our Board of Directors approved the conversion of the restricted share units into options for the purchase of Class A ordinary shares at an exercise price of \$0.01, subject to the same vesting conditions.

### ***Board of Directors***

Our Board of Directors currently consists of Dr. Charles Zhang, Dewen Chen, Dave De Yang, Xiao Chen and Charles Chan. Our directors are elected by the holders of our ordinary shares and will hold office until our next annual general meeting of shareholders and until their successors are duly elected or appointed, or until their resignation or removal in accordance with the provisions of our memorandum and articles of association. A director is not required to hold any shares in our company by way of qualification. A director may vote with respect to any contract, proposed contract or arrangement in which he is materially interested provided that the nature of such interest is disclosed prior to any vote thereon. A director may exercise all the powers of our company to borrow money, mortgage or charge our undertakings, property and uncalled capital or any part thereof, and issue debentures or other securities whether outright or as security for any debt, liability or obligation of our company or of any third party.

A company of which more than 50% of the voting power is held by a single entity is considered a “controlled company” under the Nasdaq Listing Rules. A controlled company need not comply with the applicable Nasdaq corporate governance rules requiring its Board of Directors to have a majority of independent directors and independent compensation and corporate governance and nominating committees. Because more than 50% of the voting power of our company is held by Sohu, we qualify as a “controlled company” under the Nasdaq Listing Rules, and we avail ourselves of the controlled company exception provided under those rules. In the event that we are no longer a controlled company, a majority of our Board of Directors will be required to be independent and it will be necessary for us to have compensation and corporate governance and nominating committees that are composed entirely of independent directors, subject to a phase-in period during the first year we cease to be a controlled company, unless we invoke the home country exception to such requirement available to foreign private issuers, such as us, under the Nasdaq Listing Rules.

### ***Committees of the Board of Directors***

*Audit Committee.* Our audit committee currently consists of Dave De Yang, Xiao Chen and Charles Chan. Our Board of Directors has determined that Dave De Yang, Xiao Chen and Charles Chan satisfy the independence requirements of Rule 10A-3 under the Exchange Act and Rule 5605 of the Nasdaq Listing Rules. In addition, our Board of Directors has determined that Dave De Yang meets the criteria of an audit committee financial expert as set forth under the applicable SEC rules and Rule 5605(c)(2) of the Nasdaq Listing Rules. The full responsibilities of our audit committee are set forth in its charter, which will be reviewed and updated annually and approved by our board, and will be posted on our Website at [www.changyou.com](http://www.changyou.com). The audit committee is responsible for, among other things:

- selecting the independent auditors and pre-approving all auditing and non-auditing services permitted to be performed by the independent auditors;
- overseeing our accounting and financial reporting processes and audits of the financial statements of our company;
- reviewing with the independent auditors any audit problems or difficulties and management’s response;
- reviewing and approving all proposed related party transactions, as defined in the Nasdaq Listing Rules;
- discussing the annual audited financial statements with management and the independent auditors;
- reviewing major issues as to the adequacy of our internal controls over financial reporting and any special audit steps adopted in the light of any significant deficiencies or materially weakness in our internal controls; and
- meeting separately and periodically with management and the independent auditors.

### ***Duties of Directors***

Under Cayman Islands law, our directors have a common law duty to act honestly in good faith with a view to our best interests. A director must exercise the skill and care of a reasonably diligent person having both (i) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company (an objective test), and (ii) if greater, the general knowledge, skill and experience that that director actually possesses (a subjective test). In fulfilling their duty of care to us, our directors must ensure compliance with our memorandum and articles of association. A shareholder may have the right to seek damages if a duty owed by our directors is breached.

### **Terms of Directors and Officers**

A director may be removed by ordinary resolution passed by a majority of our shareholders before the expiration of such director's term. Officers are elected by and serve at the discretion of the Board of Directors.

### **Employees**

As of December 31, 2018, we had approximately 2,131 full-time and part-time employees. None of our employees are represented under collective bargaining agreements.

### **Share Ownership**

Refer to "Item 7: Major Shareholders and Related Party Transactions" below for a description of the share ownership of our directors and senior executive officers.

## **ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS**

### **Major Shareholders**

The following table sets forth information with respect to the beneficial ownership of our shares as of March 15, 2019 by:

- each of our directors and executive officers; and
- each person known to us to own beneficially more than 5% of our shares.

	Ordinary Shares Beneficially Owned <sup>(1)</sup>	
	Number	%
<b>Directors and Executive Officers:</b>		
Charles Zhang	*	*
Dewen Chen	*	*
Xiaojian Hong	*	*
Yaobing Wang	*	*
Dave De Yang	—	—
Xiao Chen	—	—
Charles Chan	—	—
<b>Principal Shareholder:</b>		
Sohu <sup>(2)</sup>	71,750,000	67.4%

\* Less than 5% of our total outstanding voting securities.

- (1) Includes the number of Class A ordinary shares and percentage ownership represented by Class A ordinary shares determined to be beneficially owned by a person or entity in accordance with rules of the SEC. Holders of Class B ordinary shares may convert their Class B ordinary shares into the same number of Class A ordinary shares at any time and, accordingly, are deemed to beneficially own such Class A ordinary shares. The number of Class A ordinary shares or Class B ordinary shares beneficially owned by a person or entity includes restricted share units and/or share options that will vest within 60 days after the date of this report. Class A ordinary shares or Class B ordinary shares issuable upon the vesting of restricted share units are deemed outstanding for the purpose of computing the percentage of outstanding Class A ordinary shares owned by that person or entity. Such Class A ordinary shares or Class B ordinary shares issuable upon such vesting are not deemed outstanding, however, for the purpose of computing the percentage ownership of any other person or entity.
- (2) Consists of 1,500,000 Class A ordinary shares, which are represented by 750,000 ADSs, and 70,250,000 Class B ordinary shares held by Sohu.com Limited through an indirect wholly-owned subsidiary, Sohu.com (Game) Limited, a Cayman Islands company. The registered address of Sohu.com (Game) Limited is Uglan House, P O Box 309, Grand Cayman KY1-1104, Cayman Islands. The Class A ordinary shares (represented by ADSs) and the Class B ordinary shares held by Sohu collectively represent approximately 95.3% of the voting power of all issued and outstanding ordinary shares of Changyou.

Our ordinary shares are divided into Class A ordinary shares and Class B ordinary shares. With respect to matters requiring a shareholder vote, holders of Class A ordinary shares and holders of Class B ordinary shares vote together as one class. Each Class A ordinary share is entitled to one vote and each Class B ordinary share is entitled to ten votes. We issued Class A ordinary shares represented by our ADSs in our initial public offering. Holders of Class B ordinary shares may choose to convert their Class B ordinary shares into the same number of Class A ordinary shares at any time. Class B ordinary shares are only transferable to an affiliate of the holder or to an affiliate of us.

All of the 36,251,420 Class A ordinary shares issued and outstanding as of the date of this report, or approximately 34.0% of the combined total of our outstanding Class A and Class B ordinary shares, were held by a single holder of record in the United States, the Bank of New York Mellon, the depository for our ADS program.

### ***Related Party Transactions***

As of the date of this report, Sohu held approximately 67.4% of the combined total of Changyou's outstanding Class A and Class B ordinary shares and controlled approximately 95.3% of the total voting power in Changyou. As of the date of this report, Sohu has the power acting alone to approve any action requiring a vote of the majority of our ordinary shares and to elect all our directors.

### ***Contractual Arrangements with our VIEs and their Shareholders***

PRC law currently restricts foreign ownership of online game businesses. To comply with PRC law, we conduct a significant part of our online games and platform channel businesses through contractual arrangements between our principal PRC subsidiaries AmazGame and Gamespace and their corresponding VIEs Gamease and Guanyou Gamespace and their respective shareholders. See "Information on the Company—Organizational Structure" in Item 4 of this annual report for a description of the ownership information of our current principal VIEs.

The following is a summary of the agreements currently in effect between these principal PRC subsidiaries and our principal VIEs:

#### ***Contractual Arrangements with Gamease and its Sole Shareholder High Century***

- *Loan Agreement*, between AmazGame and Gamease's sole shareholder High Century. This loan agreement provides for a loan in the amount of RMB10,000,000 (approximately \$1,520,000) to High Century to make a contribution to the registered capital of Gamease in exchange for 100% of the equity interests in Gamease. The loan is interest free and is repayable on demand, but the shareholder can only repay the loan by transferring to AmazGame all of the equity interests in Gamease.
- *Equity Interest Purchase Right Agreement*, among AmazGame, Gamease and High Century. Pursuant to this agreement, AmazGame and any third party designated by AmazGame have the right, exercisable at any time during the term of the agreement, if and when it is legal to do so under PRC law, to purchase from High Century all or any part of its equity interests in Gamease at a purchase price equal to its initial contribution to the registered capital of Gamease.
- *Equity Pledge Agreements*, among AmazGame, Gamease and High Century. Pursuant to this agreement, High Century pledged to AmazGame its equity interests in Gamease to secure the performance of its obligations and Gamease's obligations under the various VIE-related agreements. If High Century breaches its obligations under any VIE-related agreements (Gamease's breach of any of its obligations under the various VIE-related agreements will be treated as High Century's breach of its obligations), including the Equity Pledge Agreement, AmazGame is entitled to exercise its rights as the beneficiary under the Equity Pledge Agreement, including all rights High Century has as a shareholder of Gamease.
- *Business Operation Agreement*, among AmazGame, Gamease and High Century. This agreement sets forth the rights of AmazGame to control the actions of Gamease and Gamease's sole shareholder High Century.
- *Power of Attorney*, executed by High Century in favor of AmazGame. This power of attorney gives the Board of Directors of AmazGame the exclusive right to appoint nominees to act on behalf of High Century in connection with all actions to be taken by Gamease.
- *Technology Support and Utilization Agreement*, between AmazGame and Gamease. Pursuant to this agreement, AmazGame has the exclusive right to provide certain product development and application services and technology support to Gamease for a fee equal to a predetermined percentage of Gamease's revenues.
- *Services and Maintenance Agreement*, between AmazGame and Gamease. Pursuant to this agreement, AmazGame provides marketing, staffing, business operation and maintenance services to Gamease in exchange for a fee equal to the cost of providing such services plus a predetermined margin.

#### *Contractual Arrangements with Guanyou Gamespace and its Sole Shareholder Changyou Star*

- *Loan Agreement*, between Gamespace and Guanyou Gamespace's sole shareholder Changyou Star. This loan agreement provides for a loan in the amount of RMB10,000,000 (approximately \$1,520,000) to Changyou Star to make a contribution to the registered capital of Guanyou Gamespace in exchange for 100% of the equity interests in Guanyou Gamespace. The loan is interest free and is repayable on demand, but Changyou Star can only repay the loan by transferring to Gamespace the equity interests in Guanyou Gamespace.
- *Equity Interest Purchase Right Agreement*, among Gamespace, Guanyou Gamespace and Changyou Star. Pursuant to this agreement, Gamespace and any third party designated by Gamespace have the right, exercisable at any time during the term of the agreement, if and when it is legal to do so under PRC law, to purchase from Changyou Star all or any part of its equity interests in Guanyou Gamespace at a purchase price equal to its initial contribution to the registered capital of Guanyou Gamespace.
- *Equity Pledge Agreements*, among Gamespace, Guanyou Gamespace and Changyou Star. Pursuant to this agreement, Changyou Star pledged to Gamespace its equity interests in Guanyou Gamespace to secure the performance of its obligations and Guanyou Gamespace's obligations under the various VIE-related agreements. If Changyou Star breaches its obligations under any VIE-related agreements (Guanyou Gamespace's breach of any of its obligations under the various VIE-related agreements will be treated as Changyou Star's breach of its obligations), including the Equity Pledge Agreement, Gamespace is entitled to exercise its rights as the beneficiary under the Equity Pledge Agreement, including all rights Changyou Star has as a shareholder of Guanyou Gamespace.
- *Business Operation Agreement*, among Gamespace, Guanyou Gamespace and Changyou Star. This agreement sets forth the rights of Gamespace to control the actions of Guanyou Gamespace and its sole shareholder Changyou Star.
- *Power of Attorney*, executed by Changyou Star in favor of Gamespace. This power of attorney gives the Board of Directors of Gamespace the exclusive right to appoint nominees to act on behalf of Changyou Star as the sole shareholder of Guanyou Gamespace in connection with all actions to be taken by Guanyou Gamespace.
- *Technology Support and Utilization Agreement*, between Gamespace and Guanyou Gamespace. Pursuant to this agreement, Gamespace has the exclusive right to provide certain product development and application services and technology support to Guanyou Gamespace for a fee equal to a predetermined percentage of Guanyou Gamespace's revenues.
- *Services and Maintenance Agreement*, between Gamespace and Guanyou Gamespace. Pursuant to this agreement, Gamespace provides marketing, staffing, business operation and maintenance services to Guanyou Gamespace in exchange for a fee equal to the cost of providing such services plus a predetermined margin.

#### ***Transactions and Agreements with Sohu in connection with the carve-out of our PC games business from Sohu***

Expenses charged from Sohu for sales and marketing services and certain other services in connection with our business amounted to \$nil, \$0.8 million, and \$1.0 million, respectively, for the years ended December 31, 2018, 2017, and 2016. The amounts of these charges were agreed to by Sohu and us with reference to amounts charged for similar services by unrelated parties. Total corporate general administrative expenses allocated from Sohu were \$nil, \$nil, and \$nil, respectively, for the years ended December 31, 2018, 2017 and 2016.

During the past few years, we have continued to use the Sohu logo and to purchase banner advertisements from Sohu. For each such banner advertisement we have paid Sohu at the same rates as Sohu charges third parties for such placements. We also use Sohu's PEAK online billing system and use Sohu to provide links to our PC game Website on Sohu.com's main Website, for which we paid Sohu at a rate comparable to the rates charged by third-party providers for similar services and placements. For so long as Sohu remains as our controlling shareholder, we intend to enter into new agreements, or make amendments to existing agreements, between us and Sohu that involve significant expenditures or commitments with reference to the terms of similar agreements between unrelated third parties. We will also submit such agreements and amendments for review by the audit committee of our Board of Directors, which will assess such agreements and amendments for potential conflicts of interest in accordance with the Nasdaq Listing Rules, and seek to ensure that terms of such agreements and amendments are no less favorable than would be comparable agreements between us and an unrelated third party. We have adopted a policy for our audit committee setting forth the guidelines under which related party transactions, including transactions between Sohu and us, must be reviewed and approved or ratified by the audit committee. In assessing a related party transaction, the audit committee is required to consider such factors as (i) the benefits to us of the transaction; (ii) the commercial reasonableness of the terms of the related party transaction; (iii) the materiality of the transaction to us; and (iv) the extent of the related party's interest in the transaction.

The following are summaries of an Amended and Restated Non-Competition Agreement, and an Amended and Restated Marketing Services Agreement between Sohu and us:

#### *Amended and Restated Non-Competition Agreement*

We are a party to a Non-Competition Agreement, effective as of January 1, 2009 and amended and restated as of November 29, 2011, pursuant to which Sohu has agreed that, until the later of three years after Sohu no longer owns in the aggregate at least 10% of the voting power of our then outstanding voting securities and March 17, 2014, or the non-competition period, Sohu will not compete with us in the client-end installed MMORPG business anywhere in the world. We have agreed during the non-competition period not to compete with Sohu in the Internet portal, search, mobile value-added services and any other businesses conducted or contemplated to be conducted by Sohu as of April 1, 2009, except the client-end installed MMORPG business and, after our acquisition of the 17173.com Website on December 15, 2011, the 17173.com Website. In addition, both parties have agreed not to solicit the employees of the other party.

#### *Amended and Restated Marketing Services Agreement*

We entered into a Marketing Services Agreement with Sohu, effective January 1, 2009, amended and restated as of January 1, 2010 and further amended as of January 1, 2011, pursuant to which Sohu provides certain rights and services to us, including marketing services and Sohu's PEAK system for the distribution of our virtual prepaid game cards. The agreement further provides for the license from Sohu to us of certain domain names, permits us to co-brand our games with the Sohu name and logos, and allows us to identify ourselves as a member of the Sohu Group. The agreement will terminate upon the later of the date that is three years after the first date upon which Sohu ceases to own in the aggregate at least 10% of the voting power of the then outstanding securities of Changyou and the fifth anniversary of March 17, 2009. The amendment and restatement of the Marketing Services Agreement effective January 1, 2010 includes certain amendments to the original agreement, including clarifications and rate adjustments, and terms under which Sohu provides us with space on Sohu servers for the purpose of our display on Sohu Websites of banner ads and promotional material, continues to give us rights to use the Sohu brand and logo, certain Sohu domain names, Sohu Passport and the Sohu PEAK online payment system, and provides certain services to us, such as the construction and maintenance of a bulletin board system for some of our PC games.

#### *Matching Loans Arrangement between Sohu and Changyou*

During 2016, 2017 and 2018, certain of our subsidiaries and certain subsidiaries of Sohu entered into a series of one year loan agreements, pursuant to which our subsidiaries are entitled to draw down U.S. dollar-denominated loans from the Sohu subsidiaries and the Sohu subsidiaries are entitled to draw down equivalent RMB-denominated loans from our subsidiaries, to facilitate each other's business operations. During 2018, certain of our subsidiaries and certain subsidiaries of Sohu extended the maturity dates of the loan agreements to December 31, 2019. All of the loans carry a fixed rate of interest equal to the current market interest rate as of the dates when the principal was drawn down. As of December 31, 2016, 2017 and 2018, we had drawn down from the Sohu subsidiaries loans in an aggregate principal amount of \$350 million, \$365 million and \$602 million, respectively. Sohu had drawn down from our subsidiaries loans in an aggregate principal amount of RMB2.21 billion (approximately \$318.2 million), RMB2.31 billion (approximately \$353.8 million) and RMB3.88 billion (approximately \$565.7 million), respectively. For the years ended December 31, 2016, 2017 and 2018, interest income that we earned from such RMB-denominated loans were \$9.8 million, \$13.0 million and \$15.9 million, respectively, and interest expense that we accrued for such U.S. dollar-denominated loans were \$3.1 million, \$3.6 million and \$8.3 million, respectively.

#### *Matching Loans Arrangement between Changyou and Fox Financial*

During 2015, certain of our subsidiaries and certain subsidiaries of Fox Financial Technology Group Limited ("Fox Financial," formerly known as "SoEasy Internet Finance Group Limited"), entered into a series of one year loan agreements pursuant to which our subsidiaries were entitled to draw down HK dollar-denominated loans from the Fox Financial subsidiaries and the Fox Financial subsidiaries were entitled to draw down equivalent RMB-denominated loans from our subsidiaries. During 2016 we repaid the subsidiaries of Fox Financial HK\$100 million (approximately \$12.9 million) of outstanding principal under the loans and paid interest of HK\$1.4 million (approximately \$0.2 million), and the subsidiaries of Fox Financial repaid our subsidiaries RMB 80 million (approximately \$12.3 million) of outstanding principal under the loans and paid interest of RMB 4.7 million (approximately \$0.7 million).

During 2016, certain of our subsidiaries and certain subsidiaries of Fox Financial entered into a series of one year loan agreements pursuant to which the subsidiaries of Fox Financial are entitled to draw down RMB-denominated loans from our subsidiaries, which in turn are entitled to draw down equivalent US dollar-denominated loans from the Fox Financial subsidiaries, to facilitate each other's business operations. Under the terms of the loan agreements, our subsidiaries will repay principal of the US dollar-denominated loans in an amount equal to the original principal amount of the equivalent RMB-denominated loans, divided by the RMB to US dollar exchange rate that is in effect on the date of the repayment. The resulting exchange gain or loss is recognized for each reporting period. All of such loan agreements were amended in March 2018 to provide that all outstanding principal and accrued interest of the loans will be repaid in the same currency in which the original principal amounts of the loans were denominated. Therefore, no further exchange gain or loss will be recognized. All of the loans carry a fixed rate of interest equal to the current market interest rate as of the dates when the loan agreements were entered into.

As of December 31, 2016 and 2017, we had drawn down from the subsidiaries of Fox Financial loans in an aggregate principal amount of \$28.1 million and \$29.8 million, respectively, and the subsidiaries of Fox Financial had drawn down loans from our subsidiaries in an aggregate principal amount of RMB195 million (approximately \$28.1 million) and RMB195 million (approximately \$29.8 million), respectively. In December 2018, we entered into a supplemental agreement with Fox Financial pursuant to which all accrued and unpaid interest on the loans as of December 31, 2018 was added to the principal of the corresponding loans. As of December 31, 2018, the aggregate principal amount due to the subsidiaries of Fox Financial was \$32.7 million and the aggregate principal amount due from the subsidiaries of Fox Financial was RMB216.9 million (approximately \$31.6 million). For the years ended December 31, 2016, 2017 and 2018, interest income that we earned from the RMB-denominated loans was \$1.2 million, \$1.2 million and \$1.1 million, respectively, interest expense that we accrued for the U.S. dollar-denominated loans was \$0.7 million, \$0.7 million and \$0.5 million, respectively, and exchange gain/(loss) recognized was \$1.9 million, negative \$1.8 million and negative \$1.0 million, respectively.

#### ***Letter Agreement with Former Chief Financial Officer***

On August 25, 2017, in connection with the resignation of Jasmine Zhou as our Chief Financial Officer effective August 31, 2017, we entered into a letter agreement with Ms. Zhou in which we agreed that, with the exception of certain specified provisions, her executive employment agreement with us dated January 1, 2015 would terminate upon the effective date of her resignation. Ms. Zhou agreed not to compete with us through August 31, 2018, and we agreed that the provisions of Ms. Zhou's employee non-competition, non-solicitation, confidential information, and work product agreement with us dated January 1, 2015, other than the non-compete provision, would remain in effect. The letter agreement also provides that Ms. Zhou will serve as a consultant to us from September 1, 2017 through February 28, 2018 in return for a fee of RMB175,000 (approximately \$26,000) per month during the consulting period.

#### ***Loan Agreement with Sohu***

##### *Loan Agreement*

On October 24, 2016, our indirect wholly-owned subsidiary AmazGame entered into a loan agreement (the "Sohu Loan Agreement") with Sohu's indirect wholly-owned subsidiary Beijing Sohu New Media Information Technology Co., Ltd. ("Sohu Media") pursuant to which AmazGame agreed to loan to Sohu Media from time to time up to RMB1.0 billion (or approximately \$148.64 million). Under the Sohu Loan Agreement, the first request by Sohu Media for an advance must be made on or prior to December 31, 2016, and requests for further advances may be made for one year following the initial advance. Such one-year request period may be extended for another one-year period at Sohu Media's request with the consent of AmazGame. Principal amounts outstanding under the Sohu Loan Agreement will bear interest at an annual rate of 6%. The maturity date for principal and accrued interest for each advance will be one year from the date of each such advance, subject to extension of the date for repayment of principal for one additional year at the request of Sohu Media with the consent of AmazGame. Interest accrued on each advance will be due on the applicable initial one-year maturity date without regard to whether the principal maturity date is extended, and interest accrued following any extension of the maturity date for an advance will be due, together with principal, upon the extended maturity date of such advance. The Sohu Loan Agreement includes customary events of default, including Sohu Media's failure to pay any principal or interest when due, becoming insolvent, or ceasing operations, or if there is a material adverse change in the assets, business, commitments, or prospects of Sohu Media. Upon AmazGame's declaration of an event of default under the Sohu Loan Agreement, AmazGame may refuse to make further advances and demand payment in full of all outstanding principal and accrued interest, and we may elect to execute our right under the Sohu Loan Share Pledge Agreement, as described below, to apply the outstanding amounts of principal and interest to repurchase Class B ordinary shares in us held by Sohu's indirect wholly-owned subsidiary Sohu.com (Game) Limited ("Sohu Game"). As of December 31, 2018, we had outstanding loans to Sohu Media in an aggregate principal amount of RMB1 billion (approximately \$145.7 million), and the maturity dates for all of the outstanding loans have been further extended for one additional year to the second anniversary dates of the original maturity dates of the loans. We earned interest income of \$8.2 million from these loans in the year ended December 31, 2018.



### *Share Pledge Agreement*

On October 24, 2016, we entered into a share pledge agreement (the “Sohu Loan Share Pledge Agreement”) with Sohu Game pursuant to which Sohu Game pledged to us 11,386,228 Class B ordinary shares in us held by Sohu Game, to secure Sohu Media’s obligations under the Sohu Loan Agreement. While any principal or interest is outstanding under the Sohu Loan Agreement, the number of Class B ordinary shares pledged by Sohu Game to us is subject to upward adjustment from time to time if the price of our ADSs on the Nasdaq Global Select Market drops for at least 10 consecutive trading days by an amount of 20% or more from such price as of the date of the Sohu Loan Share Pledge Agreement, and is subject to further upward adjustment in the event of any additional incremental drops of 20% or more in the price of our ADSs for at least 10 consecutive trading days. If there is an event of default under the Sohu Loan Agreement, we may, at our election, apply all of the unpaid principal and accrued interest under the Sohu Loan Agreement to the repurchase from Sohu Game of pledged Class B ordinary shares at a price equal to the lesser of (i) one-half of the average of the closing prices of one ADS on the Nasdaq Global Select Market for the 30 trading days preceding the date of the Sohu Loan Share Pledge Agreement, or (ii) one-half of the average of the closing prices of one ADS on the Nasdaq Global Select Market for the 30 trading days preceding the date of the occurrence of the event of default. As of the date of this report, Sohu Game had pledged to us 21,847,751 Class B ordinary shares in us held by Sohu Game.

### *Interests of Experts and Counsel*

Not applicable.

## **ITEM 8. FINANCIAL INFORMATION**

### *Consolidated Financial Statements*

Please see Item 18 “Financial Statements” for our audited consolidated financial statements filed as a part of this annual report.

### *Legal Proceedings*

We may be subject to legal proceedings, investigations and claims incidental to the conduct of our business from time to time. We are not currently a party to, nor are we aware of, any legal proceeding, investigation or claim which, in the opinion of our management, is likely to have a material adverse effect on our business, financial condition or results of operations.

### *Dividend Policy*

On April 5, 2018, we declared a special cash dividend of \$4.70 per Class A ordinary or Class B ordinary share, or \$9.40 per ADS, each of which represents two Class A ordinary shares. The aggregate amount of the special cash dividend was approximately \$500 million. In order to facilitate the distribution of the special dividend, we revised our policy for our PRC subsidiaries with respect to their distribution of cash dividends. Under the revised policy, all of our PRC subsidiaries are permitted to distribute their cumulative available and undistributed earnings to their direct overseas parent companies in the Changyou Group. The change resulted in the accrual of additional income withholding taxes for the period before December 31, 2017 of approximately \$47 million, which was recognized in our consolidated financial statements for the year ended December 31, 2018.

Future cash dividends, if any, will be declared at the sole discretion of our Board of Directors and will depend upon our future operations and earnings, capital requirements and surplus, general financial condition, contractual restrictions and other factors as our Board of Directors may deem relevant.

Holders of ADSs will be entitled to receive dividends, subject to the terms of the deposit agreement, to the same extent as the holders of our ordinary shares, less the fees and expenses payable under the deposit agreement. Cash dividends will be paid by the depositary to holders of ADSs in U.S. dollars, subject to the terms of the deposit agreement. Other distributions, if any, will be paid by the depositary to holders of ADSs in any means it deems legal, fair and practical.

**ITEM 9. THE OFFER AND LISTING**

Our ADSs are listed on the Nasdaq Global Select Market under the symbol “CYOU.” Trading in our ADSs commenced on April 2, 2009.

The following table provides the high and low reported sale prices for our ADSs on the Nasdaq Global Select Market for (1) the five most recent fiscal years (2) each quarter in the two most recent fiscal years, (3) each of the last six full months, and (4) the month of March 2019 through March 15, 2019.

	Trading Price (US\$)	
	High	Low
2014		
Full Year	34.32	17.13
2015		
Full Year	35.27	17.00
2016		
Full Year	30.28	15.21
2017		
Full Year	44.55	21.37
First Quarter	31.47	21.37
Second Quarter	40.89	25.83
Third Quarter	44.55	37.68
Fourth Quarter	40.99	34.22
2018		
Full Year	37.63	12.68
First Quarter	37.63	26.93
Second Quarter	31.36	15.68
Third Quarter	16.99	12.68
Fourth Quarter	20.99	12.69
September	14.54	12.94
October	14.26	12.69
November	19.99	13.05
December	20.99	17.48
2019		
January	20.35	16.17
February	22.27	17.89
March (through March 15 <sup>th</sup> )	20.68	17.57

## ITEM 10. ADDITIONAL INFORMATION

### *Memorandum and Articles of Association*

We incorporate by reference into this annual report the description of our second amended and restated memorandum of association contained in our Registration Statement on Form F-1 (File No. 333-158061) originally filed with the SEC on March 17, 2009. Our shareholders adopted our second amended and restated memorandum and articles of association by a special resolution on March 16, 2009.

### *Differences in Corporate Law—Mergers and Similar Arrangements*

Set forth below is a summary of the significant differences between the provisions of the Companies Law Cap. 22 (Law 3 of 1961, as consolidated and revised) of the Cayman Islands (the “Companies Law”) regarding mergers and similar arrangements that are applicable to us and the laws applicable to companies incorporated in the State of Delaware in the United States and their shareholders.

Under the laws of the Cayman Islands, two or more companies may merge or consolidate in accordance with Part XVI of the Companies Law. Merger means the merging of two or more constituent companies into a sole remaining constituent company as the surviving company and the vesting of the undertaking, property and liabilities of the constituent companies in the surviving company. Consolidation means the combination of two or more constituent companies into a new consolidated company and the vesting of the undertaking, property and liabilities of the constituent companies in the consolidated company. The directors of each constituent company must approve a written plan of merger or consolidation (the “Plan”). The Plan must contain certain prescribed information including the effective date of the merger or consolidation; the basis of cancelling the shares in a constituent company in exchange for the relevant consideration or converting the shares in each constituent company into shares of the surviving company or consolidated company and the rights attached thereto; any proposed amendments to the memorandum and articles of association of the surviving company in a merger or the proposed new memorandum and articles of association of the consolidated company in a consolidation; and details of all secured creditors.

The Plan must be approved by each constituent company by way of (a) a special resolution of the shareholders; and (b) such other authorization, if any, as may be specified in such constituent company’s articles of association. Shareholders do not need to approve a merger between a Cayman Islands parent company and a Cayman Islands subsidiary. For this purpose a subsidiary is a company of which at least 90% of the issued shares entitled to vote are registered in the name of the parent company.

The consent of each holder of a fixed or floating security interest over a constituent company is required unless this requirement is waived by a court in the Cayman Islands.

The Plan must be filed with the Registrar of Companies together with supporting documents including a declaration (a) of solvency (debts as they fall due); (b) that the merger or consolidation is bona fide and not intended to defraud unsecured creditors of the constituent companies; (c) of the assets and liabilities of each constituent company; (d) that no proceedings are outstanding and that no order has been made or resolution passed to wind up a constituent company or to appoint a receiver, trustee or administrator in any jurisdiction; (e) that no scheme, order, compromise or arrangement has been made in any jurisdiction whereby the rights of creditors have been suspended or restricted and an undertaking that a copy of the certificate of merger or consolidation will be given to members and creditors of the constituent company and notification of the merger or consolidation will be published in the Cayman Islands Gazette.

A certificate of merger or consolidation, which is prima facie evidence of compliance with all statutory requirements in respect of the merger or consolidation, is issued by the Registrar of Companies.

The effective date of a merger or consolidation is the date the Plan is registered by the Registrar of Companies, although the Plan may provide for an effective date up to 90 days after the date of registration.

Except under certain circumstances a dissenting shareholder of a Cayman Islands constituent company is entitled to payment of the fair value of his shares upon dissenting to a merger or consolidation. The exercise of appraisal rights will preclude the exercise of any other rights except for the dissenting shareholder’s rights to be paid the fair value of his shares and to seek relief on the grounds that the merger or consolidation is void or unlawful.

The following procedure will otherwise apply:

- The dissenting shareholder must give written notice of objection (“notice of objection”) to the constituent company before the vote to approve the merger or consolidation.
- Within 20 days of the vote approving the merger or consolidation the constituent company must give written notice of the approval (“approval notice”) to all dissenting shareholders who served a notice of objection.
- Within 20 days (“dissent period”) of the approval notice a dissenting shareholder must give a written notice of dissent (“notice of dissent”) to the constituent company demanding payment of the fair value of his shares.

- Within 7 days of the expiry of the dissent period or within 7 days of the date on which the plan of merger or consolidation is filed with the Registrar of Companies (whichever is later) the constituent company, surviving company or consolidated company must make a written offer (“fair value offer”), to each dissenting shareholder to purchase their shares at a price determined by the company to be their fair value.
- If the company and the dissenting shareholders fail to agree the price within 30 days of the fair value offer (“negotiation period”), then within 20 days of the expiry of the negotiation period the company must apply to the Grand Court of the Cayman Islands to determine the fair value of the shares held by all dissenting shareholders who have served a notice of dissent and who have not agreed the fair value with the company.

All rights, benefits, immunities, privileges and property (including business and goodwill) of each of the constituent companies will vest in the surviving or consolidated company which will be liable for all debts, contracts, obligations, mortgages, charges, security interests and liabilities of each constituent company. Existing claims, proceedings, judgments, orders or rulings applicable to each constituent company will automatically apply to the surviving company or the consolidated company.

In addition, there are statutory provisions applicable to a scheme of arrangement that facilitate the takeover of a company or the reconstruction and amalgamation of companies, provided that the scheme of arrangement is approved by a majority in number of each class of shareholders or creditors with whom the arrangement is to be made, and who must in addition represent three-fourths in value of each such class of shareholders or creditors, as the case may be, that are present and voting either in person or by proxy at a meeting, or meetings, convened for that purpose by order of the Grand Court of the Cayman Islands. The arrangement must be sanctioned by the Grand Court of the Cayman Islands. While a dissenting shareholder has the right to express to the court the view that the transaction ought not to be approved, the court can be expected to approve the arrangement if it determines that:

- the statutory provisions as to the required vote have been met;
- the shareholders have been fairly represented at the meeting in question and the statutory majority are acting bona fide without coercion of the minority shareholders or creditors;
- the arrangement is such that may be reasonably approved by an intelligent and honest man acting in respect of his interest in the relevant class; and
- the arrangement is not one that would more properly be sanctioned under some other provision of the Companies Law.

When a take-over offer is made for all the shares or all the shares of a particular class and accepted by holders of 90% of the shares which are the subject of the offer within four months of the date of the offer, the offeror may, within a two month period commencing on the expiration of such four month period, require the holders of the remaining shares to transfer their shares to the offeror on the same terms as the offer. An objection can be made to the Grand Court of the Cayman Islands but this is unlikely to succeed in the case of an offer which has been so approved unless there is evidence of a lack of compliance with the statutory procedures, fraud, bad faith, or breach of the Companies Law.

If a scheme of arrangement or take-over offer is approved or accepted, the dissenting shareholder(s) will have no rights comparable to appraisal rights, which would otherwise ordinarily be available to dissenting shareholders in a merger or consolidation or to dissenting shareholders of Delaware corporations, providing rights to receive payment in cash for the judicially determined value of the shares.

### ***Material Contracts***

We have not entered into any material contracts within the past two fiscal years other than in the ordinary course of business, other than those listed in Item 19 “Exhibits” or described elsewhere in this annual report, or as described below.

#### *Amended and Restated Market Services Agreement with Sohu*

Please refer to “Related Party Transactions—Transactions and Agreements with Sohu” in Item 7 of this annual report.

#### *Loan and Share Pledge Agreements with Sohu*

Please refer to “Related Party Transactions—Loan Agreement with Sohu” in Item 7 of this annual report.

### ***Exchange Controls***

China’s government imposes control over the convertibility of RMB into foreign currencies. The conversion of RMB into foreign currencies, including U.S. dollars, has been based on rates announced by the People’s Bank of China. On July 21, 2005, the PRC government changed its decade-old policy of pegging the value of the RMB to the U.S. dollar. Under the new policy, the RMB is permitted to fluctuate within a narrow and managed band against a basket of certain foreign currencies. This change in policy has resulted in significant appreciation of the RMB against the U.S. dollar by the end of 2014. While the international reaction to the RMB revaluation has generally been positive, there remains significant international pressure on the PRC government to adopt an even more flexible currency policy, which could result in a further and more significant appreciation of the RMB against the U.S. dollar.

Pursuant to the Foreign Exchange Administration Regulations issued by the State Council on January 29, 1996, and effective as of April 1, 1996 (and amended on January 14, 1997 and August 5, 2008) and the Regulations on the Administration of Settlement, Sale and Payment of Foreign Exchange issued by the People's Bank of China on June 20, 1996 and effective on July 1, 1996, or the FX Regulations, regarding the administration and control of foreign exchange, conversion of RMB into foreign exchange by foreign investment enterprises for current account items, including the distribution of dividends and profits to foreign investors in joint ventures, is permissible. Foreign investment enterprises are permitted to remit foreign exchange from their foreign exchange bank accounts in China on the basis of, inter alia, the terms of the relevant joint venture contracts and the board resolutions declaring the distribution of the dividend and payment of profits. Each conversion of RMB into a foreign currency and each remittance of a foreign currency for capital account items, including direct investment, loans and security investment, is subject to the approval of the SAFE.

Under the Foreign Exchange Administration Regulations, foreign investment enterprises are required to open and maintain separate foreign exchange accounts for capital account items (but not for other items). In addition, foreign investment enterprises may only buy, sell and/or remit foreign currencies at those banks authorized to conduct foreign exchange business upon the production of valid commercial documents and, in the case of capital account item transactions, approval of the documents by the SAFE.

Currently, foreign investment enterprises are required to apply to the SAFE for "foreign exchange registration certificates for foreign investment enterprises" (which are granted to foreign investment enterprises, upon fulfilling specified conditions and which are subject to review and renewal by the SAFE on an annual basis). With such foreign exchange registration certificates and required underlying transaction documents, or with approval documents from the SAFE if the transactions are under capital account (which are obtained on a transaction-by-transaction basis), foreign-invested enterprises may enter into foreign exchange transactions at banks authorized to engage in the foreign exchange business to obtain foreign exchange for their needs.

### ***Taxation***

The following summary of the material Cayman Islands, PRC and United States federal income tax consequences of an investment in our ADSs or Class A ordinary shares is based upon laws and relevant interpretations thereof in effect as of the date of this annual report, all of which are subject to change. This summary does not discuss all possible tax consequences relating to an investment in our ADSs or Class A ordinary shares, such as the tax consequences under United States state, local and other tax laws.

#### *Cayman Islands Taxation*

The Cayman Islands currently levies no taxes on individuals or corporations based upon profits, income, gains or appreciation and there is no taxation in the nature of inheritance tax or estate duty or withholding tax applicable to us or the holders of our ADSs or Class A ordinary shares. We will not be subject to Cayman Islands taxation on payments of dividends or upon the repurchase by us of your ADSs or Class A ordinary shares, nor will gains derived from the disposal of ADSs or Class A ordinary shares be subject to Cayman Islands income or corporation tax. There are no other taxes likely to be material to us levied by the Government of the Cayman Islands except for stamp duties which may be applicable on instruments executed in, or brought within the jurisdiction of the Cayman Islands. No stamp duty is payable in the Cayman Islands on transfers of shares of Cayman Islands exempted companies, except those which hold interests in land in the Cayman Islands. The Cayman Islands is not party to any double tax treaties. There are no exchange control regulations or currency restrictions in the Cayman Islands.

#### *PRC Taxation*

##### *PRC taxation of us and our corporate group*

We are a holding company incorporated in the Cayman Islands and hold our equity interests in AmazGame and Gamespace, our principal PRC subsidiaries, indirectly through Changyou HK. A significant portion of our business operations are conducted by these PRC subsidiaries through our principal VIEs Gamease, Guanyou Gamespace and Shanghai ICE. The CIT Law and its implementation rules provide that China-sourced income of foreign enterprises, such as dividends paid by a PRC subsidiary to its overseas parent that is not a PRC resident enterprise and has no establishment in the PRC, will normally be subject to PRC withholding tax at a rate of 10%, unless there are applicable tax treaties that reduce such rate. Under the China-HK Tax Arrangement, such dividend withholding tax rate may be reduced to 5% if a Hong Kong resident enterprise is considered a non-PRC tax resident enterprise and owns at least 25% of equity interests in the PRC company distributing the dividends, subject to approval of the PRC local tax authority. However, if the Hong Kong resident enterprise is not considered to be the beneficial owner of such dividends under applicable PRC tax regulations, such dividends may remain subject to withholding tax at a rate of 10%. The SAT issued Announcement 9, effective April 1, 2018, which provides guidance on determining whether an enterprise is a "beneficial owner" under China's tax treaties and tax arrangements. Announcement 9 provides that, in order to be a beneficial owner, an entity generally must be a direct owner of, and have the right to control, the income of the enterprise that is paying the dividends or must be a direct owner of, and have the right to control, the tangible or intangible assets generating such income, and also specifies that a company that is not organized for the purpose of engaging in substantive business activities may not be regarded as a beneficial owner. If any of our Hong Kong subsidiaries is, in the light of Announcement 9, considered to not be a beneficial owner for purposes of the China-HK Tax Arrangement, any dividends paid to it by any of our PRC subsidiaries would not qualify for the preferential dividend withholding tax rate of 5%, but rather would be subject to withholding tax at the regular withholding tax rate of 10% under the CIT Law.

Under the CIT Law, enterprises established under the laws of jurisdictions outside China with their “de facto management bodies” located within China may be considered to be PRC tax resident enterprises for tax purposes. A substantial majority of the members of our management team as well as the management team of Changyou HK and ICE HK are located in China. If we were to be considered a PRC tax resident enterprise under the CIT Law, then our global income would be subject to PRC enterprise income tax at the rate of 25%. Similarly, if Changyou HK or ICE HK were to be considered a PRC tax resident enterprise, then its global income would be subject to PRC enterprise income tax at the rate of 25%.

#### PRC taxation of our overseas shareholders

The implementation rules of the CIT Law provide that, (i) if the enterprise that distributes dividends is domiciled in the PRC, or (ii) if gains are realized from transferring equity interests of enterprises domiciled in the PRC, then such dividends or capital gains are treated as China-sourced income. It is not clear how “domicile” may be interpreted under the CIT Law, and it may be interpreted as the jurisdiction where the enterprise is a tax resident. Therefore, if we and Changyou HK are considered as a PRC tax resident enterprise for tax purposes, any dividends we pay to our overseas shareholders or ADS holders as well as gains realized by such shareholders or ADS holders from the transfer of our shares or ADSs may be regarded as China-sourced income and as a result become subject to PRC withholding tax at the rate up to 10%. See “Risk Factors—There are significant uncertainties under the Corporate Income Tax Law of the PRC (the “CIT Law”) regarding our PRC enterprise income tax liabilities, such as tax on dividends paid to us by our PRC subsidiaries. The CIT Law also contains uncertainties regarding possible PRC withholding tax on any dividends we pay to our overseas corporate shareholders and gains realized from the transfer of our shares by our overseas corporate shareholders.”

#### *United States Federal Income Taxation*

The following is a general summary of the material United States federal income tax considerations related to the purchase, ownership and disposition of our ADSs or Class A ordinary shares by U.S. holders (as defined below). This summary applies only to U.S. holders that hold the ADSs or Class A ordinary shares as capital assets and that have the U.S. dollar as their functional currency. This discussion does not address any aspect of U.S. federal gift, estate or Medicare tax, or state, local or foreign tax consequences of an investment in our ADSs. This discussion is based on the tax laws of the United States as in effect on the date of this annual report and on United States Treasury regulations in effect or, in some cases, proposed, as of the date of this annual report, as well as judicial and administrative interpretations of such tax laws and regulations available on or before such date. All of the foregoing authorities are subject to change, which change could apply retroactively and could affect the tax consequences described below.

The following discussion does not describe the tax consequences that may be relevant to any particular investor or to persons in special tax situations such as:

- banks or certain financial institutions;
- insurance companies;
- broker dealers;
- traders that elect to mark to market;
- tax-exempt entities;
- persons liable for alternative minimum tax;
- persons holding ADSs or Class A ordinary shares as part of a straddle, hedging, conversion transaction or other integrated investment;
- regulated investments companies;
- persons who acquired ADSs or ordinary shares pursuant to the exercise of any employee share option or otherwise as compensation;
- persons who actually or constructively own 10% or more of the total combined voting power of all classes of our shares entitled to vote or 10% or more of the total value of all classes of our shares; or
- partnerships or other pass-through entities for U.S. federal income tax purposes or persons holding ADSs or Class A ordinary shares through partnerships or other pass-through entities.

*U.S. holders are urged to consult their own tax advisors about the application of the United States federal tax rules to their particular circumstances as well as the state, local and foreign tax consequences to them of the purchase, ownership and disposition of our ADSs or Class A ordinary shares.*

The discussion below of the United States federal income tax consequences to “U.S. holders” will apply to a beneficial owner of ADSs or Class A ordinary shares as capital assets for purposes of U.S. federal income tax laws and who is, for United States federal income tax purposes:

- a citizen or individual resident of the United States;
- a corporation (or other entity taxable as a corporation for United States federal income tax purposes) organized under the laws of the United States, any state thereof or the District of Columbia;
- an estate whose income is subject to United States federal income taxation regardless of its source; or
- a trust (1) whose administration is subject to the primary supervision of a court within the United States and one or more United States persons have the authority to control all substantial decisions of the trust, or (2) that has a valid election in effect under applicable United States Treasury regulations to be treated as a United States person.

For U.S. federal income tax purposes, the tax treatment of a partner in a partnership or other entity taxable as a partnership that holds ADSs or Class A ordinary shares depends on the partner’s status and the activities of the partnership. U.S. holders who hold their ADSs or Class A ordinary shares through a partnership, limited liability company, or other entity taxable as a partnership should consult their tax advisers regarding their tax treatment.

The discussion below assumes that the representations contained in the Deposit Agreement are true and that the obligations in the Deposit Agreement and any related agreement have been and will be complied with in accordance with their terms. Holders of ADSs will be treated as the holders of the underlying Class A ordinary shares represented by those ADSs for United States federal income tax purposes. Accordingly, deposits of Class A ordinary shares in return for ADSs representing those shares, and surrender of ADSs in return for the underlying Class A ordinary shares, will not be subject to United States federal income tax.

The U.S. Treasury has expressed concerns that parties to whom ADSs are released before the underlying shares are delivered to the depository (“pre-release”), or intermediaries in the chain of ownership between holders of ADSs and the issuer of the security underlying the ADSs, may be taking actions that are inconsistent with the claiming of foreign tax credits by holders of ADSs. These actions would also be inconsistent with the claiming of the reduced rate of tax, described below, applicable to dividends received by certain non-corporate holders. Accordingly, the creditability of PRC taxes, and the availability of the reduced tax rate for dividends received by certain non-corporate U.S. holders, each described below, could be affected by actions taken by such parties or intermediaries.

### ***Passive Foreign Investment Company***

We believe that we may have been classified as a PFIC for United States federal income tax purposes for our 2018 taxable year ended November 30, 2018. Our expectation is based on our operations and the composition of our earnings and assets for the 2018 taxable year, including the valuation of our assets (including goodwill) based on the expected price of our ADSs in the market. We currently hold, and expect to continue to hold, a substantial amount of cash and cash equivalents, and because the value of our other assets may be based in part on the market price of our ADSs, which has fluctuated and is likely to continue to fluctuate (and may fluctuate considerably given that market prices of Internet and online game companies historically have been especially volatile), our PFIC status in the current and future taxable years may depend in large part on the market price of our ADSs. A drop in the market price of our ADSs and associated decrease in the value of our goodwill would cause a reduction in the value of our non-passive assets for purposes of the asset test. In addition, the composition of our income and assets will be affected by how, and how quickly, we spend our cash. Furthermore, it is not entirely clear how the contractual arrangements between us and our consolidated VIEs will be treated for purposes of the PFIC rules. If these contractual arrangements were found by PRC authorities with appropriate jurisdiction to be unenforceable, such a finding alone could cause more than 75% of our gross income or more than 50% of our assets to be passive in the year that this finding was made or in subsequent years, which, in a given taxable year for which we might not otherwise expect to be classified as a PFIC, could cause us to be classified as a PFIC. See “Risk Factors—Risks Related to Our Corporate Structure and Corporate Governance—Our contractual arrangements with our VIEs and their shareholders may not be as effective in providing control over our VIEs as direct ownership of the VIEs and the shareholders of our VIEs may have conflicts of interest with us or with each other.” Also our actual PFIC status for any taxable year will depend upon the character of our income and assets and the value of our assets for such year, which will not be determinable until after the close of the taxable year. Accordingly, there is no guarantee regarding our PFIC status for any taxable year.

A non-U.S. corporation is considered a PFIC for any taxable year if either:

- at least 75% of its gross income is passive income (such as certain dividends, interest or royalties) (the “income test”), or

- at least 50% of the value of its assets (based on an average of the quarterly values of the assets during a taxable year) is attributable to assets that produce or are held for the production of passive income (the “asset test”).

For the purposes of this determination, we will be treated as owning our proportionate share of the assets and earning our proportionate share of the income of any other corporation in which we own, directly or indirectly, at least 25% (by value) of the shares.

We must make a separate determination each year as to whether we are a PFIC. As a result, our PFIC status may change from one year to the next.

If we are a PFIC for any taxable year during which a U.S. holder holds our ADSs or Class A ordinary shares, such U.S. holder will be subject to special tax rules with respect to any “excess distribution” that such U.S. holder receives and any gain that such U.S. holder realizes from a sale or other disposition (including a pledge) of the ADSs or Class A ordinary shares, unless the holder makes a “mark-to-market” election as discussed below. For purposes of these special rules, if we are a PFIC for any year during which a U.S. holder holds ADSs or Class A ordinary shares, we will continue to be treated as a PFIC with respect to such U.S. holder for all succeeding years during which such U.S. holder holds ADSs or Class A ordinary shares, even if we are no longer classified as a PFIC in subsequent years. Under certain attribution rules, if we are a PFIC, a U.S. holder will be deemed to own such U.S. holder’s proportionate share of any subsidiaries or other entities that are PFICs in which we hold (directly or indirectly through other PFICs) an equity interest (“subsidiary PFICs”) and will generally be treated for purposes of the PFIC rules as if such U.S. holder directly held the shares of such subsidiary PFICs.

Under these special rules, distributions that a U.S. holder receives in a taxable year that are greater than 125% of the average annual distributions that such U.S. holder received during the shorter of the three preceding taxable years or such U.S. holder’s holding period for the ADSs or Class A ordinary shares will be treated as an excess distribution. Under these special tax rules:

- the excess distribution or gain will be allocated ratably over the U.S. holder’s holding period for the ADSs or Class A ordinary shares;
- the amount allocated to the current taxable year, and any taxable year prior to the first taxable year in which we became a PFIC, will be treated as ordinary income; and
- the amount allocated to each other taxable year will be subject to the highest tax rate in effect for that taxable year and the interest charge generally applicable to underpayments of tax will be imposed on the resulting tax attributable to each such taxable year.

The tax liability for amounts allocated to years prior to the year of disposition or “excess distribution” cannot be offset by any net operating losses for such years, and gains (but not losses) realized on the sale of ADSs or Class A ordinary shares cannot be treated as capital, even if the U.S. holder holds the ADSs or Class A ordinary shares as capital assets. A U.S. holder will be subject to the same United States federal income tax rules as described above on indirect or constructive distributions that the U.S. holder is deemed to receive on shares of a subsidiary PFIC and on indirect or constructive dispositions of shares of subsidiary PFICs.

Alternatively, a U.S. holder of “marketable stock” (as defined below) in a PFIC may make a mark-to-market election for such stock of a PFIC to elect out of the tax treatment discussed in the two preceding paragraphs. A mark-to-market election will not be available, however, with respect to any subsidiary PFICs. If a U.S. holder makes a mark-to-market election for the ADSs or Class A ordinary shares, such U.S. holder will generally include in income each year an amount equal to the excess, if any, of the fair market value of the ADSs or Class A ordinary shares as of the close of such U.S. holder’s taxable year over such U.S. holder’s adjusted tax basis in such ADSs or Class A ordinary shares. The U.S. holder will be allowed a deduction for the excess, if any, of the adjusted basis of the ADSs or Class A ordinary shares over their fair market value as of the close of the taxable year. However, deductions are allowable only to the extent of any net mark-to-market gains on the ADSs or Class A ordinary shares included in the U.S. holder’s income for prior taxable years. Amounts included in a U.S. holder’s income under a mark-to-market election, as well as gain on the actual sale or other disposition of the ADSs or Class A ordinary shares, will generally be taxed at ordinary income rates. Ordinary loss treatment will also apply to the deductible portion of any mark-to-market loss on the ADSs or Class A ordinary shares, as well as to any loss realized on the actual sale or disposition of the ADSs or Class A ordinary shares, to the extent that the amount of such loss does not exceed the net mark-to-market gains previously included for such ADSs or Class A ordinary shares. A U.S. holder’s basis in the ADSs or Class A ordinary shares will be adjusted to reflect any such income or loss amounts. If the U.S. holder makes a mark-to-market election, tax rules that apply to distributions by corporations which are not PFICs would apply to distributions by us (except that the lower applicable capital gains rate for “qualified dividend income” discussed above would not apply). The basis adjustment and income or loss inclusion described here under this alternate mark-to-market regime will only apply during years in which we are a PFIC.

The mark-to-market election will only be available for “marketable stock,” which is stock that is traded in more than de minimis quantities on at least 15 days during each calendar quarter on a qualified exchange or other market, as defined in applicable Treasury regulations. We expect that the ADSs will continue to be listed and regularly traded on the Nasdaq Global Select Market, which is a qualified exchange for these purposes, and, consequently, that the mark-to-market election would be available to U.S. holders of our ADSs if and when we are a PFIC.



A third alternative taxation regime that may be available to some U.S. investors in PFICs, known as “qualified electing fund” (QEF) treatment, will not be available to U.S. holders of our ADSs or Class A ordinary shares. This is because QEF treatment requires the PFIC to supply annually certain information to its U.S. holders that we will not be supplying.

A U.S. holder of ADSs or Class A ordinary shares in any year in which we are a PFIC will be required to file Internal Revenue Service Form 8621 regarding distributions received on the ADSs or Class A ordinary shares and any gain realized on the disposition of the ADSs or Class A ordinary shares. In addition, if we are a PFIC for a taxable year in which we pay a dividend, or for the prior taxable year, the lower rate on “qualified dividend income” discussed below with respect to dividends paid to certain non-corporate U.S. holders would not apply.

U.S. holders and prospective holders of our ADSs are urged to consult their own tax advisors regarding the application of the PFIC rules to an investment in ADSs or Class A ordinary shares.

#### ***Taxation of Dividends and Other Distributions on ADSs or Class A Ordinary Shares***

Subject to the PFIC rules discussed above, the gross amount of our distributions to a U.S. holder with respect to ADSs or Class A ordinary shares (including any amount withheld in respect of PRC taxes) generally will be included in a U.S. holder’s gross income as foreign source dividend income on the date of receipt by the depository, in the case of ADSs, or by the U.S. holder, in the case of Class A ordinary shares, but only to the extent that the distribution is paid out of our current or accumulated earnings and profits (as determined under United States federal income tax principles). To the extent, if any, that the amount of any such distribution exceeds our current and accumulated earnings and profits, it will be treated first as a tax-free return of the U.S. holder’s tax basis in the ADSs or the Class A ordinary shares (thereby increasing the amount of any gain or decreasing the amount of any loss realized on the subsequent sale or disposition of such ADSs or Class A ordinary shares) and thereafter as capital gain. Further, any distribution treated as dividends will not be eligible for the dividends-received deduction allowed to corporations in respect of dividends received from other United States corporations.

With respect to certain non-corporate U.S. holders, including individual U.S. holders, dividends may be taxed at a special rate (the applicable capital gains rate) that is applicable to “qualified dividend income” provided that (1) the ADSs or Class A ordinary shares are readily tradable on an established securities market in the United States, (2) we are not treated as a PFIC with respect to the U.S. holder (as discussed above) for our taxable year in which the dividend was paid and we were not a PFIC in the preceding taxable year, and (3) certain holding period requirements are met. Under Internal Revenue Service authority, our Class A ordinary shares, or ADSs representing such shares, will be considered for the purpose of clause (1) above to be readily tradable on an established securities market in the United States if they are listed (as our ADSs currently are) on the Nasdaq Global Select Market. U.S. holders should consult their own tax advisors regarding the availability of the lower rate for dividends paid with respect to our ADSs or Class A ordinary shares. Dividends will constitute foreign source income for foreign tax credit limitation purposes. If the dividends are taxed as qualified dividend income (as discussed above), the amount of the dividend taken into account for purposes of calculating the foreign tax credit limitation will be limited to the gross amount of the dividend, multiplied by the reduced tax rate applicable to qualified dividend income and divided by the highest tax rate normally applicable to dividends. The limitation on foreign taxes eligible for credit is calculated separately with respect to specific classes of income. For foreign tax credit purposes, dividends paid on our Class A ordinary shares will generally constitute “passive category income” but could, in the case of certain U.S. holders, constitute “general category income.”

If PRC withholding taxes apply to dividends paid to a U.S. holder with respect to our ADSs or Class A ordinary shares, subject to certain conditions and limitations, such PRC withholding taxes will be treated as foreign taxes eligible for credit against the U.S. holder’s United States federal income tax liability. The rules governing foreign tax credits are complex, and U.S. holders should consult their tax advisors regarding the availability of a foreign tax credit in such U.S. holders’ particular circumstances.

#### ***Taxation of Disposition of Shares***

Subject to the PFIC rules discussed above, a U.S. holder will recognize taxable gain or loss on any sale, exchange or other taxable disposition of an ADS or Class A ordinary share equal to the difference between the amount realized for the ADS or Class A ordinary share and the U.S. holder’s adjusted tax basis in the ADS or Class A ordinary share. Such gain or loss will be capital gain or loss. A non-corporate U.S. holder, including an individual U.S. holder, who has held the ADS or Class A ordinary share for more than one year will be eligible for reduced capital gains tax rates. The deductibility of capital losses is subject to limitations. Any such gain or loss that a U.S. holder recognizes will be treated as United States source income (or loss, in the case of losses, subject to certain limitations) for foreign tax credit limitation purposes.

As described above under “Taxation—PRC Taxation,” any gain from the disposition of our ADSs or Class A ordinary shares may be subject to PRC withholding tax. In such event, a U.S. holder that is eligible for the benefits of the income tax treaty between the United States and the PRC may elect to treat the gain as PRC source income for foreign tax credit purposes. U.S. holders should consult their tax advisors regarding their eligibility for benefits under the income tax treaty between the United States and the PRC and their ability to credit any PRC tax withheld in respect of a sale of our ADSs or Class A ordinary shares against their United States federal income tax liability.

### ***Information Reporting and Backup Withholding***

Dividend payments with respect to ADSs or Class A ordinary shares and proceeds from the sale, exchange or redemption of ADSs or Class A ordinary shares may be subject to information reporting to the Internal Revenue Service and possible United States backup withholding at a rate of 24% for taxable years beginning after December 31, 2017, and before January 1, 2026. Backup withholding will not apply, however, to a U.S. holder who furnishes a correct taxpayer identification number and makes any other required certifications or who is otherwise exempt from backup withholding. U.S. holders who are required to establish their exempt status must provide such certification on Internal Revenue Service Form W-9. U.S. holders should consult their tax advisors regarding the application of the United States information reporting and backup withholding rules.

Individual U.S. holders, and certain entities that are U.S. holders, that own “specified foreign financial assets” with an aggregate value in excess of \$50,000 are generally required to file an information statement along with their tax returns, currently on Form 8938, with respect to such assets. “Specified foreign financial assets” include any financial accounts held at a non-U.S. financial institution, as well as securities issued by a non-U.S. issuer (which would include our ADSs and Class A ordinary shares) that are not held in accounts maintained by financial institutions. Higher reporting thresholds apply to certain individuals living abroad and to certain married individuals. Regulations have been proposed that would extend this reporting requirement to certain entities that are treated as formed or availed of to hold direct or indirect interests in specified foreign financial assets based on certain objective criteria. U.S. holders who fail to report the required information could be subject to substantial penalties. Prospective investors should consult their own tax advisors concerning the application of these rules to their investment in our ADSs and Class A ordinary shares, including the application of the rules to their particular circumstances.

Prospective purchasers of our ADSs or Class A ordinary shares should consult their own tax advisor regarding the application of the U.S. federal income tax laws to their particular situations as well as any tax consequences resulting from purchasing, holding or disposing of our ADSs and Class A Ordinary Shares, including the applicability and effect of the tax laws of any state, local or foreign jurisdiction and including estate, gift and inheritance laws.

### ***Available Additional Information***

We are subject to the periodic reporting and other informational requirements of the Exchange Act. Under the Exchange Act, we are required to file reports and other information with the SEC.

Copies of reports and other information, when so filed, may be inspected without charge and may be obtained at prescribed rates at the public reference facilities maintained by the Securities and Exchange Commission at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. The public may obtain information regarding the Washington, D.C. Public Reference Room by calling the Commission at 1-800-SEC-0330. The SEC also maintains a Website at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements, and other information regarding registrants that make electronic filings with the SEC using its EDGAR system. As a foreign private issuer, we are exempt from the rules under the Exchange Act prescribing the furnishing and content of quarterly reports and proxy statements, and officers, directors and principal shareholders are exempt from the reporting and short-swing profit recovery provisions contained in Section 16 of the Exchange Act.

As permitted under Nasdaq Listing Rule 5250(d)(1)(C), we will post our annual reports filed with the SEC on our Web site at <http://www.changyou.com>. We will not furnish hard copies of such reports to holders of our ADSs unless we are requested to do so in writing by a holder. Upon receipt of such a request, we will provide a hard copy of such reports to such requesting holder free of charge.

## **ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

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

While our reporting currency is the U.S. dollar, to date the majority of our revenues and costs are denominated in RMB and a significant portion of our assets and liabilities are denominated in RMB. As a result, we are exposed to foreign exchange risk, as our revenues and results of operations may be affected by fluctuations in the exchange rate between U.S. dollar and RMB. If the RMB depreciates against the U.S. dollar, the value of our RMB revenues and assets as expressed in our U.S. dollar financial statements will decline. For example, as reported in our U.S. dollar financial statements included in this annual report, our revenues for the year ended December 31, 2018 were \$485.8 million and our total assets as of December 31, 2018 were \$1.97 billion, representing revenues of RMB3.33 billion and total assets of RMB13.5 billion at the noon buying rate of RMB6.8632 to \$1.00 on December 31, 2018. If the value of the RMB were to depreciate by approximately 10% to RMB7.5495 to \$1.00, the value of the same amount of RMB-denominated revenues and total assets in U.S. dollars would be \$441.6 million and \$1.79 billion, respectively. See “Risk Factors—Risks Related to Doing Business in China—We may suffer currency exchange losses if the RMB depreciates relative to the U.S. dollar, which could reduce the value of an investment in our ADSs” in Item 3.

The RMB is not freely tradeable in “capital account” transactions, which include foreign direct investment. Foreign exchange transactions classified as capital account transactions are subject to limitations and require approval from the SAFE. This could affect our China-based subsidiaries’ ability to obtain foreign exchange through debt or equity financing, including by means of loans or capital contributions from us. Further, the RMB is at present free convertible in “current account” transactions, which include dividends, trade and service-related foreign exchange transactions, and our China-based subsidiaries may purchase and retain foreign exchange for settlement of such transactions, including payment of dividends, without the approval of the SAFE. However, the relevant PRC governmental authorities may limit our ability to purchase or retain foreign currencies in the future. Since a significant amount of our future revenues are likely to be in the form of RMB, these existing restrictions, and any future restrictions, on currency exchange may limit our ability to use revenues generated in RMB to fund our business activities outside of China, or to make expenditures denominated in foreign currencies.

To the extent that we need to convert U.S. dollars into RMB for our operations, appreciation of the RMB against the U.S. dollar would reduce the RMB amount we would receive from the conversion. Conversely, if we decide to convert RMB into U.S. dollars for the purpose of making payments for dividends on our ordinary shares or for other business purposes, depreciation of the RMB against the U.S. dollar would reduce the U.S. dollar amounts available to us.

As of December 31, 2018 and 2017, the aggregate notional amounts of the foreign exchange forward contracts were \$nil and \$10 million, respectively. We may incur economic losses in the future due to foreign exchange rate fluctuations, which could have a negative impact on our financial condition and results of operations.

The following table sets forth a summary of our foreign currency sensitive financial instruments as of December 31, 2018, which consisted of cash and cash equivalents, restricted cash, accounts receivable, short term investments, matching loans to related parties, loans between Changyou and Sohu, prepaid and other current assets, restricted time deposits, other current liabilities, long-term bank loans, long-term tax payables and other long-term liabilities. The book value of those financial instruments approximated their fair value.

	Denominated in			Total
	US\$	RMB (in thousands)	Others	
Cash and cash equivalents	\$ 358,661	\$ 87,519	\$ 8,354	\$ 454,534
Restricted cash	—	4,775	—	4,775
Accounts receivable, net	1,188	55,750	451	57,389
Short-term investments	—	190,068	—	190,068
Matching loans to related parties	—	614,754	—	614,754
Loans between Changyou and Sohu	—	153,759	—	153,759
Prepaid and other current assets	709	24,526	163	25,398
Restricted time deposits	—	243,910	—	243,910
Other current liabilities	659,640	154,087	2,898	816,625
Long-term bank loans	220,000	—	—	220,000
Long-term tax payable	—	13,438	—	13,438
Other long-term liabilities	—	751	—	751

### ***Inflation Rate Risk***

According to the National Bureau of Statistics of China, the change in the consumer price index in China was 2.1%, 1.6% and 2.0% in 2018, 2017 and 2016, respectively. If inflation rises, it may materially and adversely affect our business.

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

Our investment policy limits our investments of excess cash in high-quality corporate securities and limits the amount of credit exposure to any one issuer. We protect and preserve our invested funds by limiting default, market and reinvestment risk.

During 2018, we drew down from the offshore branches of certain PRC banks loans that were secured by an equivalent or greater amount of RMB deposits by us in the onshore branches of the banks. As of December 31, 2018, the total outstanding principal amount of the loans was \$220 million, and all carried a floating rate of interest based on the LIBOR. The fair value of our fixed interest rate loans will fluctuate with movements of market interest rates, increasing in periods of declining rates of interest and declining in periods of increasing rates of interest. Based upon the prevailing interest rates in the market, the fair value of our loans was \$220 million as of December 31, 2018. Based on our interest-bearing loans in 2018, a 10% change in the interest rate would result in an increase or decrease of \$0.1 million of the total amount of our interest expense for 2018.

**ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

The following table summarizes the fees and charges that a holder of our ADSs may have to pay, directly or indirectly, pursuant to the Deposit Agreement and the types of services and the amount of the fees or charges paid therefore:

*Persons depositing or withdrawing shares or ADS holders must pay:*

\$5.00 (or less) per 100 ADSs (or portion of 100 ADSs)

\$.02 (or less) per ADS

A fee equivalent to the fee that would be payable if securities distributed to you had been shares and the shares had been deposited for issuance of ADSs

\$.02 (or less) per ADSs per calendar year

Registration or transfer fees

Expenses of the depository

Taxes and other governmental charges the depository or the custodian have to pay on any ADS or share underlying an ADS, for example, stock transfer taxes, stamp duty or withholding taxes

Any charges incurred by the depository or its agents for servicing the deposited securities

*For:*

- Issuance of ADSs, including issuances resulting from a distribution of shares or rights or other property
- Cancellation of ADSs for the purpose of withdrawal, including if the Deposit Agreement terminates
- Any cash distribution to ADS holders
- Distribution of securities distributed to holders of deposited securities which are distributed by the depository to ADS holders
- Depository services
- Transfer and registration of shares on our share register to or from the name of the depository or its agent when you deposit or withdraw shares
- Cable, telex and facsimile transmissions (when expressly provided in the Deposit Agreement)
- Converting foreign currency to U.S. dollars
- As necessary
- As necessary

Pursuant to an agreement dated April 1, 2009, as amended in June 4, 2010, between us and the Bank of New York Mellon, the depository for our ADSs, the depository reimbursed us in May of each of 2016, 2017 and 2018 for our expenses, including investor relations expenses, legal fees, accounting fees, Nasdaq listing application and listing fees and related expenses, of \$nil, \$nil and \$nil, respectively, which figures are net of U.S. withholding tax, related to the establishment of an American depository receipt facility.

## PART II

### ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

Not Applicable.

### ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

#### *Use of Proceeds*

On April 1, 2009, our registration statement on Form F-1 (File No. 333-158061), as amended, was declared effective by the SEC for our initial public offering, pursuant to which we and Sohu.com (Game) Limited, an indirect wholly-owned subsidiary of Sohu and the selling shareholder in the offering, offered and sold a total of 8,625,000 ADSs at the public offering price of \$16.00 per ADS. The offering was completed on April 7, 2009.

We sold 3,750,000 ADSs and the selling shareholder sold 4,875,000 ADSs in our initial public offering. We received net proceeds of approximately \$54.7 million, after deducting underwriting discounts and commissions of approximately \$4.2 million and other expenses of approximately \$1.1 million. None of the underwriting discounts and commissions or other expenses were paid directly or indirectly to any director, officer, or general partner of ours or to their associates, persons owning ten percent or more of any class of our equity securities, or to any of our affiliates. We did not receive any proceeds from the sale of our ADSs by the selling shareholder. Credit Suisse Securities (USA) LLC and Merrill Lynch, Pierce, Fenner & Smith Incorporated were the managing underwriters for the offering.

As of December 31, 2018, we had not used any of the net proceeds to us from our initial public offering. Proceeds from the offering have been deposited in banks.

### ITEM 15. CONTROLS AND PROCEDURES

#### *Disclosure Controls and Procedures*

As of the end of the period covered by this annual report, our principal executive officer and principal financial officer performed an evaluation of the effectiveness of our disclosure controls and procedures as defined and required under Rules 13a-15(e) and 15d-15(e) of the Exchange Act. Based upon that evaluation, they have concluded that our disclosure controls and procedures were effective in ensuring that the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, to allow timely decisions regarding required disclosure. Our principal executive officer and principal financial officer also concluded that the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in by the Securities and Exchange Commission's rules and regulations.

#### *Management's Annual Report on Internal Control over Financial Reporting*

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with U.S. GAAP. Our internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of are being made only in accordance with authorizations of management; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of any of our assets that could have a material effect on the financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an assessment of the effectiveness of our internal control over financial reporting based upon criteria established in the "Internal Control—Integrated Framework (2013)" issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on this assessment, management has concluded that our internal control over financial reporting is effective as of December 31, 2018.

The effectiveness of our internal control over financial reporting as of December 31, 2018 has been audited by PricewaterhouseCoopers Zhong Tian LLP, our independent registered public accounting firm, as stated in its report included on page F-2.

### **Changes in Internal Control over Financial Reporting**

There were no changes in our internal control over financial reporting identified in connection with the evaluation required by Rules 13a-15 or 15d-15 that occurred during the period covered by this annual report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

### **ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT**

Our Board of Directors has determined that Dave De Yang is an “audit committee financial expert” as defined under the applicable SEC rules and Rule 5605(c)(2) of the Nasdaq Listing Rules. Our Board of Directors has determined that all three members of our audit committee are “independent” under Rule 10A-3 under the Securities Exchange Act of 1934 and Rule 5605 of the Nasdaq Listing Rules.

### **ITEM 16B. CODE OF ETHICS**

Our Board of Directors adopted a code of ethics and conduct that is applicable to all of our directors, officers and employees. A copy of our code of ethics and conduct was filed as an exhibit to our Registration Statement on Form F-1 (File No. 333-158061) originally filed with the SEC on March 17, 2009, and is also posted on our Website at <http://www.changyou.com> under the heading “Investor Relations—Corporate Governance.”

### **ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The following table sets forth the aggregate fees by categories specified below in connection with certain professional services rendered by PricewaterhouseCoopers Zhong Tian LLP, our principal external auditors, for the periods indicated below.

	For the year ended	
	December 31,	
	2017	2018
	US\$	US\$
	(in thousands)	
Audit fees <sup>(1)</sup>	\$1,344	\$ 900
Tax fees <sup>(2)</sup>	459	317
Audit related fees <sup>(3)</sup>	93	51
All other fees	2	2
<b>Total</b>	<b>\$1,898</b>	<b>\$1,270</b>

- (1) “Audit fees” means the aggregate fees billed in each of the fiscal years listed for professional services rendered by our principal auditors for the audit of our annual financial statements and our internal controls over financial reporting.
- (2) “Tax fees” means the aggregate fees billed in each of the fiscal years listed for professional services rendered by our principal auditors for tax compliance and tax advice.
- (3) “Audit-related fees” means the aggregate fees billed in each of the fiscal years listed for professional services rendered by our principal auditors related to the audit of our financial statements and our internal controls over financial reporting that are not reported under “Audit Fees” and consultation on accounting standards or transactions.

### **Audit Committee Pre-approval Policies and Procedures**

Our audit committee has adopted procedures which set forth the manner in which the committee will review and approve all audit and non-audit services to be provided by PricewaterhouseCoopers Zhong Tian LLP before that firm is retained for such services. The pre-approval procedures are as follows:

- Any audit or non-audit service to be provided to us by the independent accountant must be submitted to the audit committee for review and approval, with a description of the services to be performed and the fees to be charged.
- The audit committee in its sole discretion then approves or disapproves the proposed services and documents such approval, if given, through written resolutions or in the minutes of meetings, as the case may be.

**ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES**

Not Applicable.

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

Not Applicable.

**ITEM 16F. CHANGE IN REGISTRANT'S CERTIFYING ACCOUNTANT**

Not Applicable.

**ITEM 16G. CORPORATE GOVERNANCE**

Because Sohu owns more than 50% of the total voting power of our ordinary shares, we are a “controlled company” under the Nasdaq Listing Rules. We intend to rely on certain exemptions that are available to controlled companies from Nasdaq corporate governance requirements, including the requirements:

- that we have a corporate governance and nominating committee that is composed entirely of independent directors with a written charter addressing the committee’s purpose and responsibilities;
- that we have a compensation committee that is composed entirely of independent directors with a written charter addressing the committee’s purpose and responsibilities; and
- for an annual performance evaluation of the nominating and governance committee and compensation committee.

We are not required to and will not voluntarily meet these requirements.

In addition, we may invoke the “home country practice” exceptions available to foreign private issuers, such as us, under the Nasdaq Listing Rules, including those that are similar to the exemptions for controlled companies and other exemptions from Nasdaq corporate governance requirements.

In November 2014 our Board of Directors approved an increase in the number of Class A ordinary shares reserved for issuance under our 2014 Share Incentive Plan, and we invoked the “home country practice” exception in order to implement the increase immediately, without seeking shareholder approval. Under the law of the Cayman Islands, which is our “home country” under the Nasdaq Listing Rules, shareholder approval is not required for such an increase.

As a result of our use of the “controlled company” exemptions and our invoking of one the “home country practice” exceptions, our investors do not have the same protection afforded to shareholders of companies that are subject to all of Nasdaq’s corporate governance requirements.

**ITEM 16H. MINE SAFETY DISCLOSURE**

Not Applicable.

**PART III**

**ITEM 17. FINANCIAL STATEMENTS**

We have elected to provide financial statements pursuant to Item 18.

**ITEM 18. FINANCIAL STATEMENTS**

The consolidated financial statements of Changyou and its subsidiaries and VIEs are included at the end of this annual report.



## ITEM 19. EXHIBITS

<u>Exhibit Number</u>	<u>Description of Document</u>
1.1 <sup>(1)</sup>	<u>Second Amended and Restated Memorandum and Articles of Association of the Registrant</u>
2.1 <sup>(1)</sup>	<u>Registrant's Specimen American Depositary Receipt</u>
2.2 <sup>(1)</sup>	<u>Registrant's Specimen Certificate for Class A ordinary shares</u>
2.3 <sup>(1)</sup>	<u>Form of Deposit Agreement among the Registrant, the depositary and all registered holders and beneficial owners of the American Depositary Shares</u>
4.1 <sup>(1)</sup>	<u>2008 Share Incentive Plan</u>
4.2 <sup>(1)</sup>	<u>Form of Indemnification Agreement with the Registrant's directors</u>
4.3 <sup>(1)</sup>	<u>English translation of Services and Maintenance Agreement, dated November 30, 2007, between AmazGame and Gamease</u>
4.4 <sup>(1)</sup>	<u>English translation of Technology Support and Utilization Agreement, dated August 20, 2008, between AmazGame and Gamease</u>
4.5 <sup>(1)</sup>	<u>Master Transaction Agreement, dated January 1, 2009, by and between Sohu.com Inc. and Changyou.com Limited</u>
4.6 <sup>(1)</sup>	<u>English Translation of License Agreement between Gamease and Louis Cha regarding TLBB †</u>
4.7 <sup>(2)</sup>	<u>English Translation of Project Cooperation Agreement, dated August 23, 2010, between AmazGame and Beijing Raycom Jingyuan Real Estate Development Co., Ltd.</u>
4.8 <sup>(2)</sup>	<u>Amended and Restated Marketing Services Agreement, dated January 1, 2010, between Changyou and Sohu</u>
4.9 <sup>(2)</sup>	<u>English translation of Services and Maintenance Agreement, dated September 1, 2010, between Gamespace and Guanyou Gamespace</u>
4.10 <sup>(2)</sup>	<u>English translation of Technology Support and Utilization Agreement, dated September 1, 2010, between Gamespace and Guanyou Gamespace</u>
4.11 <sup>(3)</sup>	<u>Master Transaction Agreement, dated as of November 29, 2011, between, on the one hand, Sohu.com Inc., Sohu.com Limited, Beijing Sohu Internet Information Service Co., Ltd., Beijing Sohu New Era Information Technology Co., Ltd., and Beijing Sohu New Media Information Technology Co., Ltd., and, on the other hand, Changyou.com Limited, Changyou.com HK Limited, and Beijing Changyou Gamespace Software Technology Co., Ltd., Beijing Guanyou Gamespace Digital Technology Co., Ltd.</u>
4.12 <sup>(3)</sup>	<u>Amended and Restated Non-Competition Agreement, dated as of November 29, 2011, by and between Sohu.com Inc. and Changyou.com Limited</u>
4.13 <sup>(3)</sup>	<u>Services Agreement, dated as of November 29, 2011, by and between Beijing Changyou Gamespace Software Technology Co., Ltd. and Beijing Sohu New Media Information Technology Co., Ltd.</u>
4.14 <sup>(3)</sup>	<u>English Translation of Form of Beijing Commercial Property Advance Sale Contract between AmazGame and Beijing Raycom Jingyuan Real Estate Development Co., Ltd.</u>
4.15 <sup>(4)</sup>	<u>Changyou.com Limited 2014 Share Incentive Plan</u>
4.16 <sup>(5)</sup>	<u>English translation of Loan Agreement, dated April 15, 2015, between AmazGame and High Century</u>
4.17 <sup>(5)</sup>	<u>English translation of Equity Interest Purchase Right Agreement, dated April 15, 2015, among AmazGame, Gamease and High Century</u>
4.18 <sup>(5)</sup>	<u>English translation of Equity Pledge Agreements, dated April 15, 2015, among AmazGame, Gamease and High Century</u>
4.19 <sup>(5)</sup>	<u>English translation of Business Operation Agreement, dated April 15, 2015, among AmazGame, Gamease and High Century</u>
4.20 <sup>(5)</sup>	<u>English translation of Power of Attorney, dated April 15, 2015, executed by High Century in favor of AmazGame</u>
4.21 <sup>(5)</sup>	<u>English translation of Loan Agreement, dated July 6, 2015, between Gamespace and Changyou Star</u>

<u>Exhibit Number</u>	<u>Description of Document</u>
4.22 <sup>(5)</sup>	<a href="#"><u>English translation of Equity Interest Purchase Right Agreement, dated July 6, 2015, among Gamespace, Guanyou Gamespace and Changyou Star</u></a>
4.23 <sup>(5)</sup>	<a href="#"><u>English translation of Equity Pledge Agreements, dated July 6, 2015, among Gamespace, Guanyou Gamespace and Changyou Star.</u></a>
4.24 <sup>(5)</sup>	<a href="#"><u>English translation of Business Operation Agreement, dated July 6, 2015, among Gamespace, Guanyou Gamespace and Changyou Star.</u></a>
4.25 <sup>(5)</sup>	<a href="#"><u>English translation of Power of Attorney, dated July 6, 2015, executed by Changyou Star in favor of Gamespace.</u></a>
4.26 <sup>(6)</sup>	<a href="#"><u>English Translation of Loan Agreement, dated as of October 24, 2016, between AmazGame and Sohu Media.</u></a>
4.27 <sup>(6)</sup>	<a href="#"><u>Share Pledge Agreement, dated as of October 24, 2016, between the Company and Sohu Game.</u></a>
4.28 <sup>(6)</sup>	<a href="#"><u>Letter Agreement, dated August 25, 2017, between the Company and Jasmine Zhou</u></a>
4.29 <sup>(6)</sup>	<a href="#"><u>Form of Executive Employment Agreement with Executive Officers</u></a>
4.30 <sup>(6)</sup>	<a href="#"><u>Form of Executive Employee Non-Competition, Non-Solicitation Agreement, Confidential Information and Work Product Agreement with Executive Officers.</u></a>
4.31*	<a href="#"><u>Facility Letter, dated October 22, 2018, between Changyou HK and China Merchants Bank Co., Ltd. Hong Kong Branch and Application for Amendment to Letter of Guarantee/Standby Letter of Credit, dated February 19, 2019, between AmazGame and China Merchants Bank Co., Ltd. Beijing Branch.</u></a>
8.1*	<a href="#"><u>Subsidiaries of the Registrant</u></a>
11.1 <sup>(1)</sup>	<a href="#"><u>Code of Ethics and Conduct for Directors, Officers and Employees</u></a>
12.1*	<a href="#"><u>Certification of Chief Executive Officer Required by Rule 13a-14(a)</u></a>
12.2*	<a href="#"><u>Certification of Chief Financial Officer Required by Rule 13a-14(a)</u></a>
13.1*	<a href="#"><u>Certification of Chief Executive Officer Required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code</u></a>
13.2*	<a href="#"><u>Certification of Chief Financial Officer Required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code</u></a>
15.1*	<a href="#"><u>Consent of PricewaterhouseCoopers Zhong Tian LLP, an independent registered public accounting firm</u></a>
15.2*	<a href="#"><u>Consent of Haiwen &amp; Partners</u></a>
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document

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- (1) Incorporated by reference to our Registration Statement on Form F-1(file no. 333-158061) filed with the Securities and Exchange Commission on March 17, 2009.
  - (2) Incorporated by reference to our Annual Report on Form 20-F filed with the Securities and Exchange Commission on February 28, 2011.
  - (3) Incorporated by reference to our Annual Report on Form 20-F filed with the Securities and Exchange Commission on February 28, 2012.
  - (4) Incorporated by reference to our Annual Report on Form 20-F filed with the Securities and Exchange Commission on March 2, 2015.

- (5) Incorporated by reference to our Annual Report on Form 20-F filed with the Securities and Exchange Commission on February 26, 2016
- (6) Incorporated by reference to our Annual Report on Form 20-F filed with the Securities and Exchange Commission on February 27, 2017
- (7) Incorporated by reference to our Annual Report on Form 20-F filed with the Securities and Exchange Commission on February 28, 2018
- † Portions of these exhibits have been omitted pursuant to a request for confidential treatment, and the omitted information has been filed separately with the Securities and Exchange Commission.
- \* Filed or furnished with this Annual Report on Form 20-F.

**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing its annual report on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

CHANGYOU.COM LIMITED

By \_\_\_\_\_ /s/ DEWEN CHEN  
Name: **Dewen Chen**  
Title: **Chief Executive Officer**

By \_\_\_\_\_ /s/ YAOBIN WANG  
Name: **Yaobin Wang**  
Title: **Chief Financial Officer**

Date: March 28, 2019

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## **Report of Independent Registered Public Accounting Firm**

To Board of Directors and Shareholders of Changyou.com Limited

### ***Opinions on the Financial Statements and Internal Control over Financial Reporting***

We have audited the accompanying consolidated balance sheets of Changyou.com Limited and its subsidiaries (the “Company”) as of December 31, 2018 and 2017, and the related consolidated statements of comprehensive income, of changes in equity and of cash flows for each of the three years in the period ended December 31, 2018, including the related notes (collectively referred to as the “consolidated financial statements”). We also have audited the Company’s internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2018 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control—Integrated Framework (2013) issued by the COSO.

### ***Basis for Opinions***

The Company’s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in Management’s Annual Report on Internal Control over Financial Reporting appearing under Item 15. Our responsibility is to express opinions on the Company’s consolidated financial statements and on the Company’s internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

### ***Definition and Limitations of Internal Control over Financial Reporting***

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers Zhong Tian LLP  
Beijing, the People's Republic of China

March 28, 2019

We have served as the Company's auditor since 2008.

**CHANGYOU.COM LIMITED**  
**CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31, 2017 AND 2018**  
(In thousands, except par value)

	Note	As of December 31,	
		2017	2018
		US\$	US\$
<b>Assets</b>			
<b>Current assets:</b>			
Cash and cash equivalents		571,139	454,534
Restricted cash		2,020	4,775
Short-term investments	15	404,584	190,068
Accounts receivable, net	8	91,636	57,389
Matching loans to related parties	26	385,782	614,754
Loans between Changyou and Sohu	26	80,326	80,907
Prepaid and other current assets	9	61,977	25,398
<b>Total current assets</b>		<b>1,597,464</b>	<b>1,427,825</b>
<b>Non-current assets:</b>			
Fixed assets, net	10	189,947	170,746
Intangible assets, net	11	8,460	13,904
Long-term investments, net	12	3,000	3,000
Goodwill	13	27,504	10,257
Restricted time deposits	7	—	243,910
Loans between Changyou and Sohu	26	76,520	72,852
Other assets, net	14	19,128	22,990
<b>Total assets</b>		<b>1,922,023</b>	<b>1,965,484</b>
<b>Liabilities and shareholders' equity</b>			
<b>Current liabilities:</b>			
Accounts payable (including accounts payable of consolidated variable interest entities ("VIEs") without recourse to the Company of \$3,904 and \$4,068, respectively)		24,647	27,855
Receipts in advance and deferred revenue (including receipts in advance and deferred revenue of consolidated VIEs without recourse to the Company of \$29,597 and \$30,602, respectively)	16	42,917	45,343
Accrued salary and benefits (including accrued salary and benefits of consolidated VIEs without recourse to the Company of \$462 and \$105, respectively)		39,084	48,880
Accrued liabilities to suppliers (including accrued liabilities to suppliers of consolidated VIEs without recourse to the Company of \$2,073 and \$944, respectively)		26,325	27,465
Tax payables (including tax payables of consolidated VIEs without recourse to the Company of \$413 and \$206, respectively)		19,468	18,211
Matching loans from related parties	26	396,192	642,968
Other short-term liabilities (including \$3,163 and \$1,318, respectively, of other short-term liabilities of consolidated VIEs without recourse to the Company)	17	8,686	5,903
<b>Total current liabilities</b>		<b>557,319</b>	<b>816,625</b>
<b>Long-term liabilities:</b>			
Long-term bank loans	7	—	220,000
Deferred tax liabilities	19(c)	34,443	83,026
Other long-term liabilities (including other long-term liabilities of consolidated VIEs without recourse to the Company of \$14,114 and \$13,438, respectively)		14,904	14,189
<b>Total liabilities</b>		<b>606,666</b>	<b>1,133,840</b>
<b>Commitments and contingencies</b>	27		
<b>Shareholders' equity:</b>			
Class A ordinary shares (par value \$0.01, 200,000 authorized; 35,186 and 36,251, respectively, issued and outstanding as of December 31, 2017 and 2018)		379	390
Class B ordinary shares (par value \$0.01, 97,740 authorized; 70,250 and 70,250, respectively, issued and outstanding as of December 31, 2017 and 2018)		703	703
Additional paid-in capital		138,750	132,289
Treasury shares (2,730 and 2,730 shares, respectively, as of December 31, 2017 and 2018)	25	(35,323)	(35,323)
Statutory reserves	22	14,277	20,568
Retained earnings		1,197,617	775,972
Accumulated other comprehensive loss		(4,398)	(64,864)
<b>Total Changyou.com Limited shareholders' equity</b>		<b>1,312,005</b>	<b>829,735</b>
Non-controlling interest		3,352	1,909
<b>Total shareholders' equity</b>		<b>1,315,357</b>	<b>831,644</b>
<b>Total liabilities and shareholders' equity</b>		<b>1,922,023</b>	<b>1,965,484</b>

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



**CHANGYOU.COM LIMITED**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
**FOR THE YEARS ENDED DECEMBER 31, 2016, 2017 AND 2018**  
(In thousands, except per share and per ADS data)

	Note	For the Year Ended December 31,		
		2016 US\$	2017 US\$	2018 US\$
<b>Revenues:</b>				
Online game		395,708	449,533	389,790
Online advertising		39,409	25,129	19,697
Cinema advertising		68,542	91,419	70,202
IVAS		21,726	14,180	6,074
<b>Total revenues</b>		<b>525,385</b>	<b>580,261</b>	<b>485,763</b>
<b>Cost of revenues:</b>				
Online game		96,171	62,774	60,983
Online advertising		10,104	6,660	5,204
Cinema advertising		45,959	84,944	89,233
IVAS		13,576	9,408	5,408
<b>Total cost of revenues</b>		<b>165,810</b>	<b>163,786</b>	<b>160,828</b>
<b>Gross profit</b>		<b>359,575</b>	<b>416,475</b>	<b>324,935</b>
<b>Operating expenses:</b>				
Product development		121,619	131,032	124,166
Sales and marketing (including transactions with related parties of \$1,039, \$802 and \$nil, respectively)		56,543	60,917	54,303
General and administrative		50,560	47,163	30,116
Goodwill impairment and impairment of intangible assets acquired as part of acquisition of a business		—	86,882	16,369
<b>Total operating expenses</b>		<b>228,722</b>	<b>325,994</b>	<b>224,954</b>
<b>Operating profit</b>		<b>130,853</b>	<b>90,481</b>	<b>99,981</b>
Interest income (including transactions with related parties of \$11,250, \$22,162 and \$25,155, respectively)		21,490	32,319	34,409
Foreign currency exchange gain/(loss)		5,108	(5,196)	1,320
Interest expense (including transactions with related parties of \$3,727, \$4,372 and \$8,769, respectively)		(4,321)	(4,372)	(10,197)
Other income, net		15,523	9,374	22,879
<b>Income before income tax expense</b>		<b>168,653</b>	<b>122,606</b>	<b>148,392</b>
Income tax expense	19	21,583	40,767	64,467
<b>Net income</b>		<b>147,070</b>	<b>81,839</b>	<b>83,925</b>
Less: Net income/(loss) attributable to non-controlling interest shareholders		2,123	(26,995)	(407)
<b>Net income attributable to Changyou.com Limited</b>		<b>144,947</b>	<b>108,834</b>	<b>84,332</b>
<b>Net income</b>		147,070	81,839	83,925
Change in foreign currency translation adjustment (net of tax of \$nil, \$nil, and \$nil, respectively)		(66,321)	68,028	(60,466)
Total other comprehensive income/(loss)		(66,321)	68,028	(60,466)
<b>Comprehensive income</b>		<b>80,749</b>	<b>149,867</b>	<b>23,459</b>
Comprehensive income/(loss) attributable to non-controlling interest shareholders		2,127	(26,995)	(407)
<b>Comprehensive income attributable to Changyou.com Limited</b>		<b>78,622</b>	<b>176,862</b>	<b>23,866</b>
Basic net income per share	23	1.39	1.03	0.79
Diluted net income per share	23	1.36	1.02	0.79
Basic net income per ADS		2.78	2.06	1.59
Diluted net income per ADS		2.72	2.04	1.57
Weighted average number of ordinary shares outstanding, basic		104,560	105,188	106,170
Weighted average number of ordinary shares outstanding, diluted		106,278	106,570	107,236
Weighted average number of ADS outstanding, basic		52,280	52,594	53,085
Weighted average number of ADS outstanding, diluted		53,139	53,285	53,618
<b>Total share-based compensation expense/(benefit) included in:</b>				
Cost of revenues		31	73	(31)
Product development		2,881	6,163	(2,427)
Sales and marketing		572	1,212	(497)
General and administrative		4,918	9,945	(3,506)

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

**CHANGYOU.COM LIMITED**  
**CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY**  
**FOR THE YEARS ENDED DECEMBER 31, 2016, 2017 AND 2018**  
(In thousands)

	Ordinary shares				Statutory reserves	Retained earnings	Accumulated other comprehensive income/(loss)	Non-controlling interest	Total shareholders' equity
	Number of shares	Amount	Additional paid-in capital	Treasury shares					
	US\$	US\$	US\$	US\$	US\$	US\$	US\$	US\$	US\$
<b>Balance as of December 31, 2015</b>	107,069	1,071	111,719	(35,323)	6,746	951,367	(6,101)	29,770	1,059,249
Issuance of ordinary shares upon vesting and settlement of restricted share units and share options	412	4	(2)	—	—	—	—	—	2
Share-based compensation	—	—	8,331	—	—	—	—	71	8,402
Foreign currency translation adjustment	—	—	—	—	—	—	(66,325)	4	(66,321)
Net income attributable to Changyou.com Limited and non-controlling interest shareholders	—	—	—	—	—	144,947	—	2,123	147,070
Changes in statutory reserve	—	—	—	—	315	(315)	—	—	—
Contribution from non-controlling interest shareholder	—	—	1,333	—	—	—	—	(1,333)	—
Disposal of non-controlling interest	—	—	—	—	—	—	—	(238)	(238)
<b>Balance as of December 31, 2016</b>	<u>107,481</u>	<u>1,075</u>	<u>121,381</u>	<u>(35,323)</u>	<u>7,061</u>	<u>1,095,999</u>	<u>(72,426)</u>	<u>30,397</u>	<u>1,148,164</u>
Issuance of ordinary shares upon vesting and settlement of restricted share units and share options	685	7	—	—	—	—	—	—	7
Share-based compensation	—	—	17,369	—	—	—	—	24	17,393
Foreign currency translation adjustment	—	—	—	—	—	—	68,028	—	68,028
Net income/(loss) attributable to Changyou.com Limited and non-controlling interest shareholders	—	—	—	—	—	108,834	—	(26,995)	81,839
Changes in statutory reserve	—	—	—	—	7,216	(7,216)	—	—	—
Acquisition of a subsidiary	—	—	—	—	—	—	—	6	6
Disposal of non-controlling interest	—	—	—	—	—	—	—	(80)	(80)
<b>Balance as of December 31, 2017</b>	<u>108,166</u>	<u>1,082</u>	<u>138,750</u>	<u>(35,323)</u>	<u>14,277</u>	<u>1,197,617</u>	<u>(4,398)</u>	<u>3,352</u>	<u>1,315,357</u>
Issuance of ordinary shares upon vesting and settlement of share options	1,065	11	—	—	—	—	—	—	11
Share-based compensation	—	—	(6,461)	—	—	—	—	—	(6,461)
Foreign currency translation adjustment	—	—	—	—	—	—	(60,466)	—	(60,466)
Net income/(loss) attributable to Changyou.com Limited and non-controlling interest shareholders	—	—	—	—	—	84,332	—	(407)	83,925
Changes in statutory reserve	—	—	—	—	6,291	(6,291)	—	—	—
Organization of subsidiaries	—	—	—	—	—	—	—	1,080	1,080
Special cash dividends	—	—	—	—	—	(499,686)	—	—	(499,686)
Disposal of non-controlling interest	—	—	—	—	—	—	—	(2,116)	(2,116)
<b>Balance as of December 31, 2018</b>	<u>109,231</u>	<u>1,093</u>	<u>132,289</u>	<u>(35,323)</u>	<u>20,568</u>	<u>775,972</u>	<u>(64,864)</u>	<u>1,909</u>	<u>831,644</u>

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

**CHANGYOU.COM LIMITED**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**FOR THE YEARS ENDED DECEMBER 31, 2016, 2017 AND 2018**  
(In thousands)

	<b>For the Year Ended December 31,</b>		
	<b>2016</b>	<b>2017</b>	<b>2018</b>
	<b>US\$</b>	<b>US\$</b>	<b>US\$</b>
<b>Cash flows from operating activities:</b>			
Net income	147,070	81,839	83,925
Adjustments to reconcile net income to net cash provided by operating activities			
Bad debt provision	1,615	2,083	2,871
Depreciation	13,643	11,993	11,749
Amortization of intangible assets and other assets	12,377	7,814	6,426
Goodwill impairment and impairment of intangible assets acquired as part of acquisition of a business	—	86,882	16,369
Impairment loss of other assets	4,391	2,933	1,538
Share-based compensation expense/(benefit)	8,402	17,393	(6,461)
Loss from equity investments	1,079	518	—
Disposal loss/(gain) of fixed assets and intangible assets	156	(167)	(60)
Deferred tax expense	11,403	1,524	50,008
Change in fair value of financial instruments	(12,290)	(9,186)	(17,451)
Disposal loss/(gain) of subsidiaries and long-term investment	(149)	523	(134)
Changes in current assets and liabilities, net of acquisition			
Accounts receivable, net	14,840	(40,368)	28,161
Prepaid and other assets (including changes in interest receivables from related parties of \$(4,247), \$4,855 and \$22,693, respectively)	1,756	14,149	(7,846)
Accounts payable	2,489	175	4,968
Receipts in advance and deferred revenue	4,449	(3,276)	4,542
Accrued salary and benefits	(4,985)	6,278	11,977
Accrued liabilities to suppliers	7,211	2,466	3,976
Tax payables	(4,630)	10,105	(925)
Other short-term liabilities (including changes in interest payables to related parties of \$(772), \$781 and \$8,810, respectively)	(3,165)	7,117	5,879
<b>Net cash provided by operating activities</b>	<b>205,662</b>	<b>200,795</b>	<b>199,512</b>
<b>Cash flows from investing activities:</b>			
Purchase of fixed assets	(4,032)	(2,414)	(2,611)
Purchase of intangible assets and other assets	(9,003)	(1,191)	(14,241)
Purchase of financial instruments	(316,081)	(1,364,514)	(1,317,321)
Proceeds from financial instruments	364,121	1,197,774	1,539,525
Matching loans to related parties	(210,797)	(15,110)	(237,003)
Proceeds from matching loans	12,064	—	—
Loans to Sohu (Note 26)	(72,077)	(72,510)	—
Return of funds from 7Road	5,061	4,928	5,264
Other investing activities	566	(3,389)	1,321
<b>Net cash used in investing activities</b>	<b>(230,178)</b>	<b>(256,426)</b>	<b>(25,066)</b>
<b>Cash flows from financing activities:</b>			
Loan proceeds from offshore banks	—	—	220,000
Matching loans from related parties	209,941	15,000	237,000
Repayment of matching loans	(12,900)	—	—
Repayments of loans to offshore banks	(344,500)	—	—
Dividend distribution	—	—	(499,686)
Issuance of common stock	—	7	11
Other financing activities	—	6	51
<b>Net cash provided by/(used in) financing activities</b>	<b>(147,459)</b>	<b>15,013</b>	<b>(42,624)</b>
<b>Effect of exchange rate changes on cash, cash equivalents, restricted cash and restricted time deposits</b>	<b>(14,563)</b>	<b>4,905</b>	<b>(1,762)</b>
<b>Reclassification of cash, cash equivalents, restricted cash and restricted time deposits from/(to) assets held for sale</b>	<b>(11,684)</b>	<b>11,684</b>	<b>—</b>
<b>Net increase/(decrease) in cash, cash equivalents, restricted cash and restricted time deposits</b>	<b>(198,222)</b>	<b>(24,029)</b>	<b>130,060</b>
<b>Cash, cash equivalents, restricted cash and restricted time deposits, beginning of year</b>	<b>795,410</b>	<b>597,188</b>	<b>573,159</b>
<b>Cash, cash equivalents, restricted cash and restricted time deposits, end of year</b>	<b>597,188</b>	<b>573,159</b>	<b>703,219</b>
<b>Supplemental disclosures of cash flows</b>			
Cash paid for income taxes	(12,348)	(36,884)	(38,586)
Cash paid for interest expense	(5,263)	(3,648)	—
<b>Supplemental schedule of non-cash investing activities</b>			
Changes in accounts payable, accrued expenses and other liabilities related to fixed assets and intangible assets additions	(2,909)	2,377	(1,520)
<b>Supplemental schedule of non-cash financing activities</b>			
Changes in non-controlling interest related to organization of subsidiaries	—	—	1,029

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

**CHANGYOU.COM LIMITED**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. ORGANIZATION AND NATURE OF OPERATIONS**

The accompanying consolidated financial statements include the financial statements of Changyou.com Limited (the “Company” or “Changyou”) and its subsidiaries and variable interest entities (including subsidiaries of variable interest entities, “VIEs”). The Company was incorporated in the Cayman Islands on August 6, 2007. The Company and its subsidiaries and VIEs are collectively referred to as the “Group”. The principal subsidiaries and VIEs through which the Company conducts its business operations as of December 31, 2018 are described below:

<u>Name of entity</u>	<u>Place and date of incorporation or acquisition</u>	<u>Effective interest held</u>
<b>Subsidiaries:</b>		
Changyou.com (HK) Limited (“Changyou HK”)	Hong Kong, China, incorporated on August 13, 2007	100%
Beijing AmazGame Age Internet Technology Co., Ltd. (“AmazGame”)	Beijing, China, incorporated on September 26, 2007	100%
Beijing Changyou Gamespace Software Technology Co., Ltd. (“Gamespace”)	Beijing, China, incorporated on October 29, 2009	100%
Beijing Yang Fan Jing He Information Consulting Co., Ltd. (“Yang Fan Jing He”)	Beijing, China, incorporated on April 22, 2010	100%
Beijing Changyou Jingmao Film & Culture Communication Co., Ltd.	Beijing, China, acquired on January 25, 2011	100%
Shanghai Jingmao Culture Communication Co., Ltd	Shanghai, China, acquired on January 25, 2011	100%
7Road.com Limited (“7Road”)	Cayman Islands, incorporated on June 15, 2011	100%
7Road.com HK Limited	Hong Kong, China, incorporated on July 6, 2011	100%
Changyou.com Webgames (HK) Limited (“Changyou HK Webgames”)	Hong Kong, China, incorporated on September 21, 2011	100%
Shenzhen Brilliant Imagination Technologies Co., Ltd. (“Brilliant Imagination”)	Shenzhen, China, incorporated on April 18, 2014	100%
Beijing Changyou Chuangxiang Software Technology Co., Ltd. (“Chuangxiang”)	Beijing, China, incorporated on November 8, 2016	100%
<b>VIEs:</b>		
Beijing Gamease Age Digital Technology Co., Ltd. (“Gamease”)	Beijing, China, incorporated on August 23, 2007	100%
Shanghai ICE Information Technology Co., Ltd. (“Shanghai ICE”), a wholly-owned subsidiary of Gamease	Shanghai, China, acquired on May 28, 2010	100%
Beijing Guanyou Gamespace Digital Technology Co., Ltd. (“Guanyou Gamespace”)	Beijing, China, incorporated on August 5, 2010	100%

The Group’s primary businesses are the online game business; the platform channel business, which consists primarily of online advertising; and the cinema advertising business. The online game business is the Group’s core business.

The Company is a leading online game developer and operator in China as measured by the popularity of the PC game TLBB and the mobile game Legacy TLBB Mobile. The Group engages in the development, operation and licensing of online games for PCs and mobile devices. This includes PC games, which are interactive online games that are accessed and played simultaneously by hundreds of thousands of game players through personal computers and require that local client-end game access software be installed on the computers used; and mobile games, which are played on mobile devices and require an Internet connection.

The Group’s platform channel business mainly consists of the operation of the 17173.com Website, one of the leading information portals in China, which provides news, electronic forums, online videos and other information services on online games to game players.

The Group’s cinema advertising business consists primarily of the acquisition, from operators of movie theaters, and the sale, to advertisers, of pre-film advertising slots, which are advertisements shown before the screening of a movie in a cinema theater.

## 2. REORGANIZATION AND ACQUISITIONS

### *a. Reorganization*

Prior to a reorganization of the Sohu Group undertaken in 2007 that resulted in the establishment of the Group in connection with a contemplated initial public offering by the Company on the Nasdaq Global Select Market, the operation and licensing of PC games were carried out by various companies owned or controlled by Sohu.com Inc. (the “Predecessor Operations”). In connection with such reorganization, the Predecessor Operations, which include all operating assets and liabilities relating to the operation of massively multi-player online role-playing games (“MMORPGs”), were transferred to the Group with legal effect as of December 1, 2007.

On April 7, 2009, the Company completed an initial public offering on the Nasdaq Global Select Market. In the offering, 8,625,000 American depositary shares (“ADSs”), representing 17,250,000 Class A ordinary shares, were sold to the public at a price of \$16.00 per ADS. Of these, 3,750,000 ADSs, representing 7,500,000 Class A ordinary shares, were sold by the Company; and 4,875,000 ADSs, representing 9,750,000 Class A ordinary shares, were sold by an indirect wholly-owned subsidiary of Sohu.com. The net proceeds to the Company from the initial public offering, after deducting commissions and offering expenses, were approximately \$54.7 million.

Effective May 31, 2018, the Sohu Group undertook a reorganization pursuant to which Sohu.com Inc., which had been the Company’s ultimate parent company, was dissolved and liquidated, and Sohu.com Limited, which had been a wholly-owned subsidiary of Sohu.com Inc., became the Company’s ultimate parent company and the top-tier publicly-traded entity of the Sohu Group. Sohu.com Limited (or its predecessor Sohu.com Inc., as applicable) is referred to in these Notes to Consolidated Financial Statements as “Sohu.com.” Sohu.com Limited (or its predecessor Sohu.com Inc., as applicable) and its subsidiaries and VIEs, excluding the Company and its subsidiaries and VIEs, are collectively referred to herein as “Sohu.” Sohu.com Limited (or its predecessor Sohu.com Inc., as applicable) and its subsidiaries and VIEs, including the Company and its subsidiaries and VIEs, are collectively referred to as the “Sohu Group.”

### *b. Share Repurchase Program*

On July 27, 2013, Changyou’s Board of Directors authorized a share repurchase program (the “Share Repurchase Program”) of up to \$100 million of the outstanding ADSs of Changyou over a two-year period from July 27, 2013 to July 26, 2015. As of July 26, 2015, Changyou had repurchased 1,364,846 Changyou ADSs, representing 2,729,692 Class A ordinary shares, at an average price of \$25.9 per ADS, or \$12.95 per Class A ordinary share, for aggregate consideration of \$35 million, which were recorded in treasury shares in shareholder’s equity.

### *c. MoboTap Transaction*

On July 16, 2014, Changyou, through a wholly-owned subsidiary, entered into an investment agreement with MoboTap Inc. (“MoboTap”), which is a Cayman Islands company that is the mobile technology developer behind the Dolphin Browser, MoboTap’s subsidiaries and variable interest entities and MoboTap’s shareholders. On July 31, 2014, pursuant to the investment agreement, Changyou purchased from existing shareholders of MoboTap shares of MoboTap representing 51% of the equity interests in MoboTap on a fully-diluted basis for approximately \$91 million in cash.

On July 31, 2014, pursuant to the investment agreement, Changyou, MoboTap and the non-controlling shareholders of MoboTap entered into a shareholder agreement pursuant to which Changyou has the right to designate three of the five directors of MoboTap, including the chairman of the board; Changyou’s approval is required for any proposed transfers of equity interests in MoboTap held by the non-controlling shareholders; and Changyou is entitled to customary pre-emptive rights with respect to any new issuance of equity interests in MoboTap. Changyou has the right to purchase up to 10% of the equity interests in MoboTap from non-controlling shareholders, at a price of 20% below the initial public offering (“IPO”) price, before a qualified IPO of MoboTap.

In 2016, the Company’s Board of Directors approved the disposal of the 51% equity interest in MoboTap held by the Company. As of December 31, 2016, the Company was negotiating with a potential buyer on the terms of the disposal. Accordingly, the assets and liabilities attributable to MoboTap were classified as assets and liabilities held for sale and measured at the lower of their carrying amounts or their fair value less cost to sell, in the Company’s consolidated balance sheet as of December 31, 2016.

In the first quarter of 2017, the Company’s management determined that the disposal was unlikely to be completed within one year due to the suspension of negotiations with the potential buyer. As a result, the assets held for sale and liabilities held for sale related to MoboTap were reclassified as assets and liabilities held for use and measured at the carrying value before MoboTap was classified as held for sale, adjusted for any depreciation and amortization expense that would have been recognized had the assets and liabilities been continuously classified as held for use.

In the third quarter of 2017, due to enhanced restrictions the Chinese regulatory authorities imposed on card and board games, some of the Company's key distribution partners informed the Company that they had decided to stop the distribution and promotion of card and board games, which had an adverse impact on MoboTap's current performance, and also increased uncertainty with respect to its future operations and cash flow. As a result, the Company's management determined that it was unlikely for MoboTap to gain users and grow its online card and board games revenues in China. Management performed an impairment test in the third quarter of 2017 using the discounted cash flow method, and impairment charges of \$86.9 million were recognized to reflect the fair value of the MoboTap business, of which an \$83.5 million impairment loss was recognized for goodwill and a \$3.4 million impairment loss was recognized for intangible assets.

On March 13, 2018, the Company completed the sale of all of the equity interests in MoboTap.

#### ***d. Acquisition of RaidCall***

On November 19, 2013, the Company entered into an investment agreement with Beijing Kunlun Tech Co., Ltd. and certain of its affiliates (collectively, the "Kalends Group"), pursuant to which TalkTalk Limited ("TalkTalk") was incorporated in the British Virgin Islands and initially wholly-owned by the Kalends Group, RaidCall (HK) Limited ("RaidCall HK") was incorporated in Hong Kong as a wholly-owned subsidiary of TalkTalk, and Beijing Changyou RaidCall Internet Technology Co., Ltd. ("Changyou RaidCall") was incorporated in the PRC as a wholly-owned subsidiary of RaidCall HK. The Kalends Group then transferred to RaidCall HK and Changyou RaidCall all of the assets associated with a free social communication software platform designed for online gaming and music-related value-added services that the Kalends Group operated through a series of Websites ("RaidCall"). On December 24, 2013, pursuant to the investment agreement, the Company acquired 62.5% of the equity interests, on a fully-diluted basis, in TalkTalk for cash consideration of \$47.6 million. Of the total consideration, \$27.6 million was paid to purchase from the Kalends Group a portion of the ordinary shares of TalkTalk held by the Kalends Group, and \$20 million was injected for newly-issued ordinary shares of TalkTalk. Also effective upon the closing of the transaction, 15% of the equity interests in TalkTalk on a fully-diluted basis were reserved for grants of equity incentive awards to key employees associated with RaidCall, and the Kalends Group continued to hold the remaining 22.5% of the equity interests on a fully-diluted basis.

At the closing of the transaction, the parties entered into a shareholder agreement pursuant to which the Company has the right to designate three of the five directors of TalkTalk, including the chairman of the board, and the Company has customary rights of first refusal with respect to proposed transfers of equity interests in TalkTalk by the Kalends Group.

In March 2015, the Kalends Group transferred additional ordinary shares of TalkTalk held by it to the Company and TalkTalk issued additional ordinary shares to the Company pursuant to the investment agreement because RaidCall had failed to achieve certain average daily active account milestones specified in the agreement. As a result, the Company's equity interests in TalkTalk increased to 70% on a fully-diluted basis.

### **3. VARIABLE INTEREST ENTITIES**

#### ***Consolidated VIEs***

##### **Basic Information**

PRC law and regulations prohibit or restrict foreign ownership of companies that operate online games and internet content services. Consequently, the Group operates its online game business and its platform channel business primarily through its principal VIEs. Gamease is 100% owned directly by Beijing Century High Tech Investment Co., Ltd. ("High Century"), which is a PRC company and a VIE of Sohu.com that is held 80% by Charles Zhang, Changyou's Chairman of the Board, and 20% by Wei Li, an employee of Sohu. Guanyou Gamespace is 100% owned directly by Beijing Changyou Star Digital Technology Co., Ltd. ("Changyou Star"), which is a PRC company owned 50% by Dewen Chen, Changyou's Chief Executive Officer, and 50% by Jie Liu, a Changyou employee. Shanghai ICE is owned 100% by Changyou's VIE Gamease.

The loans to the shareholders of Gamease and Guanyou Gamespace and the registered capital of these VIEs are eliminated for accounting purposes during consolidation.

Under contractual agreements with the Company, shareholders of Gamease and Guanyou Gamespace are required to transfer their ownership in Gamease and Guanyou Gamespace to the Company, if permitted by PRC law and regulations, or, if not so permitted, to designees of the Company at any time to repay the loans outstanding. All voting rights of Gamease and Guanyou Gamespace are assigned to the Company; the Company has the right to designate all directors and senior management personnel of Gamease and Guanyou Gamespace. High Century, Changyou Star have pledged their shares in Gamease, Guanyou Gamespace as collateral for the loans. The aggregate amount of these loans as of December 31, 2018 was \$2.9 million.

On July 31, 2014, the Group purchased from existing shareholders of MoboTap shares of MoboTap representing 51% of the equity interests in MoboTap on a fully-diluted basis, and MoboTap's VIE Baina (Wuhan) Information Technology Co., Ltd. ("Wuhan Baina Information") was held 60% and 40%, respectively, by the Group's VIE Gamease and Yongzhi Yang, the Chief Executive Officer of MoboTap. See "Note 2.c — MoboTap Transaction." In October 2015, Gamease transferred its 60% equity interests in Wuhan Baina Information to Changyou Star. Before the Company disposed of MoboTap on March 13, 2018, Changyou Star held a 60% interest in Wuhan Baina Information, and Yongzhi Yang held a 40% interest in Wuhan Baina Information.

The Group follows the relevant guidance on accounting for VIEs, which requires certain variable interest entities to be consolidated by the primary beneficiary of the entity. The Group's management evaluated the contractual relationship between the Company, AmazGame and Gamease; the contractual relationship between the Company, Gamespace and Guanyou Gamespace; and the contractual relationship between the Company, MoboTap's subsidiary Baina Zhiyuan (Beijing) Technology Co., Ltd. ("Beijing Baina Technology") and Wuhan Baina Information before the Company's sale of MoboTap on March 13, 2018; and the economic benefit flows of these contractual arrangements. In connection with such evaluation, management also took into account the facts that, as a result of these contractual arrangements, AmazGame and Gamespace control 100% of the shareholders' voting interests in Gamease and Guanyou Gamespace; that before the Company's sale of MoboTap on March 13, 2018, Beijing Baina Technology controlled 100% of the shareholders' voting interests in Wuhan Baina Information; and that Gamease holds and controls 100% of the equity and voting interests in Shanghai ICE. The Group concluded that Gamease, Guanyou Gamespace and Shanghai ICE are VIEs of the Company and that the Company is the primary beneficiary of each of them; and that Wuhan Baina Information was a VIE of the Company and that the Company was the primary beneficiary of Wuhan Baina Information before the Company's sale of the MoboTap business on March 13, 2018. As a result, Gamease's, Guanyou Gamespace's and Shanghai ICE's results of operations, assets and liabilities; and Wuhan Baina Information's results of operations, assets and liabilities until March 13, 2018, have been included in the Group's consolidated financial statements.

### Financial Information

The following combined financial information of the Group's VIEs was included in the accompanying consolidated financial statements of the Group as follows:

	As of December 31, (in thousands)	
	2017	2018
<b>ASSETS:</b>		
Cash and cash equivalents	\$ 3,275	\$ 345
Accounts receivable, net	10,140	5,832
Prepaid expense	1,154	595
Other receivable	8,155	1,282
Due from affiliates	328,227	360,402
Other current assets	3,582	988
Total current assets	<u>354,533</u>	<u>369,444</u>
Goodwill	10,257	10,257
Intangible assets, net	2,612	10,777
Deferred tax assets	2,187	1,590
Other non-current assets	391	100
Total assets	<u>\$369,980</u>	<u>\$392,168</u>
<b>LIABILITIES:</b>		
Accounts payable	\$ 3,904	\$ 4,068
Accrued and other short-term liabilities	5,699	2,367
Due to affiliates	83,966	100,630
Due to Sohu	5	5
Receipts in advance and deferred revenue	29,597	30,602
Tax payable	413	206
Total current liabilities	<u>123,584</u>	<u>137,878</u>
Other long-term liabilities	15,645	14,895
Total liabilities	<u>\$139,229</u>	<u>\$152,773</u>

	For the Year ended December 31, (in thousands)		
	2016	2017	2018
Net revenue	\$426,329	\$321,495	\$292,414
Net income	48,496	21,219	22,556

	For the Year ended December 31, (in thousands)		
	2016	2017	2018
Net cash provided by/(used in) operating activities	\$ (3,161)	\$ (10,846)	\$ 2,693
Net cash provided by/(used in) investing activities	2,319	4,802	(5,684)
Net cash used in financing activities	—	—	—

Under contractual arrangements with the Company's VIEs, the Company has the power to direct activities of the VIEs, and can have assets transferred freely out of the VIEs without any restrictions. Therefore, the Company considers that there is no asset of the consolidated VIEs that can be used only to settle obligations of the VIEs, except for registered capital and PRC statutory reserves of the VIEs. As of December 31, 2018, the registered capital and PRC statutory reserves of the Company's VIEs totaled \$6.7 million. As the Company's consolidated VIEs are incorporated as limited liability companies under PRC law, creditors of the consolidated VIEs do not have recourse to the general credit of the Company for any of the liabilities of such VIEs.

Currently there is no contractual arrangement that requires the Company to provide additional financial support to the Company's VIEs. As the Company is conducting its online game business and platform channel business mainly through its principal VIEs, the Company may provide such support on a discretionary basis in the future, which could expose the Company to a loss.

Summary of significant agreements currently in effect

Agreements Between Principal VIEs and Nominee Shareholders

*Loan agreements and equity pledge agreements* between AmazGame and the sole shareholder of Gamease and between Gamespace and the sole shareholder of Guanyou Gamespace. The loan agreements provide for loans to the shareholders of Gamease and Guanyou Gamespace for the shareholders to make contributions to the registered capital of Gamease and Guanyou Gamespace in exchange for 100% of the equity interests in Gamease and Guanyou Gamespace. The loans are interest free and are repayable on demand, but the shareholders can only repay the loans by transferring to AmazGame or Gamespace, as applicable, their equity interests in Gamease and Guanyou Gamespace. Under the equity pledge agreements, the respective shareholders of Gamease and Guanyou Gamespace pledge to AmazGame and Gamespace, their equity interests in Gamease and Guanyou Gamespace to secure the performance of their obligations under the loan agreements and Gamease's and Guanyou Gamespace's obligations to AmazGame and Gamespace under the various VIE-related agreements. If the shareholders breach their obligations under any VIE-related agreements (Gamease's or Guanyou Gamespace's breach of any of its obligations under the various applicable VIE-related agreements will be treated as its shareholder's breach of its obligations), including the equity pledge agreements, AmazGame and Gamespace are entitled to exercise their rights as the beneficiaries under the applicable equity pledge agreements, including all rights the respective shareholders have as shareholders of Gamease or Guanyou Gamespace.

*Equity interest purchase right agreements* among AmazGame, Gamease and the sole shareholder of Gamease and among Gamespace, Guanyou Gamespace and the sole shareholder of Guanyou Gamespace. Pursuant to these agreements, AmazGame and Gamespace have the right, exercisable at any time during the terms of these agreements, if and when it is legal to do so under PRC law, to purchase from the respective shareholders of Gamease and Guanyou Gamespace all or any part of their equity interests in Gamease and Guanyou Gamespace at a purchase price equal to their initial contributions to registered capital of Gamease and Guanyou Gamespace.

*Powers of attorney* executed by the sole shareholder of Gamease in favor of AmazGame and by the sole shareholder of Guanyou Gamespace in favor of Gamespace, with a term of 10 years. These powers of attorney give the respective board of directors of AmazGame and Gamespace the exclusive right to appoint nominees to act on behalf of their respective shareholders in connection with all actions to be taken by Gamease and Guanyou Gamespace.

*Business operation agreements* among AmazGame, Gamease and the sole shareholder of Gamease and among Gamespace, Guanyou Gamespace and the sole shareholder of Guanyou Gamespace. These agreements set forth the right of AmazGame and Gamespace, to control the actions of Gamease and Guanyou Gamespace, as the case may be, and the respective shareholders of Gamease and Guanyou Gamespace. Each agreement has a term of 10 years.



### Business Arrangements Between Principal WFOEs and VIEs

*Technology support and utilization agreements* between AmazGame and Gamease and between Gamespace and Guanyou Gamespace. Pursuant to these agreements, AmazGame and Gamespace have the exclusive right to provide certain product development and application services and technology support to Gamease and Guanyou Gamespace, respectively, for a fee equal to a predetermined percentage, subject to adjustment by AmazGame or Gamespace at any time, of Gamease's and Guanyou Gamespace's respective revenues. Each agreement terminates only when AmazGame or Gamespace is dissolved.

*Services and maintenance agreements* between AmazGame and Gamease and between Gamespace and Guanyou Gamespace. Pursuant to these agreements, AmazGame and Gamespace, respectively, provide marketing, staffing, business operation and maintenance services to Gamease and Guanyou Gamespace, respectively, in exchange for a fee equal to the cost of providing such services plus a predetermined margin. Each agreement terminates only when AmazGame or Gamespace, as the case may be, is dissolved.

Certain of the agreements described above between the Company's principal VIEs and the corresponding wholly-owned subsidiaries ("WFOEs"), of the Company do not have renewal terms. However, because the VIEs are controlled by their corresponding WFOEs through their respective business operation agreements and through the powers of attorney granted to the WFOEs by the shareholders of the VIEs, such agreements can be, and are expected to be, renewed at the election of the WFOEs.

### ***VIE-Related Risks***

It is possible that the Group's conduct of certain of its operations and businesses through VIEs could be found by PRC authorities to be in violation of PRC law and regulations prohibiting or restricting foreign ownership of companies that engage in such operations and businesses. The Group's management considers the possibility of such a finding by PRC regulatory authorities under current law and regulations to be remote.

If a finding were made by PRC authorities under existing PRC law and regulations that the Group's conduct of certain of its operations and businesses through VIEs violates PRC law or regulations, regulatory authorities with jurisdiction over the licensing and operation of such operations and businesses would have broad discretion in dealing with such a violation, including levying fines, confiscating the Group's income, revoking the business or operating licenses of the affected businesses, requiring the Group to restructure its ownership structure or operations, or requiring the Group to discontinue all or any portion of its operations. Any of these actions could cause significant disruption to the Group's business operations, and have a severe adverse impact on the Group's cash flows, financial position and operating performance.

In addition, it is possible that the contracts among the Group, the Group's VIEs and shareholders of its VIEs would not be enforceable in China if PRC government authorities or courts were to find that such contracts contravene PRC law and regulations or are otherwise not enforceable for public policy reasons. In the event that the Group was unable to enforce these contractual arrangements, the Group would not be able to exert effective control over the affected VIEs. Consequently, such VIEs' results of operations, assets and liabilities would not be included in the Group's consolidated financial statements. If such were the case, the Group's cash flows, financial position and operating performance would be severely adversely affected. The Group's contractual arrangements with respect to its consolidated VIEs are approved and in place. The Group's management believes that such contracts are enforceable, and considers the possibility remote that PRC regulatory authorities with jurisdiction over the Group's operations and contractual relationships would find the contracts to be unenforceable.

The Group's operations and businesses rely on the operations and businesses of its principal VIEs, which hold certain recognized and unrecognized revenue-producing assets. The recognized revenue-producing assets include goodwill and intangible assets acquired through business acquisitions. Goodwill primarily represents the expected synergies from combining an acquired business with the Group. Intangible assets acquired through business acquisitions mainly consist of customer relationships, non-compete agreements, user bases, copyrights, trademarks and developed technologies. Unrecognized revenue-producing assets mainly consist of licenses and intellectual property. Licenses include operations licenses, such as Internet information service licenses and licenses for providing content. Intellectual property developed by the Group mainly consists of patents, copyrights, trademarks, and domain names. The Group's operations and businesses may be adversely impacted if the Group loses the ability to use and enjoy assets held by these VIEs.

#### **4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

##### ***a. Basis of presentation and consolidation***

The consolidated financial statements have been prepared on a historical cost basis to reflect the financial position and results of operations of the Company in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") and on a going concern basis.

The consolidated financial statements include the financial statements of the Company and its controlled operating entities, including the Group's subsidiaries and VIEs. All inter-company balances and transactions within the Group have been eliminated on consolidation.

The Company has adopted the guidance of accounting for VIEs, which requires VIEs to be consolidated by the primary beneficiary of the entity. The Company's management made evaluations of the relationships between the Company and its VIEs and the economic benefit flow of contractual arrangements with the VIEs. In connection with such evaluation, management also took into account the fact that, as a result of such contractual arrangements, the Group controls the shareholders' voting interests in the VIEs. As a result of such evaluation, management concluded that the Company is the primary beneficiary of its VIEs. As a result, the Company consolidates all of its VIEs in its consolidated financial statements. Please refer to "Note 3 — VARIABLE INTEREST ENTITIES" for more details.

##### ***b. Use of estimates***

The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

##### ***c. Fair value measurement***

U.S. GAAP establishes a three-tier hierarchy to prioritize the inputs used in the valuation methodologies in measuring the fair value of financial instruments. This hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The three-tier fair value hierarchy is:

Level 1 — observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 — other inputs that are directly or indirectly observable in the marketplace.

Level 3 — unobservable inputs which are supported by little or no market activity.

The Company's financial instruments consist primarily of cash equivalents, accounts receivable, short-term investments, matching loans to related parties, loans between Changyou and Sohu, prepaid and other current assets, restricted time deposits, other non-current assets, accounts payable, receipts in advance and deferred revenue, accrued liabilities to suppliers, matching loans from related parties and other short-term liabilities.

##### ***d. Cash and cash equivalents***

Cash and cash equivalents consist of cash on hand, time deposits with original maturities of three months or less and highly-liquid investments that are readily convertible into known amounts of cash.

In November 2016, the FASB issued new guidance related to the classification of restricted cash in the statement of cash flows. The new standard requires that a statement of cash flows explain any change during the year in total cash, cash equivalents, and restricted cash. The new standard is effective for fiscal years beginning after December 15, 2017, and should be applied retrospectively. The Company adopted the new standard during the beginning of 2018 and applied the standard retrospectively for all periods presented.

***e. Restricted time deposits — Loans from offshore banks, secured by time deposits***

Loans from offshore branches of lending banks are classified as short-term bank loans or long-term bank loans based on their repayment periods. The rates of interest under the loan agreements with the lending banks were determined based on the prevailing interest rates in the market. The RMB onshore deposits securing the offshore loans are treated as restricted time deposits in the consolidated balance sheets. Restricted time deposits are valued based on the prevailing interest rates in the market.

***f. Short-term investments***

In accordance with Accounting Standards Codification (“ASC”) 825, for investments in financial instruments with a variable interest rate indexed to the performance of underlying assets, the Company elected the fair value method at the date of initial recognition and carried these investments subsequently at fair value. Changes in the fair value are reflected in the consolidated statements of comprehensive income. To estimate fair value, the Company refers to the quoted rate of return provided by banks at the end of each period using the discounted cash flow method. Since these investments’ maturity dates are within one year, they are classified as short-term investments.

***g. Accounts receivable, net***

The carrying value of accounts receivable is reduced by an allowance that reflects the Company’s best estimate of the amounts that will not be collected. The Company makes estimates of the collectability of accounts receivable. Many factors are considered in estimating the general allowance, including reviewing delinquent accounts receivable, performing aging analyses and customer credit analyses, and analyzing historical bad debt records and current economic trends. Additional allowance for specific doubtful accounts might be made if a customer of the Company is unable to make payments because the customer’s financial condition is deteriorating.

***h. Fixed assets and depreciation***

Fixed assets, mainly comprising office buildings, leasehold improvements, building improvements, office furniture, vehicles, and computer equipment (including servers) are stated at cost less accumulated depreciation and impairment. Fixed assets are depreciated at rates sufficient to write off their costs less impairment, if any, over the estimated useful lives of the assets on a straight-line basis, with no residual value. The estimated useful lives are as follows:

	<u>Estimated useful life</u>
Office building	36-47 years
Leasehold improvements	Lesser of the term of the lease or the estimated useful lives of the assets
Building improvements	10 years
Office furniture	5 years
Vehicles	4 years
Computer equipment (including servers)	3-5 years

Repairs and maintenance costs are charged to expenses as incurred, whereas the costs of renewals and betterment that extends the useful lives of fixed assets are capitalized as additions to the related assets. Retirements, sales and disposals of assets are recorded by removing the costs, accumulated depreciation and impairment with any resulting gain or loss recognized in the consolidated statements of comprehensive income.

### ***i. Intangible assets***

Intangible assets mainly comprise operating rights for licensed games, computer software, developed technologies and trademarks and domain names. Intangible assets are recorded at cost less accumulated amortization and impairments. Amortization is computed using the straight-line method over the estimated useful lives of the assets with no residual value. The estimated useful lives are as follows:

	<u>Estimated useful life</u>
Operating rights for licensed games	Contract terms
Computer software	1-5 years
Developed technologies	3-5 years
Trademarks and domain names	5-30 years

### ***j. Long-term investments***

#### Equity investments

In January 2016, the FASB issued ASU 2016-01 (“ASU 2016-01”), Recognition and Measurement of Financial Assets and Financial Liabilities, which, among other things, generally requires companies to measure investments in other entities, except those accounted for under the equity method, at fair value and to recognize any changes in fair value in net income. ASU 2016-01 also simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. ASU 2016-01 is effective for fiscal years beginning after December 15, 2017, and the guidance should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The guidance related to equity investments without readily determinable fair values (including disclosure requirements) is applied prospectively to equity investments that exist as of the date of adoption. ASU 2016-01, which the Company adopted on January 1, 2018, did not have a material impact on the consolidated financial statements.

Investments in entities over which the Company does not have significant influence are recorded as equity investments and are accounted for either at fair value with any changes recognized in net income, or for those without readily determinable fair values, at cost less impairment, adjusted for subsequent observable price changes. Under the equity method, the Company’s share of the post-acquisition profits or losses of equity investments is recognized in the Company’s consolidated statements of comprehensive income; and the Company’s share of post-acquisition movements in equity is recognized in equity in the Company’s consolidated balance sheets. Unrealized gains on transactions between the Company and an entity in which the Company has recorded an equity investment are eliminated to the extent of the Company’s interest in the entity. To the extent of the Company’s interest in the investment, unrealized losses are eliminated unless the transaction provides evidence of an impairment of the asset transferred. When the Company’s share of losses in an entity in which the Company has recorded an equity investment equals or exceeds its interest in the entity, the Company does not recognize further losses, unless the Company has incurred obligations or made payments on behalf of the equity investee.

### ***k. Goodwill***

Goodwill represents the excess of the purchase price over the fair value of the identifiable assets and liabilities acquired as a result of the Company’s acquisitions of interests in its subsidiaries and VIEs.

The Company tests goodwill for impairment at the reporting unit level on an annual basis as of October 1, and between annual tests when an event occurs or circumstances change that could indicate that the asset might be impaired. In accordance with the FASB guidance on “Testing of Goodwill for Impairment,” a company first has the option to assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. For those reporting units where it is determined that it is more likely than not that their fair values are less than the units’ carrying amounts, the Group performs the first step of a two-step quantitative goodwill impairment test. In the first step, the Group determines the fair values of the individual reporting units using the income approach and the market approach. After performing the assessment, if the carrying amounts of the reporting units were higher than their fair values, the Group performs the second step of the two-step quantitative goodwill impairment test. In the second step, the implied fair value of the goodwill is estimated as the fair value of the reporting unit determined in the first step less the fair values of all other net tangible and intangible assets of the reporting unit. If the carrying amount of the goodwill exceeds its implied fair market value, an impairment loss is recognized in an amount equal to that excess, not to exceed the carrying amount of the goodwill.

The quantitative impairment test consists of a comparison of the fair value of goodwill with its carrying value. Application of a goodwill impairment test requires significant management judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value of each reporting unit. The Group estimates the fair value using the income approach and the market approach, both of which are typically used under ASC 350. The judgment in estimating the fair value of reporting units includes estimating future cash flows, determining appropriate discount rates, control premium, comparable companies' multipliers and making other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value for each reporting unit.

#### ***l. Impairment of long-lived assets and intangible assets***

The carrying amounts of long-lived assets and intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amounts of the assets may not be recoverable. Recoverability of assets to be held and used is evaluated by a comparison of the carrying amounts of the assets to future undiscounted net cash flows expected to be generated by the assets. If such assets are considered to be impaired, where the undiscounted cash flows are less than the carrying amounts of the assets, the impairment to be recognized is measured by the amount by which the carrying amounts of the assets exceed the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less cost to sell. The Company tests impairment of long-lived assets and intangible assets at the asset group level when impairment indicators appear and recognizes impairment in the event that the carrying value exceeds the fair value of each reporting unit.

#### ***m. Receipts in advance and deferred revenues***

For the operation of PC games, proceeds received from sales of prepaid game cards are initially recorded as receipts in advance. For online advertising and cinema advertising services, cash payments that are received in advance of the delivery of services pursuant to applicable advertising contracts, are recorded as receipts in advance.

For self-operated games, deferred revenues are recognized when the game points are sold through the Company's online payment platform or when prepaid cards are charged by the players to their respective game accounts. The deferred revenues are amortized when virtual items are consumed. For licensed out games, deferred revenues represent the unamortized balance of license fees paid by third-party operators, and the deferred revenues are amortized on a straight-line basis through the service period.

#### ***n. Non-controlling interest***

Non-controlling interests are recognized to reflect the portion of the equity of majority-owned subsidiaries and VIEs which is not attributable, directly or indirectly, to the controlling shareholder. The non-controlling interests in the Company's consolidated financial statements consist primarily of the non-controlling interests in RaidCall; the non-controlling interests in Beijing Changmica Culture Co., Ltd., which is a joint venture that operates Korean comics online in China; and, for periods prior to the Company's sale of MoboTap in March 2018, the non-controlling interests in MoboTap.

#### ***o. Treasury shares***

On July 27, 2013, the Company's Board of Directors authorized a share repurchase program of up to \$100 million of the outstanding ADSs of Changyou over a two-year period from July 27, 2013 to July 26, 2015. The Company accounted for those shares repurchased as treasury shares at cost in accordance with ASC 505-30, and the treasury shares acquired are shown separately in shareholders' equity as the Company has not yet decided on the ultimate disposition of those shares. If and when the Company cancels the treasury shares, the difference between the original issuance price and the repurchase price will be debited into additional paid-in capital.

#### ***p. Functional currency and foreign currency translation***

##### **Functional currency**

An entity's functional currency is the currency of the primary economic environment in which it operates. Normally that is the currency of the environment in which the entity primarily generates and expends cash. Management's judgment is essential to determine the functional currency by assessing various indicators, including cash flows, sale prices, market prices, expenses, financing and inter-company transactions and arrangements. The functional currency of Changyou.com Limited is the U.S. dollar. The functional currency of our subsidiaries in the U.S., the Cayman Islands, the British Virgin Islands and Hong Kong is the U.S. dollar. The functional currencies of our subsidiaries and VIEs in other countries are the national currencies of those countries, rather than the U.S. dollar.

#### Foreign currency translation

Financial statements of entities with other than U.S. dollar functional currency are translated into the U.S. dollar reporting currency. Assets and liabilities are translated at the current exchange rate in effect at the balance sheet date, and revenues and expenses are translated at the average exchange rates in effect during the reporting period. Shareholders' equity accounts are translated using the historical exchange rates at the date the entry to shareholders' equity was recorded, except for the change in retained earnings during the year, which is translated using the historical exchange rates used to translate each period's income statement. Differences resulting from translation of foreign currency to reporting currency are recorded in accumulated other comprehensive income/(loss) in the consolidated balance sheets.

Foreign currency transactions denominated in currencies other than the functional currency are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are re-measured at the applicable rates of exchange in effect at that date. Gains and losses resulting from foreign currency re-measurement are included in the consolidated statements of comprehensive income.

#### ***q. Revenue recognition***

In May 2014, the FASB issued ASC Topic 606, Revenue From Contracts with Customers (the "New Revenue Standard" or "ASC 606"), which replaced ASC Topic 605, Revenue Recognition (the "Old Revenue Standard" or "ASC 605"), including industry-specific requirements, and provided companies with a single principles-based revenue recognition model for recognizing revenue from contracts with customers. The core principle of the New Revenue Standard is that a company should recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The Group adopted ASC 606 on January 1, 2018, applying the modified retrospective method to contracts that were not completed as of January 1, 2018. Adoption had no significant impact on the consolidated financial statements. The Group has updated significant accounting policies and relevant disclosures hereinafter.

Effective January 1, 2018, the Group evaluated and recognized revenue based on the criteria set forth in ASC 606 by:

- identifying the contract(s) with the customer;
- identifying the performance obligations in the contract;
- determining the transaction price;
- allocating the transaction price to performance obligations in the contract; and
- recognizing revenue as each performance obligation is satisfied through the transfer of a promised good or service to a customer (i.e., "transfer of control").

#### Online game revenues

The Group's online game revenues are generated primarily from its self-operated and licensed out PC games and mobile games. Prior to the sale of the MoboTap business in 2018, the Group also generated a small amount of revenues from online card and board games. All of the Group's games are operated under the item-based revenue model, where the basic game play functions are free of charge and players are charged for purchases of in-game virtual items, including those with a predetermined expiration time and perpetual virtual items. Revenues that the Group generates from self-operated and licensed out online games are included in online game revenues.

#### *Self-Operated Games*

The Group is the primary principal of its self-operated games. The Group hosts the games on its own servers and is responsible for the sale and marketing of the games as well as customer service. Accordingly, revenues are recorded gross of revenue-sharing payments to third-party developers and/or mobile application stores, but are net of value-added tax and discounts to game card distributors where applicable. The Group obtains revenues from the sale of in-game virtual items. Revenues are recognized over time for virtual items with estimated lives and upon use for items that are consumed immediately. If different assumptions were used in deriving the estimated lives of the virtual items, the timing of the recording of the revenues would be impacted.

#### PC games

Proceeds from self-operated PC games are collected from players and third-party game card distributors through sales of game points on online payment platforms and prepaid game cards. The Group applies the portfolio approach in determining the commencement date of consumption and the estimated lives of virtual items for the recognition of games revenue, given that the effect of applying a portfolio approach to the behaviors of game players as a group would not differ materially from considering each of them individually.

Self-operated PC games are either developed in house or licensed from third-party developers. For licensed PC games, the Group remits a pre-agreed percentage of the proceeds to the third-party developers, and keeps the balance pursuant to revenue-sharing agreements. Such revenue-sharing amounts paid to third-party developers are included in the Group's cost of revenues.

#### Mobile games

For self-operated mobile games, the Group sells game points to game players via third-party mobile application stores. The mobile application stores in turn pay the Group proceeds after deducting their share of pre-agreed revenue-sharing amounts.

Self-operated mobile games are either developed in house or licensed from or jointly developed with third-party developers. For licensed and jointly developed mobile games, the Group remits a pre-agreed percentage of the proceeds to the third-party developers, and keeps the balance pursuant to revenue-sharing agreements. Such revenue-sharing amounts paid to mobile application stores and third-party developers are included in the Group's cost of revenues.

#### *Licensed Out Games*

The Group also authorizes third-parties to operate its online games. The licensed out games include PC games and mobile games developed in house and mobile games jointly developed with third-party developers. The Group receives monthly revenue-based royalty payments from the third-party licensee operators. The Group receives additional up-front license fees from certain third-party licensee operators who are entitled to an exclusive right to operate the Group's games in specified geographic areas. Since the Group is obligated to provide post-sale services ("PCS"), the initial license fees are allocated between the license and PCS based on relative standalone selling prices. The amount allocated to the license is recognized as revenue upon the commencement of the license period, given that the Group's intellectual property rights subject to the license are considered to be functional and the licensee has the right to use such intellectual property rights as they exist at the point when the license is granted, and the amount allocated to PCS is recognized as revenue ratably over the license period. Monthly revenue-based royalty payments are recognized when the relevant services are delivered, provided that collectability is reasonably assured. The Group views the third-party licensee operators as its customers and recognizes revenues on a net basis, as the Group does not have the primary responsibility for fulfillment and acceptability of the game services. The Group remits to the third-party developers a pre-agreed percentage of revenues and keeps the balance pursuant to revenue-sharing agreements. Such revenue-sharing amounts paid to third-party developers are included in the Group's cost of revenues or product development expenses.

#### Online advertising revenues

##### *17173.com Website*

The Group's online advertising revenues are mainly generated from the 17173.com Website. The Group signs contracts with advertisers to fix the advertising services to be provided and the prices for the services. Based on the contracts, the Group provides advertisement placements on the 17173.com Website in different forms, including text, rich media and video advertisements. Currently the main type of pricing model of 17173.com Website is the Fixed Price Model, under which a contract is signed to establish a fixed price for the advertising services to be provided.

To determine the method of recognition of online advertising revenues, prior to entering into contracts, management makes a credit assessment of customers to assess the collectability of amounts due under the contracts. For those contracts for which collectability is determined to be reasonably assured, revenues are recognized ratably over the period during which the advertising services are provided and when all revenue-recognition criteria have been met. For those contracts for which collectability is determined to be not reasonably assured, revenues are recognized only when the cash is received and all other revenue-recognition criteria have been met.

The Group treats advertising contracts for the 17173.com Website with multiple deliverable elements as separate units of accounting for revenue recognition purposes and recognizes revenues on a periodic basis during the contract periods when each deliverable service is provided. Since the contract price is for all the deliverables under one advertising contract, the Group allocates the contract price among all the deliverables at the inception of the arrangement on the basis of their relative selling prices according to the selling price hierarchy established by ASU No. 2009-13. The Group first uses vendor-specific objective evidence of selling price, if it exists. If vendor-specific objective evidence of selling price does not exist, the Group uses third-party evidence of selling price. If neither vendor-specific objective evidence of selling price nor third-party evidence of selling price exists, the Group uses management's best estimate of the selling price for the deliverables.

### Cinema advertising revenues

Revenues generated from the cinema advertising business are classified as cinema advertising revenues. The Group provides clients advertising placements in slots that are shown in theaters before the screening of movies. The rights to place advertisements in such advertising slots are granted under contracts the Group signs with different theaters. The Group charges its advertising clients fees either on a per advertising-slot basis or a fixed amount for an agreed-upon number of slots during a specified contract period. When the advertising service delivery is confirmed by the customers by their signing a form, revenues from cinema advertising are recognized based on a percentage of the advertising slots actually delivered or on a straight-line basis over the contract period.

### IVAS revenues

The Group's IVAS revenues are derived primarily from software applications for PCs and mobile devices offered by RaidCall. Prior to March 2018, IVAS revenues also included revenues generated from the Dolphin Browser operated by MoboTap. Revenues from IVAS are recognized during the period the services are rendered or items are consumed under the gross method, as the Group is the principal obligor for provision of the services.

### Significant judgments

#### *Estimate of the lives of the virtual items*

The Group's self-operated game revenues are generated through direct online sale of game points and prepaid game cards, and recognition of these revenues depends on such factors as whether the virtual items purchased by game players are considered consumable or perpetual. The Group's revenue recognition policy with respect to perpetual virtual items is based on best estimate of the lives of the items. The Group considers the average period that paying players typically play games and other player behavior patterns to arrive at the best estimate of the lives of these perpetual items.

#### *Allocating the transaction price for the contracts with multiple deliverables*

Part of the Group's revenue from licensed-out games is received pursuant to license contracts. The contracts often include multiple performance obligations, including obligations characterized as license obligations and PCS obligations. Determining how to allocate the transaction prices between license obligations and PCS obligations may require significant judgments. Certain of the Group's games may contain licenses of the Group's right to distribute and operate games to the third-party operators and requirements for the provision by the Group of a significant level of upgrade and maintenance. In these cases, significant judgment is required to determine whether the license should be considered distinct and accounted for separately, or not distinct and accounted for together with the PCS provided and recognized over time. Generally, for cases in which the license is functional without the PCS, the Group believes it has separate performance obligations for the license of the right to distribute and operate games and the PCS. Significant judgment is also required to determine the standalone selling price for each distinct performance obligation and to determine whether there is a discount that needs to be allocated based on the relative standalone selling price of the license and the PCS. To estimate the standalone selling price, the Group considers market data, including the Group's pricing strategies for the products being evaluated and other similar products the Group offers, competitor pricing to the extent data is available, and costs to determine whether the estimated selling price yields an appropriate profit margin.

### Contract balances

The timing of revenue recognition may differ from the timing of invoicing to customers. Accounts receivable represent amounts invoiced and revenue recognized prior to invoicing, when the Group has satisfied its performance obligations and has the unconditional right to payment. The allowance for doubtful accounts and authorized credits is estimated based upon the Group's assessment of various factors, including historical experience, the age of the accounts receivable balances, current economic conditions and other factors that may affect the Group's customers' ability to pay. Contract assets as of December 31, 2018 were not material.

Receipts in advance and deferred revenues related to unsatisfied performance obligations at the end of an applicable reporting period consist of fees received from game players in the online game business and from advertisers in the online advertising and cinema advertising businesses. Due to the generally short-term duration of the relevant contracts, a majority of the performance obligations are satisfied in the following reporting period.



### Practical expedients

The Group has used the following practical expedients as allowed under ASC 606:

- The transaction price allocated to the performance obligations that are unsatisfied, or partially unsatisfied, has not been disclosed, as substantially all of the contracts have a duration of one year or less;
- Payment terms and conditions vary by contract types, although terms generally include a requirement of prepayment or payment within one year or less. In instances where the timing of revenue recognition differs from the timing of invoicing, the Group has determined that the contracts generally do not include a significant financing component;
- The Group generally expenses sales commissions when incurred, because the amortization period would be one year or less. These costs are recorded within sales and marketing expenses.

### Sales rebates

In the online advertising and cinema advertising businesses, certain customers may receive sales rebates, which are accounted for as variable consideration. The Group estimates the annual expected revenue volume from each individual agent with reference to the agent's historical results. The sales rebates reduce the amount of revenues recognized. The Group recognizes revenue for the amount of fees it receives from its advertisers after deducting sales rebates, and net of VAT and related surcharges. The Group believes that there will not be significant changes to its estimates of variable consideration.

### Principal/agent considerations

An entity is the principal if it controls a good or service before it is transferred to the end customer. Key indicators that the Group evaluates in determining gross treatment, which applies if the entity is determined to be the principal, versus net treatment, which applies if the entity is determined to be an agent, include the following:

- which party is primarily responsible for fulfilling the promise to provide the specified good or service to the end customer;
- which party has inventory risk before the specified good or service has been transferred to the end customer; and
- which party has discretion in establishing the price for the specified good or service.

Based on evaluation of the above indicators, the Group has determined that generally the Group is considered to be the principal to end customers, except in the case of licensed-out games, where the Group is not the primarily obligor and is not entitled to establish the price.

#### ***r. Cost of revenues***

Cost of online game revenues consists primarily of revenue-sharing payments, salary and benefits expense, bandwidth leasing costs, content and license fees, tax surcharges, depreciation and amortization expenses, and other direct costs.

Cost of online advertising revenues consists primarily of salary and benefits expense, bandwidth leasing costs, depreciation and amortization expenses, and advertising design costs.

Cost of cinema advertising revenues consists primarily of payments to theaters for pre-film screening advertising slots.

Cost of IVAS revenues consists primarily of revenue-sharing payments to third-party developers and service providers; bandwidth leasing costs; and salary and benefits expense.

#### ***s. Product development expenses***

Product development expenses include the costs incurred for the development of the product prior to the establishment of technological feasibility and maintenance costs incurred after the establishment of technological feasibility. During the fiscal years ended December 31, 2016, 2017 and 2018, the Group did not capitalize any product development expenses.

#### ***t. Advertising expenses***

Advertising expenses, which generally represent the cost of promotions to create or stimulate a positive image of the Group or a desire to buy the Group's products and services, are expensed as incurred.

***u. Government grants***

A government grant is recognized when the grant is received and the relevant requirements have been complied with. Government grants are generally recorded as other income, and grants for which the government stipulates specified uses are recorded as a reduction in operating expenses and cost of revenues.

***v. Operating leases***

Leases for which substantially all of the risks and rewards of ownership of assets remain with the leasing company are accounted for as operating leases. Payments made under operating leases net of any incentives received by the Company from the leasing company are charged to the Group's consolidated statements of comprehensive income on a straight-line basis over the lease periods.

***w. Share-based compensation expense***

Share-based compensation expense is for share awards, including ordinary shares, share options, restricted shares and restricted share units, granted by the Company to employees and directors. For share-based awards for which a grant date has occurred, share-based compensation expense is recognized as costs and expenses in the consolidated statements of comprehensive income based on the fair values of the related share-based awards on their grant dates. For share-based awards for which the service inception date precedes the grant date, share-based compensation expense is recognized as costs and expenses in the consolidated statements of comprehensive income beginning on the service inception date and is re-measured on each subsequent reporting date before the grant date, based on the estimated fair values of the related share-based awards. The fair value is estimated based on the public market price of the underlying shares.

Changyou has used two incentive plans, the Company's 2008 Share Incentive Plan (the "Changyou 2008 Share Incentive Plan") and 2014 Share Incentive Plan (the "Changyou 2014 Share Incentive Plan"), for the granting of share-based awards, including share options, restricted shares and restricted share units, to its employees and directors. The Changyou 2008 Share Incentive Plan expired in August 2018 and is no longer available for granting new share-based awards.

Share-based compensation expense for share options, restricted shares and restricted share units granted is recognized on an accelerated basis over the requisite service period, net of estimated forfeitures. Forfeiture rates are estimated at the time of grant and revised in the subsequent periods if actual forfeitures differ from the initial estimates.

Options for the purchase of Changyou Class A ordinary shares contractually granted under the Changyou 2014 Share Incentive Plan are subject to vesting in four equal installments over a period of four years, with each installment vesting upon satisfaction of a service period requirement and certain subjective performance targets. Under ASC 718-10-25, no grant date can be established until a mutual understanding is reached between Changyou and the recipients clarifying the subjective performance requirements. In accordance with ASC 718-10-55, as the service inception date preceded the grant date, compensation expense was accrued beginning on the service inception date and will be re-measured on each subsequent reporting date before the grant date is established, based on the then-current fair value of the awards. The estimates of the awards' fair values will be fixed in the period in which the grant date occurs, and cumulative compensation expense will be adjusted based on the fair values at the grant date. In determining the fair values of Changyou share options granted, the public market price of the underlying shares at each reporting date was used, and a binomial valuation model was applied.

***x. Income taxes***

Current income taxes are provided on the basis of income for financial reporting purposes, adjusted for income and expense items which are not assessable or deductible for income tax purposes, in accordance with regulations of the relevant tax jurisdictions. Deferred income taxes are provided using the asset and liability method. Under this method, deferred income taxes are determined based on the differences between the financial reporting and tax bases of assets and liabilities and are measured using the currently enacted tax rates and laws. The deferred tax assets are reduced by a valuation allowance if it is considered based on available evidence more likely than not that some portion, or all, of the deferred tax assets will not be realized. Deferred tax liability is not recognized for undistributed earnings of a PRC subsidiary if the subsidiary has invested or will invest the undistributed earnings indefinitely.

**y. Uncertain tax positions**

In order to assess uncertain tax positions, the Company applies a more likely than not threshold and a two-step approach for tax position measurement and financial statement recognition. For the two-step approach, the first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon settlement.

**z. Earnings (Losses) per share**

Basic earnings (losses) per share are computed using the weighted average number of ordinary shares outstanding during the year. Diluted earnings (losses) per share are computed using the weighted average number of ordinary shares and, if dilutive, potential ordinary shares outstanding during the year. Potential ordinary shares consist of shares issuable upon the exercise of share options and shares issuable upon the settlement of restricted share units. Potential ordinary shares are accounted for in the computation of diluted earnings (losses) per share using the treasury stock method. Potential ordinary shares are not included in the denominator of the diluted earnings (losses) per share calculation when inclusion of such shares would be anti-dilutive, such as in a period in which a net loss is recorded. Earnings (losses) per share is computed on Class A ordinary shares and Class B ordinary shares together, because both classes have the same dividend rights and the same participation rights in the Company's undistributed earnings (losses).

**aa. Comprehensive income (loss)**

Comprehensive income (loss) is defined as the change in equity of a company during a period from transactions and other events and circumstances excluding transactions resulting from investments from owners and distributions to owners. Accumulated other comprehensive income (loss), as presented on the accompanying consolidated balance sheets, consists of the cumulative foreign currency translation adjustment.

**ab. Segment reporting**

Operating segments are defined as components of an enterprise about which separate financial information is available and is evaluated regularly by the chief operating decision maker ("CODM"), or a decision making group, in deciding how to allocate resources and in assessing performance. From November 2, 2014 to July 31, 2016, the CODMs were the Company's former Co-Chief Executive Officers; and since August 1, 2016 the CODM has been the Company's current Chief Executive Officer.

The Company's organizational structure is based on a number of factors that the CODM uses to evaluate, view and run the Company's business operations, which include, but are not limited to, customer base, homogeneity of products and technology. The Company's operating segments are based on its organizational structure and information reviewed by the Company's CODM to evaluate the operating segment results.

As of December 31, 2016 and December 31, 2017, the business segments that constituted the Company's reportable segments were the Online Game segment, which consisted primarily of PC games and mobile games; the Platform Channel segment, which consisted primarily of online advertising services offered on the 17173.com Website, and also included IVAS offered on the Dolphin Browser, which was operated by MoboTap, and by RaidCall and online card and board games offered by MoboTap; and the Cinema Advertising segment.

The Company disposed of the MoboTap business in March 2018 and, as a result, as of December 31, 2018 the business segments that constituted the Company's reportable segments were the Online Game segment, which consisted primarily of PC games and mobile games; the Platform Channel segment, which consisted primarily of online advertising services offered on the 17173.com Website, and also included IVAS offered by RaidCall; and the Cinema Advertising segment.

**ac. Foreign exchange forward contracts**

Foreign exchange forward contracts are initially recognized on the date a foreign exchange forward contract is entered into and are subsequently measured at fair value. The Company entered into such foreign exchange forward contracts in compliance with the Company's risk management policy for the purpose of eliminating the negative impact on earnings and equity resulting from fluctuations in the exchange rate between the U.S. dollar and the RMB. The instruments are marked-to-market at each period-end with the associated changes in fair value recognized in the line item "Other income, net" in the consolidated statements of comprehensive income and "Prepaid and other current assets" or "Other short-term liabilities" in the consolidated balance sheets. The net cash inflow and outflow related to the settlement of the forward contracts are recorded in the line item "Other investing activities" under "Cash flows from investing activities" in the consolidated statements of cash flows.

***ad. Recently issued accounting standards***

*Leases.* On February 25, 2016, the FASB issued Accounting Standards Update (“ASU”) No. 2016-02 (“ASU 2016-02”), Leases, which specifies the accounting for leases. For operating leases, ASU 2016-02 requires a lessee to recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in its balance sheet. The standard also requires a lessee to recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term, generally on a straight-line basis. In addition, this standard requires both lessees and lessors to disclose certain key information about lease transactions. The only exceptions are short-term leases, whose periods are one year or less. ASU 2016-02 is effective for publicly-traded companies for annual reporting periods, and interim periods within those years, beginning after December 15, 2018. Early adoption is permitted. Based on the Group’s preliminary assessment, the Company expects to record a right-of-use asset of approximately \$2.6 million and a lease liability of approximately \$2.4 million on the Company’s adoption date of January 1, 2019, primarily related to its leased office space. The Company will use an additional transition method (“ASU 2018-11”) and will not restate prior periods. The Company expects to implement new accounting policies as well as to elect certain practical expedients available to it under ASU 2016-02, including those related to leases with terms of less than 12 months. The Group’s implementation of the amended lease guidance is subject to the same internal controls over financial reporting that the Company applies to its consolidated financial statements.

*Financial Instruments-Credit Losses.* In June 2016, the FASB issued ASU 2016-13, Financial Instruments-Credit Losses (Topic 326), which requires entities to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. This replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Group is currently evaluating the impact of adopting this standard on its consolidated financial statements.

*Simplifying the Test for Goodwill Impairment.* In January 2017, the FASB issued ASU 2017-04, “Simplifying the Test for Goodwill Impairment.” The guidance removes Step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation. A goodwill impairment will now be the amount by which a reporting unit’s carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The guidance should be adopted on a prospective basis for the annual or any interim goodwill impairment tests beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. Based on management’s preliminary assessment, the Group believes that the change will not have a material impact on its consolidated financial statements.

## 5. CONCENTRATION RISKS

### *Operations risk*

Approximately 42%, 34% and 41%, respectively, of the Group's revenues for the years ended December 31, 2016, 2017 and 2018 were derived from the PC game TLBB, which was launched in May 2007, and approximately 24% and 21%, respectively, of the Group's revenues for the years ended December 31, 2017 and 2018 were derived from the mobile game Legacy TLBB Mobile, which was launched in May 2017. Approximately 97%, 97% and 96%, respectively, of the Group's revenues for the years ended December 31, 2016, 2017 and 2018 were derived from domestic operations.

Substantially all the Company's long-lived assets are located in the PRC.

### *Currency risk*

A majority of the Group's sales and expense transactions are denominated in RMB and a significant portion of the Group's assets and liabilities is denominated in RMB. The RMB is not freely convertible into foreign currencies. In the PRC, certain foreign exchange transactions are required by law to be transacted only by authorized financial institutions at exchange rates set by the People's Bank of China ("PBOC"). Remittances in currencies other than RMB by the Group in China must be processed through the PBOC or other China foreign exchange regulatory bodies, which require certain supporting documentation in order to effect the remittance. Total cash, cash equivalents, restricted cash and restricted time deposits in currencies other than RMB held at financial institutions in mainland China were \$1.1 million and \$nil, respectively, as of December 31, 2017 and 2018.

### *Credit risk*

The Group holds its cash, cash equivalents, restricted cash and restricted time deposits at Chinese financial institutions that are among the largest and most respected in the PRC and at international financial institutions with high ratings from internationally-recognized rating agencies. The Company's management chooses these institutions because of their reputations and track records for stability, and their known large cash reserves, and management periodically reviews these institutions' reputations, track records, and reported reserves. Management expects that any additional institutions that the Group uses for its cash and bank deposits will be chosen with similar criteria for soundness. As a further means of managing its credit risk, the Group held its cash and bank deposits in approximately 23 and 19 different financial institutions as of December 31, 2017 and 2018, respectively, and held no more than approximately 50% and 64%, of its total cash, cash equivalents, restricted cash and restricted time deposits at any single institution as of December 31, 2017 and 2018, respectively.

Under PRC law, it is generally required that a commercial bank in the PRC that holds third-party cash deposits protect the depositors' rights over and interests in their deposited money; PRC banks are subject to a series of risk control regulatory standards; and PRC bank regulatory authorities are empowered to take over the operation and management of any PRC bank that faces a material credit crisis.

## 6. BUSINESS COMBINATIONS

### *MoboTap Transaction*

On July 16, 2014, Changyou, through a wholly-owned subsidiary, entered into an investment agreement with MoboTap, MoboTap's subsidiaries and variable interest entities, and MoboTap's shareholders, pursuant to which Changyou purchased from then existing shareholders of MoboTap at the closing, which took place on July 31, 2014, shares of MoboTap representing 51% of the equity interests in MoboTap on a fully-diluted basis for approximately \$91 million in cash. In addition, Changyou has the right to purchase up to 10% of the equity interests in MoboTap from the non-controlling shareholders, at a price of 20% below the IPO price, before a qualified IPO of MoboTap. The Group began to consolidate MoboTap's financial statements commencing with the closing of the acquisition. On the acquisition date, the allocation of the consideration of the assets acquired and liabilities assumed based on their fair values was as follows:

	As of July 31, 2014 (in thousands)
Cash consideration	\$ 90,830
Repurchase option	793
Identifiable intangible assets acquired	27,000
Goodwill	113,040
Other assets	6,714
Put option	(298)
Liabilities assumed	(2,995)
Non-controlling interest	(53,424)
Total	<u>\$ 90,830</u>

The acquired identifiable intangible assets represented the Dolphin Browser user base, technology and trademark, the useful lives of which were 2.4 years, 5.4 years and 10.4 years, respectively. The acquired user base was valued using the cost saving approach, and the acquired technology and trademark were valued using the income approach. Goodwill of \$113 million was recognized at the time of the Company's acquisition of MoboTap.

Based on an assessment of MoboTap's financial performance conducted in connection with the acquisition, MoboTap was not considered material to the Group. Thus the Group's management concluded that the presentation of pro forma financial information with respect to the results of operations of the Group including the acquired MoboTap was not necessary.

In accordance with ASC 350, goodwill is not amortized but is tested for impairment and is not deductible for tax purposes. In the year ended December 31, 2015, the financial performance of MoboTap was below original expectations, and Changyou's management concluded that the Dolphin Browser was unable to provide expected synergies with Changyou's platform channel business, and accordingly performed a goodwill impairment test using the net present value method for the goodwill generated in the acquisition of MoboTap. As a result, Changyou recorded \$29.6 million and \$8.9 million, respectively, in goodwill and intangible assets impairment losses.

In 2016, the Company's Board of Directors approved the disposal of the 51% equity interest in MoboTap held by the Group. As of December 31, 2016, the Company was negotiating with a potential buyer on the terms of the disposal. Accordingly, the assets and liabilities attributable to MoboTap were classified as assets and liabilities held for sale and measured at the lower of their carrying amounts or their fair value less cost to sell, in the Company's consolidated balance sheet as of December 31, 2016.

In the first quarter of 2017, the Company's management determined that the disposal was unlikely to be completed within one year due to the suspension of negotiations with the potential buyer. As a result, the assets held for sale and liabilities held for sale related to MoboTap were reclassified as assets and liabilities held for use and measured at the carrying value before MoboTap was classified as held for sale, adjusted for any depreciation and amortization expense that would have been recognized had the assets and liabilities been continuously classified as held for use.

In the third quarter of 2017, due to enhanced restrictions the Chinese regulatory authorities imposed on card and board games, some of the Company's key distribution partners informed the Company that they had decided to stop the distribution and promotion of card and board games, which had an adverse impact on MoboTap's current performance, and also increased uncertainty with respect to its future operations and cash flow. As a result, the Company's management determined that it was unlikely for MoboTap to gain users and grow its online card and board games revenues in China. Management performed an impairment test in the third quarter of 2017 using the discounted cash flow method, and impairment charges of \$86.9 million were recognized to reflect the fair value of the MoboTap business, of which an \$83.5 million impairment loss was recognized for goodwill and a \$3.4 million impairment loss was recognized for intangible assets.

On March 13, 2018, the Company completed the sale of all of the equity interests in MoboTap.

### **Acquisition of RaidCall**

In December 2013, the Group acquired 62.5% of the equity interests, on a fully-diluted basis, in TalkTalk for cash consideration of \$47.6 million. Of the total consideration, \$27.6 million was paid by the Company to the Kalends Group for a portion of the ordinary shares of TalkTalk held by the Kalends Group, and \$20 million was injected for newly issued ordinary shares of TalkTalk. See “Note 2.d — Acquisition of RaidCall.” On the acquisition date, the allocation of the consideration for assets acquired and liabilities assumed based on their fair values was as follows:

	<b>As of December 24, 2013</b>
	<b>(in thousands)</b>
Cash Consideration	<u>\$ 47,627</u>
Tangible assets	20,016
Identifiable intangible assets acquired	17,888
Goodwill	33,740
Fair value of non-controlling interest	(17,172)
Liabilities assumed	(6,845)
Total	<u>\$ 47,627</u>

The excess of the purchase price over the tangible assets and identifiable intangible assets acquired (consisting primarily of software technology and a domain name) reduced by liabilities assumed was initially recorded as goodwill. The acquired identifiable intangible assets were valued using the income approach. Total goodwill of \$33.7 million primarily represented synergies between the Company’s existing online game business and RaidCall that were expected to result from an enhancement of game players’ experience through the Company’s offering of the RaidCall communications tool with the Company’s online games. In December 2014, Changyou’s management concluded that RaidCall was unable to provide the expected synergies with Changyou’s online games business. Accordingly, goodwill impairment and impairment of acquired intangible assets of \$33.8 million and \$15.3 million, respectively, were charged as of December 31, 2014.

### **7. BANK LOANS AND RESTRICTED TIME DEPOSITS**

Beginning in 2012, Changyou drew down loans from offshore branches of certain banks for the purposes of expediting the payment of a special one-time cash dividend to its shareholders, providing working capital to support its overseas operations, and funding the Company’s acquisitions and the Company’s share repurchase program. These bank loans were secured by an equivalent or greater amount of RMB deposits by Changyou in the onshore branches of such banks. The loans from the offshore branches of the lending banks are classified as short-term bank loans or long-term bank loans based on their payment terms. The RMB deposits are valued based on the prevailing interest rates in the market.

As of December 31, 2015, the total amount of the bank loans was \$344.5 million, all of which carried a floating rate of interest based on the London Inter-Bank Offered Rate (“LIBOR”). All of the loans were repaid, and accordingly all of the restricted time deposits that secured these loans were released, in 2016. For the years ended December 31, 2015 and 2016, interest income from the restricted time deposits securing the loans was \$12.8 million and \$0.5 million, respectively, and interest expense for the bank loans was \$7.1 million and \$0.6 million, respectively.

As of December 31, 2018, the total amount of the bank loans was \$220.0 million, all of which carried a floating rate of interest based on the LIBOR. All of the loans will be repaid, and accordingly all of the restricted time deposits \$243.9 million (equivalent to RMB1.7 billion) that secured these loans will be released, in 2021. For the year ended December 31, 2018, interest income from the restricted time deposits securing the loans was \$1.0 million, and interest expense for the bank loans was \$1.4 million. Outstanding principal of the bank loans totaling \$80.0 million was repaid in January 2019, and the corresponding restricted time deposits were released.

## 8. ACCOUNTS RECEIVABLE, NET

The carrying amounts of accounts receivable of the Group are as follows:

	As of December 31, (in thousands)	
	2017	2018
Accounts receivable, gross	\$94,987	\$62,736
Allowance for doubtful accounts	(3,351)	(5,347)
Accounts receivable, net	<u>\$91,636</u>	<u>\$57,389</u>

The following table sets forth the Group's allowance for doubtful accounts for the years ended 2016, 2017 and 2018.

	Balance at January 1, (in thousands)	Additional provision for bad debt, net of recoveries (in thousands)	Write-off of receivable balances (in thousands)	Balance at December 31, (in thousands)
2016	1,174	1,615	(1,371)	1,418
2017	1,418	2,083	(150)	3,351
2018	3,351	2,871	(875)	5,347

## 9. PREPAID AND OTHER CURRENT ASSETS

	As of December 31, (in thousands)	
	2017	2018
Prepaid cost of revenue	\$12,579	\$12,268
Rental deposits	7,402	6,253
Prepaid tax	1,440	1,072
Loans to third parties	28,544	—
Due from 7Road	5,344	—
Others	6,668	5,805
<b>Total</b>	<u>\$61,977</u>	<u>\$25,398</u>

## 10. FIXED ASSETS, NET

	As of December 31, (in thousands)	
	2017	2018
Office building	\$194,067	\$184,764
Computer equipment (including servers)	37,617	32,687
Leasehold and building improvements	27,685	26,183
Office furniture	3,537	3,279
Vehicles	2,022	1,845
Total	264,928	248,758
Less: accumulated depreciation	(74,981)	(78,012)
<b>Net book value</b>	<u>\$189,947</u>	<u>\$170,746</u>

Depreciation expense for fixed assets was \$13.6 million, \$12.0 million and \$11.7 million, respectively, for the years ended December 31, 2016, 2017 and 2018.



## 11. INTANGIBLE ASSETS, NET

The following tables summarize the Group's intangible assets, net:

Items	As of December 31, 2018 (in thousands)			Net Carrying Amount
	Gross Carrying Amount	Accumulated Amortization	Impairment <sup>[1]</sup>	
Operating rights for licensed games	\$46,328	\$ (22,299)	\$ (11,806)	\$12,223
Computer software	6,618	(6,415)	—	203
Developed technologies	8,319	(880)	(7,439)	—
Trademarks and domain names	15,577	(5,451)	(9,823)	303
Others	6,119	(2,251)	(2,693)	1,175
<b>Total</b>	<b>\$82,961</b>	<b>\$ (37,296)</b>	<b>\$ (31,761)</b>	<b>\$13,904</b>

Items	As of December 31, 2017 (in thousands)			Net Carrying Amount
	Gross Carrying Amount	Accumulated Amortization	Impairment	
Operating rights for licensed games	\$34,296	\$ (17,883)	\$ (10,925)	\$ 5,488
Computer software	7,413	(6,585)	—	828
Developed technologies	18,688	(4,495)	(14,088)	105
Trademarks and domain names	20,151	(6,305)	(13,279)	567
Others	19,427	(12,170)	(5,785)	1,472
<b>Total</b>	<b>\$99,975</b>	<b>\$ (47,438)</b>	<b>\$ (44,077)</b>	<b>\$ 8,460</b>

- [1] The Group recognized \$8.9 million and \$3.4 million in losses for impairment of intangible assets of MoboTap in 2015 and 2017, respectively. The Group completed the sale of all of the equity interests in MoboTap in March 2018.

### *Amortization*

Amortization expense for intangible assets was \$12.4 million, \$7.8 million and \$6.4 million, respectively, for the years ended December 31, 2016, 2017 and 2018.

As of December 31, 2018, amortization expense of intangible assets for future years was expected to be as follows:

	Amortization expense of intangible assets (in thousands)
2019	\$ 6,350
2020	4,837
2021	1,916
2022	362
2023	290
Thereafter	149
Total expected amortization expense	<u>\$ 13,904</u>

### *Impairment of Intangible Assets*

In 2016, the Group recognized \$0.4 million in losses for impairment of intangible assets, primarily related to the content of and license rights to the Group's online games.

In 2017, the Group recognized \$4.6 million in losses for impairment of intangible assets, primarily related to the intangible assets operated by MoboTap and the content of and license rights to the Group's online games. In 2017, the business operations and performance of MoboTap were adversely affected by enhanced restrictions the Chinese regulatory authorities imposed on card and board games. As a result, the Company's management determined that it was unlikely for MoboTap to gain users and grow its online card and board games revenues in China. Management performed an impairment test in the third quarter of 2017 using the discounted cash flow method and recognized \$3.4 million impairment loss for intangible assets. Please refer to "Note 2 — REORGANIZATION AND ACQUISITIONS" for more details. The impairment loss was recognized in the consolidated statements of comprehensive income under "goodwill impairment and impairment of intangibles as part of acquisition of a business". The impaired intangible assets consisted of technology, trademarks and license rights.

In 2018, the Group recognized \$1.5 million in losses for impairment of intangible assets, primarily related to the content of and license rights to the Group's online games.

## 12. LONG-TERM INVESTMENTS, NET

	As of December 31, (in thousands)	
	2017	2018
Equity investments	\$3,000	\$3,000
<b>Total</b>	<b>\$3,000</b>	<b>\$3,000</b>

Changyou entered into an investment agreement with a mobile product development company to acquire 30% of the equity interests in the company, with initial consideration of \$0.7 million, which was paid in 2015. The investment was accounted for under the equity method, because Changyou can exercise significant influence over the company through the right to appoint one director to the board of the investee company, but does not own a majority of the equity interests in or control the company. During 2017 and 2018, the Company recognized impairment losses of \$0.5 million and \$nil, respectively, for the equity investment, due to the investee company's disappointing financial results. As of December 31, 2017 and 2018, the carrying amount of this equity method investment was \$nil and \$nil, respectively, reflecting the Company's proportionate share of the equity in the investee company, and the Company recognized a loss of \$60,322, \$45,212 and \$nil, respectively, in other income in the consolidated statements of comprehensive income in 2016, 2017 and 2018.

In 2015, Changyou made an initial investment of \$3 million in return for a limited partner interest in an incubator fund. Changyou accounted for the investment using the cost method, as the investment did not have a readily determinable fair value in 2018.

## 13. GOODWILL

Changes in the carrying value of goodwill were as follows:

	Online Game (in thousands)	Platform Channel (in thousands)	Cinema Advertising (in thousands)	Total (in thousands)
Balance as of December 31, 2016				
Goodwill	\$ 10,257	\$ 81,491	\$ 5,201	\$ 96,949
Accumulated impairment loss	—	(65,246)	(5,201)	(70,447)
	<u>\$ 10,257</u>	<u>\$ 16,245</u>	<u>\$ —</u>	<u>\$ 26,502</u>
Transactions in 2017				
Foreign exchange	\$ —	\$ 1,002	\$ —	\$ 1,002
Transfer from assets held for sale <sup>[1]</sup>	—	83,470	—	83,470
Impairment loss <sup>[1]</sup>	—	(83,470)	—	(83,470)
Balance as of December 31, 2017				
Goodwill	\$ 10,257	\$ 165,963	\$ 5,201	\$ 181,421
Accumulated impairment loss	—	(148,716)	(5,201)	(153,917)
	<u>\$ 10,257</u>	<u>\$ 17,247</u>	<u>\$ —</u>	<u>\$ 27,504</u>

	Online Game (in thousands)	Platform Channel (in thousands)	Cinema Advertising (in thousands)	Total (in thousands)
Transactions in 2018				
Foreign exchange	\$ —	\$ (878)	\$ —	\$ (878)
Impairment loss <sup>[2]</sup>	—	(16,369)	—	(16,369)
Balance as of December 31, 2018				
Goodwill	\$ 10,257	\$ 165,085	\$ 5,201	\$ 180,543
Accumulated impairment loss	—	(165,085)	(5,201)	(170,286)
	<u>\$ 10,257</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 10,257</u>

[1] In 2016, the Company's Board of Directors approved the disposal of the 51% equity interest in MoboTap held by the Company. As of December 31, 2016, the Company was negotiating with a potential buyer on the terms of the disposal. Accordingly, the assets and liabilities of MoboTap were recognized as "assets held for sale" and "liabilities held for sale", respectively. As of December 31, 2016, goodwill in the amount of \$83.5 million was reclassified from goodwill to "assets held for sale". The fair values of the other reporting units exceeded their carrying values, indicating that the goodwill of those reporting units was not impaired.

In 2017, the assets and liabilities held for sale related to MoboTap were reclassified and recorded as assets and liabilities held for use. The business operations and performance of MoboTap were adversely affected by enhanced restrictions the Chinese regulatory authorities imposed on card and board games in 2017. As a result, the Company's management determined that it was unlikely for MoboTap to gain users and grow its online card and board games revenues in China. Management performed an impairment test using the discounted cash flow method and recorded \$83.5 million in goodwill impairment losses for goodwill associated with the acquisition of MoboTap. The goodwill impairment losses were included in the Group's statements of comprehensive income under "goodwill impairment and impairment of intangibles as part of acquisition of a business". Please refer to "Note 2 — REORGANIZATION AND ACQUISITIONS" for more details.

[2] In 2018, the Company recognized a \$16.4 million impairment loss for goodwill relating to the 17173.com Website, primarily due to (i) the launch of new initiatives for the 17173.com Website having fallen behind schedule in the fourth quarter of 2018 and the profit outlook for the 17173.com Website being uncertain, and (ii) the relevant Chinese authority's temporary suspension between April and December of 2018 of its review of, and issuance of publishing and authorization codes for, online games, which resulted in declines in the number of new games launched and the related demand from game developers and operators for online advertising services on the 17173.com Website, both of which the Company's management determined had a material adverse impact on the Company's ability to generate revenues and net income from the 17173.com Website.

The Changyou online game business was the only reporting unit with goodwill under the Online Game segment. Prior to the sale of MoboTap, there were three reporting units with goodwill under the Platform Channel segment, consisting of the 17173.com Website, RaidCall and MoboTap. After the sale of MoboTap, there were two reporting units with goodwill under the Platform Channel segment, consisting of the 17173.com Website and RaidCall. The only reporting unit with goodwill under the Cinema Advertising segment was the cinema advertising business. The Group tested goodwill for impairment at the reporting unit level as of October 1, 2018. The Changyou online game business was the only reporting unit within the Group with net value of goodwill, which is goodwill less accumulated impairment loss, as of December 31, 2018.

Changyou tested goodwill for impairment at the reporting unit level on an annual basis on October 1, and between annual tests when an event occurred or circumstances indicated that the asset might be impaired. The Group performed impairment tests using the qualitative and quantitative methods. Changyou first qualitatively assessed whether it was more likely than not that the fair values of the assets of the reporting units were less than their carrying amounts. For those reporting units where it was more likely than not that the fair values of their assets were less than their carrying amounts, Changyou performed the first step of a two-step quantitative goodwill impairment test. Changyou estimated the fair values using the income approach, considering factors that included expected future cash flows, growth rates and discount rates. After the qualitative and quantitative assessments, management concluded that the fair values of the assets of Changyou's reporting units other than the 17173.com Website exceeded their carrying values, indicating that the goodwill of those reporting units was not impaired.

## 14. OTHER ASSETS, NET

	As of December 31, (in thousands)	
	2017	2018
Deferred tax assets, net	\$10,100	\$13,467
Employee advance	8,873	9,465
Others	155	58
<b>Total</b>	<b>\$19,128</b>	<b>\$22,990</b>

## 15. FAIR VALUE MEASUREMENT

### *Fair Value of Financial Instruments*

The following tables set forth financial instruments, measured at fair value, by level within the fair value hierarchy as of December 31, 2017 and 2018:

Items	As of December 31, 2018	Fair value measurement (in thousands) at reporting date using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	\$ 335,516	\$ —	\$ 335,516	\$ —
Short-term investments	190,068	—	190,068	—
Restricted time deposits	243,910	—	243,910	—
<b>Total</b>	<b>\$ 769,494</b>	<b>\$ —</b>	<b>\$ 769,494</b>	<b>\$ —</b>

Items	As of December 31, 2017	Fair value measurement (in thousands) at reporting date using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	\$ 512,417	\$ —	\$ 512,417	\$ —
Short-term investments	404,584	—	404,584	—
Foreign exchange forward contracts	(715)	—	(715)	—
<b>Total</b>	<b>\$ 916,286</b>	<b>\$ —</b>	<b>\$ 916,286</b>	<b>\$ —</b>

### *Cash equivalents*

The Company's cash equivalents mainly consist of time deposits and highly-liquid investments that have original maturities of three months or less. The fair values of cash equivalents are determined based on the pervasive interest rates in the market. The Company classifies the valuation techniques that use the pervasive interest rates input as Level 2 of fair value measurements. Generally there are no quoted prices in active markets for identical cash equivalents at the reporting date. In order to determine the fair value, the Company must use the discounted cash flow method and observable inputs other than quoted prices in active markets for identical assets or liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

### *Short-term investments*

To estimate the fair value of investments in financial instruments with a variable interest rate indexed to the performance of underlying assets, the Company refers to the quoted rate of return provided by banks at the end of each period using the discounted cash flow method. The Company classifies the valuation techniques that use these inputs as Level 2 of fair value measurement.

As of December 31, 2017 and 2018, the Company's investments in financial instruments were approximately \$404.6 million and \$190.1 million, respectively. The financial instruments are issued by commercial banks in China with a variable interest rate indexed to the performance of underlying assets. Since the maturity dates of these financial instruments are within one year, the investments are classified as short-term investments. For the years ended December 31, 2016, 2017 and 2018, the Company recorded gains resulting from changes in the fair values of short-term investments in the line item "other income, net" in the consolidated statements of comprehensive income of \$9.3 million, \$12.9 million and \$16.7 million, respectively.

#### *Restricted time deposits*

Restricted time deposits are valued based on the prevailing interest rates in the market using the discounted cash flow method. The Company classifies the valuation techniques that use these inputs as Level 2 of fair value measurements.

#### *Foreign exchange forward contracts*

The Company estimated the fair values of foreign exchange forward contracts using the Black-Scholes model. The fair values of the forward contracts were estimated based on quoted forward exchange prices at the reporting date. The Company classifies the fair value measurement of the forward contracts based on such inputs as Level 2 of fair value measurements.

In September 2016 and January 2017, the Company entered into foreign exchange forward contracts with banks in aggregate notional amounts of \$100 million and \$50 million, respectively. The Company entered into such foreign exchange forward contracts in compliance with the Company's risk management policy for the purpose of eliminating the negative impact on earnings and equity resulting from fluctuations in the exchange rate between the U.S. dollar and the RMB. For the years ended December 31, 2016, 2017 and 2018, the Company recorded gains resulting from changes in the fair values of forward contracts of \$3.0 million, a loss of \$7.2 million, and a loss of \$0.2 million, respectively, in the consolidated statements of comprehensive income, and the Company recorded cash outflows related to the forward contracts of \$nil, \$3.5 million and \$0.9 million, respectively, in the consolidated statements of cash flows.

As of December 31, 2017, the aggregate notional amount of the foreign exchange forward contracts, which expired in January 2018, was \$10.0 million. As of December 31, 2018, the aggregate notional amount of the foreign exchange forward contracts was \$nil.

The following are other financial instruments not measured at fair value in the balance sheets but for which the fair value is estimated for disclosure purposes.

#### *Short-term receivables and payables*

Accounts receivable, matching loans to related parties, loans between Changyou and Sohu and prepaid and other current assets are financial assets with carrying values that approximate fair value due to their short-term nature. Short-term accounts payable, receipts in advance and deferred revenue, matching loans from related parties and other short-term liabilities are financial liabilities with carrying values that approximate fair value due to their short-term nature. The rates of interest under loan agreements with lending banks were determined based on the prevailing interest rates in the market. The Company classifies the valuation techniques that use these inputs as Level 2 of fair value measurements.

#### *Other non-current assets and long-term payables*

Other non-current assets are financial assets, and long-term payables are financial liabilities, with carrying values that approximate fair value because the change in fair value, after considering the discount rate, is immaterial. The rates of interest under the Company's loan agreements with lending banks were determined based on the prevailing interest rates in the market. The Company classifies the valuation techniques that use these inputs as Level 2 of fair value measurements.

#### ***Assets Measured at Fair Value on a Nonrecurring Basis***

The following tables set forth assets measured at fair value on a nonrecurring basis by level within the fair value hierarchy as of December 31, 2017 and 2018:

Items	Fair value measurements (in thousands) at reporting date using				Total Losses
	As of December 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Intangible assets, net	\$ 13,904	\$ —	\$ —	\$ 13,904	\$ 1,538
Goodwill	10,257	—	—	10,257	16,369
	<u>\$ 24,161</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 24,161</u>	<u>\$17,907</u>

Items	Fair value measurements (in thousands) at reporting date using				Total Losses
	As of December 31, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Intangible assets, net	\$ 8,460	\$ —	\$ —	\$ 8,460	\$ 4,575
Goodwill	27,504	—	—	27,504	83,470
	<u>\$ 35,964</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 35,964</u>	<u>\$88,045</u>

#### *Intangible Assets*

Intangible assets mainly comprise operating rights for licensed games, computer software, developed technologies, trademarks, domain names and cinema advertising slot rights. See “Note 11 — Intangible Assets, Net.”

#### *Goodwill*

Goodwill represents the excess of the purchase price over the fair value of identifiable assets and liabilities acquired as a result of the Group’s acquisitions of the interests in its subsidiaries and consolidated VIEs. See “Note 13 — Goodwill.”

## 16. RECEIPTS IN ADVANCE AND DEFERRED REVENUE

	As of December 31, (in thousands)	
	2017	2018
Receipts in advance	\$18,498	\$19,013
Deferred revenue	24,419	26,330
<b>Total</b>	<u><b>\$42,917</b></u>	<u><b>\$45,343</b></u>

The amount of recognized revenue that was included in the receipts in advance and deferred revenue balance at the beginning of the year was \$35.1 million during the year ended December 31, 2018.

## 17. OTHER SHORT-TERM LIABILITIES

	As of December 31, (in thousands)	
	2017	2018
Customer deposits	\$ 2,221	\$1,147
Others	6,465	4,756
<b>Total</b>	<u><b>\$ 8,686</b></u>	<u><b>\$5,903</b></u>

## 18. SHARE-BASED COMPENSATION

### *Changyou 2008 Share Incentive Plan*

The Changyou 2008 Share Incentive Plan expired in August 2018.

Share-based compensation expense recognized for the years ended December 31, 2016, 2017 and 2018 for restricted share units granted under the Changyou 2008 Share Incentive Plan was \$0.08 million, \$2,200 and \$nil, respectively. As of December 31, 2018, there was no unrecognized compensation expense related to restricted share units under the Changyou 2008 Share Incentive Plan.

The total fair values of restricted share units granted under the Changyou 2008 Share Incentive Plan vested on their respective vesting dates during the years ended December 31, 2016, 2017 and 2018 were \$0.1 million, \$0.2 million and \$nil, respectively.

### *Changyou 2014 Share Incentive Plan*

On June 27, 2014, the Company adopted and reserved for issuance 2,000,000 of Class A ordinary shares under the Changyou 2014 Share Incentive Plan. On November 2, 2014, the Company increased to 6,000,000 the number of Class A ordinary shares reserved under the Changyou 2014 Share Incentive Plan.

#### i) Summary of share option activity

Through December 31, 2014, the Company had granted under the Changyou 2014 Share Incentive Plan an aggregate of 2,416,000 Class A restricted share units (settleable upon vesting in Class A ordinary shares) to certain employees. On February 16, 2015, Changyou's Board of Directors approved the conversion of 2,400,000 Class A restricted share units into options for the purchase of Class A ordinary shares at an exercise price of \$0.01. The conversion constituted a modification of share-based compensation. The incremental value of the modification was approximately zero due to the facts that the exercise price was approximately zero and the other terms were not changed. On June 1, 2015, Changyou's Board of Directors approved the grants of options for the purchase of an aggregate of 1,998,000 Class A ordinary shares to certain members of the Company's management and certain other employees, at an exercise price of \$0.01. On July 28, 2016, Changyou's Board of Directors approved the contractual grant of options for the purchase of an aggregate of 100,000 Class A ordinary shares to a member of its management at an exercise price of \$0.01. These Changyou share options vest in four equal installments over a period of four years, with each installment vesting upon satisfaction of a service period requirement and the achievement of certain subjective performance targets. No grant date had been established for the unvested options for accounting purposes as of December 31, 2018, because a mutual understanding had not been reached between Changyou and the recipients clarifying the subjective performance requirements. Compensation expense for the options was accrued commencing on the service inception date and was, and will be, re-measured based on the then-current fair value of the options on each subsequent reporting date until the grant date is established. To determine the fair value of these share options, the public market price of Changyou's ADSs at each reporting date was used and a binomial valuation model was applied.

For the years ended December 31, 2016, 2017 and 2018, 779,000, 770,000 and 719,000, respectively, of these Changyou share options were granted and vested, as a mutual understanding of the subjective performance targets had been reached between Changyou and the recipients, the targets had been satisfied, and the service period requirements had been fulfilled. The cumulative share-based compensation expense of \$9.1 million, \$14.8 million and \$6.8 million, respectively, for these share options granted during the years ended December 31, 2016, 2017 and 2018, has been adjusted and fixed based on the aggregate amounts of the fair values of these granted share options at their respective grant dates.

A summary of Changyou share option activity under the Changyou 2014 Share Incentive Plan as of and for the year ended December 31, 2018 is presented below:

<u>Options</u>	<u>Number of Shares (in thousands)</u>	<u>Weighted- Average Exercise Price</u>	<u>Weighted- Average Remaining Contractual Life (Years)</u>	<u>Aggregate Intrinsic Value (1) (in thousands)</u>
Outstanding at January 1, 2018	947	0.01	7.01	17,240
Granted	719	0.01		
Exercised	(1,065)	0.01		
Forfeited or expired	—			
Outstanding at December 31, 2018	<u>601</u>	0.01	5.98	5,487
Vested at December 31, 2018	<u>601</u>	0.01		5,487
Exercisable at December 31, 2018	<u>601</u>	0.01		

Note (1): The aggregate intrinsic value in the preceding table represents the difference between the closing price of \$18.28 per Changyou ADS, or \$9.14 per Class A ordinary share, on December 31, 2018 and the nominal exercise price of the share options.

Share-based compensation expense/(benefit) recognized for share options for the years ended December 31, 2016, 2017 and 2018 under the Changyou 2014 Share Incentive Plan was \$8.3 million, \$17.4 million and negative \$6.5 million, respectively.

The total fair values of share options vested on their respective vesting dates during the year ended December 31 of each of 2016, 2017 and 2018 was \$9.1 million, \$14.8 million and \$5.7 million, respectively.

The weighted-average grant date fair value of the options granted during the years ended December 31, 2016, 2017 and 2018 was \$11.72, \$19.24 and \$7.92 per share, respectively.

The total intrinsic value of share options exercised for the years ended December 31, 2016, 2017 and 2018 was \$4.3 million, \$10.3 million and \$14.9 million, respectively.

#### ii) Summary of restricted share unit activity

On November 2, 2014, the Company granted under the Changyou 2014 Share Incentive Plan an aggregate of 16,000 Class A restricted share units to an employee. These Class A restricted share units were subject to vesting over a four-year period commencing on their grant dates. The fair values as of the grant dates of the restricted share units were determined based on market price of Changyou's ADSs on the grant dates. Due to the termination of the employee's employment during the second quarter of 2015 prior to vesting, the Company recognized share-based compensation expense of negative \$17,000 for the year ended December 31, 2015 and there was no unrecognized compensation expense for these restricted share units after the second quarter of 2015, as all of them were forfeited during that quarter.

#### ***MoboTap Equity Incentives***

Compensation expense of \$71,449, \$24,708 and \$nil, respectively, was recognized for the years ended December 31, 2016, 2017 and 2018 with respect to share awards in MoboTap granted to employees of MoboTap.

## **19. TAXATION**

### ***a. PRC Value-added tax and related surcharges***

Substantially all of the Group's revenues are subject to a PRC value-added tax ("VAT") at a rate of 6% and related surcharges on VAT payable at a rate of 12%. To record VAT payable for these revenues, the Group adopted the net presentation method, which presents the difference between the output VAT (at a rate of 6%) and the available input VAT amount (at the rate applicable to the supplier).

There is a culture construction fee surcharge of 3% on gross revenues from the online advertising and cinema advertising businesses.

### ***b. Income tax***

#### *Cayman Islands*

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

#### *Hong Kong*

Entities incorporated in Hong Kong are subject to profits tax in Hong Kong at the rate of 16.5% for each of the years ended December 31, 2016, 2017 and 2018.

#### *China*

#### *Principal Entities Qualified as HNTEs*

The CIT Law generally applies an income tax rate of 25% to all enterprises, but grants preferential tax treatment to High and New Technology Enterprises ("HNTEs"). Under this preferential tax treatment, HNTEs are entitled to an income tax rate of 15%, subject to a requirement that they re-apply for HNTE status every three years. During this three-year period, an HNTE must conduct a qualification self-review each year to ensure it meets the HNTE criteria and is eligible for the 15% preferential tax rate for that year. If an HNTE fails to meet the criteria for qualification as an HNTE in any year, the enterprise cannot enjoy the 15% preferential tax rate in that year, and must instead use the regular 25% CIT rate.



AmazGame and Gamease qualified as HNTEs for the years 2017 through 2019, and will need to re-apply for HNTE qualification in 2020.

Gamespace qualified as an HNTE for the years 2016 through 2018, and will need to re-apply for HNTE qualification in 2019.

#### Principal Entities Qualified as Software Enterprises and KNSEs

The CIT Law and its implementing regulations provide that a “Software Enterprise” is entitled to an income tax exemption for two years beginning with its first profitable year and a 50% reduction to a rate of 12.5% for the subsequent three years. An entity that qualifies as a “Key National Software Enterprise” (a “KNSE”) is entitled to a further reduced preferential income tax rate of 10%. Enterprises wishing to enjoy the status of a Software Enterprise or KNSE must perform a self-assessment each year to ensure they meet the relevant criteria for qualification and file required supporting documents with the tax authorities before using the preferential CIT rates. These enterprises will be subject to relevant governmental authorities’ assessment each year as to whether they are entitled to use the relevant preferential CIT treatments. If at any time during the preferential tax treatment years an enterprise uses the preferential CIT rates but the relevant authorities determine that it fails to meet applicable criteria for qualification, the authorities may revoke the enterprise’s Software Enterprise or KNSE status, as applicable.

- In 2018, prior to the Company’s sale of MoboTap, the Company’s VIE Wuhan Baina Information was in its first year of a three-year period of qualification as a Software Enterprise, during which it was subject to a reduced tax rate of 12.5%. The Company’s sale of MoboTap on March 13, 2018 included the sale of Wuhan Baina Information.
- Chuangxiang performed a self-assessment and filed required supporting documents in 2018 for Software Enterprise status for 2017. Chuangxiang was qualified as a Software Enterprise after the relevant government authorities’ assessment and was in its first year of a two-year period of qualification as a Software Enterprise in 2017, during which it was entitled to an income tax exemption. As a result, a reversal of income tax of \$18.4 million to reflect the preferential income tax rate was recorded in the consolidated statements of comprehensive income for the year ended December 31, 2018. The same process will be followed in 2019 by Chuangxiang for preferential income tax treatment as a Software Enterprise for 2018.
- AmazGame performed a self-assessment and filed required supporting documents in 2018 for KNSE status for 2017. AmazGame was qualified as a KNSE after the relevant government authorities’ assessment and was entitled to a preferential income tax rate of 10% for 2017. As a result, a reversal of income tax of \$6.5 million to reflect the preferential income tax rate was recorded in the consolidated statements of comprehensive income for the year ended December 31, 2018. The same process will be followed in 2019 by AmazGame for preferential income tax treatment as a KNSE for 2018.

The license fees and royalty payments received from licensees in various jurisdictions outside of the PRC are subject to foreign withholding taxes. The Group recognizes such foreign withholding taxes as income tax expense when the related license fee and royalty revenue is recognized.

#### PRC Withholding Tax on Dividends

Under the CIT Law and its implementation rules, the profits of a foreign invested enterprise arising in 2008 and onwards which are distributed to its immediate holding company outside the PRC are subject to a withholding tax rate of 10%. A lower withholding tax rate will be applied if there is a beneficial tax treaty between the PRC and the jurisdiction of the foreign holding company. A holding company in Hong Kong, for example, will be subject to a 5% withholding tax rate under the Arrangement Between the PRC and the Hong Kong Special Administrative Region on the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income (the “China-HK Tax Arrangement”) if such holding company is considered a non-PRC resident enterprise and holds at least 25% of the equity interests in the PRC foreign invested enterprise distributing the dividends, subject to approval of the PRC local tax authority. However, if the Hong Kong holding company is not considered to be the beneficial owner of such dividends under applicable PRC tax regulations, such dividend may remain subject to withholding tax rate of 10%.

The PRC State Administration of Taxation issued Announcement 9, effective April 1, 2018, which provides guidance on determining whether an enterprise is a beneficial owner under China’s tax treaties and tax arrangements. If any of the Company’s Hong Kong subsidiaries is, in the light of Announcement 9, considered to not be a beneficial owner for purpose of the China-HK Tax Arrangement, any dividends paid to it by any of the Company’s PRC subsidiaries would not qualify for the preferential dividend withholding tax rate of 5%, but rather would be subject to the statutory withholding tax rate of 10%.

On April 5, 2018, the Company's Board of Directors declared a special cash dividend of \$4.70 per Class A ordinary or Class B ordinary share, or \$9.40 per ADS. The aggregate amount of the special cash dividend was approximately \$500.0 million. In order to facilitate the distribution of this special dividend, the Company revised its policy for its PRC subsidiaries with respect to their distribution of cash dividends. Under the revised policy, all PRC subsidiaries in the Group are able to distribute their cumulative available and undistributed earnings to their direct overseas parent companies in the Group. The change resulted in the Company's accrual of additional income withholding tax for the period before December 31, 2017 of approximately \$47 million, which was recognized in the Company's consolidated financial statements for the first quarter in 2018. The Company's management believes that under the CIT Law and relevant rules, such a dividend out of earnings generated after January 1, 2012 is subject to a 5% withholding tax. Therefore, withholding tax associated with this distribution plan was accrued and recorded as deferred tax liabilities in the amount of \$79.8 million as of December 31, 2018.

With the exception of that dividend, the Group does not intend to have any of its PRC VIEs distribute any undistributed profits of such VIEs to their overseas parent companies, but rather intends that such profits will be permanently reinvested by the VIEs for their PRC operations. As of December 31, 2018, the total amount of undistributed profits from the VIEs for which no withholding tax has been accrued was \$254.6 million, and the unrecognized tax liabilities were \$12.7 million.

#### *Uncertain Tax Positions*

For the years ended December 31, 2016, 2017 and 2018, the Company did not have any material interest or penalties associated with tax positions, nor did the Company have any significant unrecognized uncertain tax positions.

As management determined that certain business transactions that took place during 2015 may result in additional tax obligations under relevant tax rules, the Company recognized \$14.6 million in tax payable in 2015, which was reclassified to other long-term liabilities in 2016, due to the Company's expectation that such tax payable would not be settled within twelve months after December 31, 2016.

The Group does not anticipate that the uncertain tax positions will significantly increase or decrease within twelve months after December 31, 2018.

#### *Composition of Income Tax Expense*

The current and deferred portions of income tax expense included in the consolidated statements of comprehensive income are as follows:

	For the year ended December 31, (in thousands)		
	2016	2017	2018
Income/(loss) from foreign entities	\$ 5,371	\$ (79,263)	\$ (62,555)
Income from PRC entities	163,282	201,869	210,947
Income before income tax expense	\$ 168,653	\$ 122,606	\$ 148,392
Current income tax expense	\$ 9,109	\$ 38,625	\$ 13,990
Deferred income tax expense	11,403	1,524	50,008
Income tax expense applicable to PRC entities	\$ 20,512	\$ 40,149	\$ 63,998
Foreign withholding tax expense	1,071	618	469
<b>Income tax expense</b>	<b>\$ 21,583</b>	<b>\$ 40,767</b>	<b>\$ 64,467</b>

Reconciliation between the statutory CIT rate and the Group's effective tax rate is as follows:

	For the year ended December 31,		
	2016	2017	2018
Statutory CIT rate	25.0%	25.0%	25.0%
Effect of tax holidays <sup>[1]</sup>	(16.0)%	(19.1)%	(27.0)%
Tax differential from statutory rate applicable to overseas subsidiaries	1.2%	8.7%	1.9%
Effect of withholding taxes <sup>[2]</sup>	2.3%	3.0%	35.5%
Changes in valuation allowance	0.9%	11.2%	6.5%
Other permanent book-tax differences	(0.6)%	4.5%	1.5%
<b>Effective CIT rate</b>	<b>12.8%</b>	<b>33.3%</b>	<b>43.4%</b>

- [1] The income tax reversals resulting from the preferential income tax rate that AmazGame received as a 2015, 2016 and 2017 KNSE and from the preferential income tax rate that Chuangxiang received as a 2017 Software Enterprise are included in the “Effect of tax holidays” in the table above.
- [2] Additional income withholding tax of \$47 million that was recognized in the first quarter of 2018 due to a revised policy for the Company’s PRC subsidiaries with respect to their distribution of cash dividends is included in “Effect of withholding taxes” in the table above. The revised policy was adopted to facilitate the distribution of a special cash dividend in the aggregate amount of approximately \$500.0 million that was declared by the Company’s Board of Directors on April 5, 2018.

The combined effects of the income tax expense exemption and reduction available to the Group are as follows:

	<b>For the year ended December 31,</b> <b>(in thousands, except per share data)</b>		
	<b>2016</b>	<b>2017</b>	<b>2018</b>
Tax holiday effect	\$26,969	\$23,344	\$ 40,086
Basic earnings per share	\$ 0.26	\$ 0.22	\$ 0.38

**c. Deferred tax assets and liabilities**

Significant components of the Group’s deferred tax assets and liabilities consist of the followings:

	<b>As of December 31,</b> <b>(in thousands)</b>	
	<b>2017</b>	<b>2018</b>
<b>Deferred tax assets</b>		
Net operating loss from operations	\$ 24,869	\$ 28,118
Accrued salary and benefits	6,430	9,110
Intangible assets	2,172	1,524
Others	5,463	6,193
Total deferred tax assets	38,934	44,945
Less: Valuation allowance	(28,834)	(31,478)
Net deferred tax assets	<u>\$ 10,100</u>	<u>\$ 13,467</u>
<b>Deferred tax liabilities</b>		
Withholding tax related to distribution of dividend	\$ 30,992	\$ 79,824
VAT refund	3,451	3,202
Net deferred tax liabilities	<u>\$ 34,443</u>	<u>\$ 83,026</u>

As of December 31, 2017 and 2018, the Group had made a valuation allowance against its deferred tax assets to the extent such deferred tax assets were not expected to be realized by certain subsidiaries and VIEs. The Group evaluated a variety of factors in determining the amount of the valuation allowance, including uncertainty as to the success of the Group’s businesses due to intense competition in the industries in which the Group operates its businesses and the migration of game players to mobile devices.

In 2018, \$6.8 million of PRC net operating losses generated from previous years expired. The remaining PRC net operating losses will expire successively commencing in 2019.

The Group does not believe that sufficient positive evidence exists to support a conclusion that the recoverability of deferred tax assets of certain entities in the Group is more likely than not to be realized. Consequently, the Group has provided full valuation allowances for the deferred tax assets of these entities. The following table sets forth the movement of the aggregate valuation allowances for deferred tax assets for the periods presented:

	For the year ended December 31, (in thousands)		
	2016	2017	2018
Balance as of the beginning of period	\$ 32,534	\$ 32,744	\$ 28,834
Additions charged to expense	7,588	18,391	8,451
Deletions credited to expense	(5,285)	(24,078)	(4,298)
Currency translation	(2,093)	1,777	(1,509)
Balance as of the end of period	\$ 32,744	\$ 28,834	\$ 31,478

## 20. CHINA CONTRIBUTION PLAN

The Company's subsidiaries and VIEs in the PRC participate in a government-mandated multi-employer defined contribution plan pursuant to which certain retirement, medical and other welfare benefits are provided to employees. Chinese labor regulations require the Company's subsidiaries and VIEs in the PRC to pay to the local labor bureau a monthly contribution at a stated contribution rate based on the monthly compensation of qualified employees. The relevant local labor bureau is responsible for meeting all retirement benefit obligations. The Group has no further commitments beyond its monthly contribution. During the years ended December 31, 2016, 2017 and 2018, the Group contributed approximately a total of \$27.3 million, \$27.3 million and \$27.7 million, respectively, to these funds.

## 21. ADVERTISING EXPENSES

Included in sales and marketing expense, advertising expenses generally represent the expenses of promotions to create or stimulate a positive image of the Group or a desire to subscribe for the Group's products and services. Advertising expenses are expensed as incurred. Advertising expenses recognized in the consolidated statements of comprehensive income were \$18.7 million, \$18.1 million and \$16.7 million, respectively, for the years ended December 31, 2016, 2017 and 2018. Advertising expenses charged from Sohu were \$1.0 million, \$0.8 million and \$nil, respectively, for the years ended December 31, 2016, 2017 and 2018.

## 22. STATUTORY RESERVES

The Company's China-based subsidiaries and VIEs are required to make appropriations to certain non-distributable reserve funds.

Pursuant to the China Foreign Investment Enterprises laws, some of the Company's China-based subsidiaries, which are called wholly foreign-owned enterprises, have to make appropriations from their after-tax profit as determined under generally accepted accounting principles in the PRC (the "after-tax-profit under PRC GAAP") to non-distributable reserve funds, including (i) a general reserve fund, (ii) an enterprise expansion fund, and (iii) a staff bonus and welfare fund. Each year, at least 10% of the after-tax-profit under PRC GAAP is required to be set aside to the general reserve fund until such appropriations for the fund equal 50% of the paid-in capital of the applicable entity. Appropriations for the other two reserve funds are at the Company's discretion as determined by the Board of Directors of each entity.

Pursuant to PRC law, some of the Company's China-based subsidiaries, which are called domestically funded enterprises, as well as the Company's VIEs, have to make appropriations from their after-tax-profit under PRC GAAP to non-distributable reserve funds, including a statutory surplus fund and a discretionary surplus fund. Each year, at least 10% of the after-tax-profit under PRC GAAP is required to be set aside to the statutory surplus fund until appropriations for the fund equal 50% of the registered capital of the applicable entity. Appropriations for the discretionary surplus fund are at the Company's discretion as determined by the Board of Directors of each entity.

Upon certain regulatory approvals and subject to certain limitations, the general reserve fund and the statutory surplus fund can be used to offset prior year losses, if any, and can be converted into paid-in capital of the applicable entity.

For the years ended December 31, 2016, 2017 and 2018, profit appropriation to the statutory surplus fund was approximately \$0.3 million, \$7.2 million and \$6.3 million, respectively.

## 23. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted net income per share for the years indicated:

	For the year ended December 31, (in thousands, except per share data)		
	2016	2017	2018
<b>Numerator:</b>			
Net income attributable to Changyou.com Limited	\$ 144,947	\$ 108,834	\$ 84,332
Numerator for basic earnings per share	144,947	108,834	84,332
Numerator for diluted earnings per share	144,936	108,838	84,332
<b>Denominator:</b>			
Weighted average number of ordinary shares outstanding — basic	104,560	105,188	106,170
Incremental shares from treasury stock method	1,718	1,382	1,066
Weighted average number of ordinary shares outstanding — diluted	<u>106,278</u>	<u>106,570</u>	<u>107,236</u>
Basic net income per share	\$ 1.39	\$ 1.03	\$ 0.79
Diluted net income per share	\$ 1.36	\$ 1.02	\$ 0.79

As of December 31, 2016, 2017 and 2018, no outstanding non-vested restricted shares or share options were excluded from the computation of dilutive income per share for the years ended December 31, 2016, 2017 and 2018. The dilutive effects of restricted shares and share options are calculated using the treasury stock method.

## 24. SEGMENT INFORMATION

Operating segments are defined as components of an enterprise about which separate financial information is available and is evaluated regularly by the CODM, or a decision making group, in deciding how to allocate resources and in assessing performance. From November 2, 2014 to July 31, 2016, the CODMs were the Company's former Co-Chief Executive Officers; and since August 1, 2016, the CODM has been the Company's current Chief Executive Officer.

The Company's organizational structure is based on a number of factors that the CODM uses to evaluate, view and run the Company's business operations, which include, but are not limited to, customer base, homogeneity of products and technology. The Company's operating segments are based on its organizational structure and information reviewed by the Company's CODM to evaluate the operating segment results.

As of December 31, 2016 and December 31, 2017, the business segments that constituted the Company's reportable segments were the Online Game segment, which consisted primarily of PC games and mobile games; the Platform Channel segment, which consisted primarily of online advertising services offered on the 17173.com Website, and also included IVAS offered on the Dolphin Browser, which was operated by MoboTap, and by RaidCall and online card and board games offered by MoboTap; and the Cinema Advertising segment.

The Company disposed of the MoboTap business in March 2018 and, as a result, as of December 31, 2018 the business segments that constituted the Company's reportable segments were the Online Game segment, which consisted primarily of PC games and mobile games; the Platform Channel segment, which consisted primarily of online advertising services offered on the 17173.com Website, and also included IVAS offered by RaidCall; and the Cinema Advertising segment.

Year Ended December 31, 2018

(US\$ in thousands)

	Online Game	Platform Channel	Cinema Advertising	Eliminations and adjustments	Consolidated
<b>Revenues (1):</b>					
Online game	389,790	—	—	—	389,790
Online advertising	—	19,988	—	(291)	19,697
Cinema advertising	—	—	76,775	(6,573)	70,202
IVAS	—	6,074	—	—	6,074
<b>Total revenues</b>	<b>389,790</b>	<b>26,062</b>	<b>76,775</b>	<b>(6,864)</b>	<b>485,763</b>
<b>Cost of revenues:</b>					
Online game	61,014	—	—	—	61,014
Online advertising	—	5,204	—	—	5,204
Cinema advertising	—	—	89,233	—	89,233
IVAS	—	5,408	—	—	5,408
SBC (2) in cost of revenues	(31)	—	—	—	(31)
<b>Total cost of revenues</b>	<b>60,983</b>	<b>10,612</b>	<b>89,233</b>	<b>—</b>	<b>160,828</b>
<b>Gross profit/(loss)</b>	<b>328,807</b>	<b>15,450</b>	<b>(12,458)</b>	<b>(6,864)</b>	<b>324,935</b>
<b>Operating expenses:</b>					
Product development	119,560	7,033	—	—	126,593
Sales and marketing	39,026	2,350	20,288	(6,864)	54,800
General and administrative	24,347	4,310	4,965	—	33,622
Goodwill impairment and impairment of acquired intangibles via acquisition of businesses	—	16,369	—	—	16,369
SBC (2) in operating expenses	(6,430)	—	—	—	(6,430)
<b>Total operating expenses</b>	<b>176,503</b>	<b>30,062</b>	<b>25,253</b>	<b>(6,864)</b>	<b>224,954</b>
<b>Operating profit/(loss)</b>	<b>152,304</b>	<b>(14,612)</b>	<b>(37,711)</b>	<b>—</b>	<b>99,981</b>
Interest income	34,397	6	6	—	34,409
Foreign currency exchange gain/(loss)	1,474	(154)	—	—	1,320
Interest expense	(10,197)	—	—	—	(10,197)
Other income/(expense), net	23,446	(10)	(557)	—	22,879
<b>Income/(loss) before income tax expense</b>	<b>201,424</b>	<b>(14,770)</b>	<b>(38,262)</b>	<b>—</b>	<b>148,392</b>
Income tax expense	64,467	—	—	—	64,467
<b>Net income/(loss)</b>	<b>136,957</b>	<b>(14,770)</b>	<b>(38,262)</b>	<b>—</b>	<b>83,925</b>
Less: Net loss attributable to the non-controlling interest	(42)	(365)	—	—	(407)
<b>Net income/(loss) attributable to Changyou.com Limited</b>	<b>136,999</b>	<b>(14,405)</b>	<b>(38,262)</b>	<b>—</b>	<b>84,332</b>

Year Ended December 31, 2017

(US\$ in thousands)

	Online Game	Platform Channel	Cinema Advertising	Eliminations and adjustments	Consolidated
<b>Revenues (1):</b>					
Online game	443,625	5,908	—	—	449,533
Online advertising	—	25,311	—	(182)	25,129
Cinema advertising	—	—	91,419	—	91,419
IVAS	—	14,180	—	—	14,180
<b>Total revenues</b>	<b>443,625</b>	<b>45,399</b>	<b>91,419</b>	<b>(182)</b>	<b>580,261</b>
<b>Cost of revenues:</b>					
Online game	61,837	864	—	—	62,701
Online advertising	—	6,660	—	—	6,660
Cinema advertising	—	—	84,944	—	84,944
IVAS	—	9,408	—	—	9,408
SBC (2) in cost of revenues	73	—	—	—	73
<b>Total cost of revenues</b>	<b>61,910</b>	<b>16,932</b>	<b>84,944</b>	<b>—</b>	<b>163,786</b>
<b>Gross profit</b>	<b>381,715</b>	<b>28,467</b>	<b>6,475</b>	<b>(182)</b>	<b>416,475</b>
<b>Operating expenses:</b>					
Product development	112,886	11,983	—	—	124,869
Sales and marketing	34,389	2,876	22,622	(182)	59,705
General and administrative	29,055	4,330	3,833	—	37,218
Goodwill impairment and impairment of acquired intangibles via acquisition of businesses	—	86,882	—	—	86,882
SBC (2) in operating expenses	17,296	24	—	—	17,320
<b>Total operating expenses</b>	<b>193,626</b>	<b>106,095</b>	<b>26,455</b>	<b>(182)</b>	<b>325,994</b>
<b>Operating profit/(loss)</b>	<b>188,089</b>	<b>(77,628)</b>	<b>(19,980)</b>	<b>—</b>	<b>90,481</b>
Interest income	32,203	116	—	—	32,319
Foreign currency exchange loss	(5,007)	(189)	—	—	(5,196)
Interest expense	(4,372)	—	—	—	(4,372)
Other income/(expense), net	7,974	1,439	(39)	—	9,374
<b>Income/(loss) before income tax expense</b>	<b>218,887</b>	<b>(76,262)</b>	<b>(20,019)</b>	<b>—</b>	<b>122,606</b>
Income tax expense	40,252	3	512	—	40,767
<b>Net income/(loss)</b>	<b>178,635</b>	<b>(76,265)</b>	<b>(20,531)</b>	<b>—</b>	<b>81,839</b>
Less: Net income/(loss) attributable to the non-controlling interest	4	(26,999)	—	—	(26,995)
<b>Net income/(loss) attributable to Changyou.com Limited</b>	<b>178,631</b>	<b>(49,266)</b>	<b>(20,531)</b>	<b>—</b>	<b>108,834</b>

Year Ended December 31, 2016

(US\$ in thousands)

	Online Game	Platform Channel	Cinema Advertising	Eliminations and adjustments	Consolidated
<b>Revenues:</b>					
Online game	380,537	15,171	—	—	395,708
Online advertising	—	39,409	—	—	39,409
Cinema advertising	—	—	68,542	—	68,542
IVAS	—	21,726	—	—	21,726
<b>Total revenues</b>	<b>380,537</b>	<b>76,306</b>	<b>68,542</b>	<b>—</b>	<b>525,385</b>
<b>Cost of revenues:</b>					
Online game	94,900	1,240	—	—	96,140
Online advertising	—	10,104	—	—	10,104
Cinema advertising	—	—	45,959	—	45,959
IVAS	—	13,576	—	—	13,576
SBC (2) in cost of revenues	31	—	—	—	31
<b>Total cost of revenues</b>	<b>94,931</b>	<b>24,920</b>	<b>45,959</b>	<b>—</b>	<b>165,810</b>
<b>Gross profit</b>	<b>285,606</b>	<b>51,386</b>	<b>22,583</b>	<b>—</b>	<b>359,575</b>
<b>Operating expenses:</b>					
Product development	97,990	20,748	—	—	118,738
Sales and marketing	26,898	12,720	16,353	—	55,971
General and administrative	36,032	6,070	3,540	—	45,642
SBC (2) in operating expenses	8,301	70	—	—	8,371
<b>Total operating expenses</b>	<b>169,221</b>	<b>39,608</b>	<b>19,893</b>	<b>—</b>	<b>228,722</b>
<b>Operating profit</b>	<b>116,385</b>	<b>11,778</b>	<b>2,690</b>	<b>—</b>	<b>130,853</b>
Interest income	21,562	67	—	(139)	21,490
Foreign currency exchange gain	4,905	203	—	—	5,108
Interest expense	(4,321)	(139)	—	139	(4,321)
Other income, net	13,964	1,378	181	—	15,523
<b>Income before income tax expense</b>	<b>152,495</b>	<b>13,287</b>	<b>2,871</b>	<b>—</b>	<b>168,653</b>
Income tax expense/(credit)	23,689	161	(2,267)	—	21,583
<b>Net income</b>	<b>128,806</b>	<b>13,126</b>	<b>5,138</b>	<b>—</b>	<b>147,070</b>
Less: Net income attributable to the non-controlling interest	—	2,123	—	—	2,123
<b>Net income attributable to Changyou.com Limited</b>	<b>128,806</b>	<b>11,003</b>	<b>5,138</b>	<b>—</b>	<b>144,947</b>

Note (1): The intra-group elimination for segment revenues mainly consists of sales and marketing services provided by the platform channel business and the cinema advertising business to the online game business.

Note (2): "SBC" stands for share-based compensation expense/(benefit).



## 25. TREASURY SHARES

On July 27, 2013, the Company's Board of Directors approved a share repurchase program, pursuant to which the Company may repurchase from time to time at management's discretion, at prevailing market prices in the open market in accordance with Rule 10b-18 under the Securities Exchange Act of 1934, up to \$100 million of the Company's outstanding ADSs over a two-year period from July 27, 2013 to July 26, 2015. As of July 26, 2015, the Company had repurchased under the Share Repurchase Program an aggregate of 1,364,846 ADSs, representing 2,729,692 Class A ordinary shares, at an average price of \$25.9 per ADS, or \$12.95 per Class A ordinary share, for aggregate consideration of \$35 million. These shares were recorded at their historical purchase cost of \$35 million and were not canceled.

## 26. RELATED PARTY TRANSACTIONS

The table below sets forth major related parties and their relationships with the Group:

<u>Company name</u>	<u>Relationship with the Group</u>
Sohu	Under common control of Sohu.com
Fox Financial	An associate of Sohu, over which Sohu has significant influence

### *Matching loans between Changyou and Sohu*

During 2016, 2017 and 2018, certain subsidiaries of the Company and certain subsidiaries of Sohu entered into a series of one-year loan agreements, pursuant to which the subsidiaries of the Company are entitled to draw down U.S. dollar-denominated loans from the Sohu subsidiaries and the Sohu subsidiaries are entitled to draw down equivalent RMB-denominated loans from the subsidiaries of the Company, to facilitate each other's business operations. All of the loans carry a fixed rate of interest equal to the current market interest rate as of the dates when the principal was drawn down. As of December 31, 2016, 2017 and 2018, the Company had drawn down from the Sohu subsidiaries loans in an aggregate principal amount of \$350 million, \$365 million and \$602 million, respectively, and Sohu had drawn down from the subsidiaries of the Company loans in an aggregate principal amount of RMB2.21 billion (approximately \$318.2 million), RMB2.31 billion (approximately \$353.8 million) and RMB3.88 billion (approximately \$565.7 million), respectively. For the years ended December 31, 2016, 2017 and 2018, interest income that the Company earned from such RMB-denominated loans was \$9.8 million, \$13.0 million and \$15.9 million, respectively, and interest expense that the Company accrued for such U.S. dollar-denominated loans was \$3.1 million, \$3.6 million and \$8.3 million, respectively.

### *Matching loans between Changyou and Fox Financial*

During 2015, certain subsidiaries of the Company and certain subsidiaries of Fox Financial Technology Group Limited ("Fox Financial," formerly known as "SoEasy Internet Finance Group Limited"), entered into a series of one-year loan agreements, pursuant to which the subsidiaries of the Company were entitled to draw down HK dollar-denominated loans from the Fox Financial subsidiaries and the Fox Financial subsidiaries were entitled to draw down equivalent RMB-denominated loans from the subsidiaries of the Company. During 2016, the Company repaid the subsidiaries of Fox Financial all of the outstanding principal, in the amount of HK\$100 million (approximately \$12.9 million), under the loans and paid interest of HK\$1.4 million (approximately \$0.2 million), and the subsidiaries of Fox Financial repaid the subsidiaries of the Company all of the outstanding principal, in the amount of RMB80 million (approximately \$12.3 million), under the loans and paid interest of RMB4.7 million (approximately \$0.7 million).

During 2016, certain subsidiaries of the Company and certain subsidiaries of Fox Financial entered into a series of one-year loan agreements, pursuant to which the subsidiaries of Fox Financial are entitled to draw down RMB-denominated loans from the subsidiaries of the Company, which in turn are entitled to draw down equivalent U.S. dollar-denominated loans from the Fox Financial subsidiaries, to facilitate each other's business operations. Under the initial terms of the loan agreements, the subsidiaries of the Company were required to repay principal of the U.S. dollar-denominated loans in an amount equal to the original principal amount of the equivalent RMB-denominated loans divided by the RMB to U.S. dollar exchange rate that was in effect on the date of the repayment, and the resulting exchange gain or loss was recognized for each reporting period. All of such loan agreements were amended in March 2018 to provide that all the outstanding principal and accrued interest of a loan will be repaid in the same currency in which the original principal of the loan was denominated. Therefore, no further exchange gain or loss will be recognized. All of the loans carry a fixed rate of interest equal to the current market interest rate as of the dates when the loan agreements were entered into.

As of December 31, 2016 and 2017, the Company had drawn down from the subsidiaries of Fox Financial loans in an aggregate principal amount of \$28.1 million and \$29.8 million, respectively, and the subsidiaries of Fox Financial had drawn down from the subsidiaries of the Company loans in an aggregate principal amount of RMB195 million (approximately \$28.1 million) and RMB195 million (approximately \$29.8 million), respectively. In December 2018, the Company entered into a supplemental agreement with Fox Financial pursuant to which all accrued and unpaid interest on the loans as of December 31, 2018 was added to the principal of the corresponding loans. As of December 31, 2018, the aggregate principal amount due to the subsidiaries of Fox Financial was \$32.7 million and the aggregate principal amount due from the subsidiaries of Fox Financial was RMB216.9 million (approximately \$31.6 million). For the years ended December 31, 2016, 2017 and 2018, interest income that the Company earned from the RMB-denominated loans was \$1.2 million, \$1.2 million and \$1.1 million, respectively, interest expense that the Company accrued for the U.S. dollar-denominated loans was \$0.7 million, \$0.7 million and \$0.5 million, respectively, and exchange gain/(loss) recognized was \$1.9 million, negative \$1.8 million and negative \$1.0 million, respectively.

#### *Loans between Changyou and Sohu*

On October 24, 2016, AmazGame entered into a loan agreement (the “Sohu Loan Agreement”) with Beijing Sohu New Media Information Technology Co., Ltd. (“Sohu Media”), a PRC company that is an indirect wholly-owned subsidiary of Sohu, pursuant to which Sohu Media may borrow from time to time from AmazGame up to RMB1.0 billion (or approximately \$148.64 million). The first request for an advance under the Sohu Loan Agreement was required to be made on or prior to December 31, 2016, and requests for further advances may be made for one year following the initial advance. Such one-year request period may be extended for another one-year period with the consent of AmazGame. Principal amounts outstanding under the Sohu Loan Agreement will bear interest at an annual rate of 6%. The outstanding principal of each advance will be due one year from the date of the advance, subject to extension for an additional year with the consent of AmazGame.

Also on October 24, 2016, Changyou and Sohu.com (Game) Limited (“Sohu Game”), a Cayman Islands company that is an indirect subsidiary of Sohu and is the direct parent of Changyou, entered into a share pledge agreement (the “Sohu Share Pledge Agreement”) pursuant to which Sohu Game pledged to Changyou an agreed-upon number of Changyou Class B ordinary shares of Changyou held by Sohu Game, to secure Sohu Media’s obligations under the Sohu Loan Agreement. The Sohu Share Pledge Agreement gives Changyou the right to apply the outstanding principal and accrued interest under the Sohu Loan Agreement to the repurchase of Changyou Class B ordinary shares from Sohu Game in the event that such principal and interest are not paid when due. As of the date of this report, Sohu Game had pledged to Changyou 21,847,751 Class B ordinary shares in Changyou held by Sohu Game.

During 2016 and 2017, Sohu Media received advances aggregating RMB500 million (or approximately \$72.1 million) and RMB500 million (or approximately \$76.5 million), respectively, under the Sohu Loan Agreement. The due dates of the principal of each of the advances have been extended additional one-year periods on 31 December, 2017 and 31 December, 2018, respectively. The Company reclassified RMB500 million (or approximately \$76.5 million) and RMB500 million (or approximately \$72.9 million) of such loans into other non-current assets as of December 31, 2017 and December 31, 2018, respectively. The Company earned interest income of \$0.2 million, \$8.0 million and \$8.2 million, respectively, from these loans for the years ended December 31, 2016, 2017 and 2018.

During the years ended December 31, 2016, 2017 and 2018, significant related party transactions were as follows:

	For the year ended December 31, (in thousands)		
	2016	2017	2018
<b>Transactions with Sohu</b>			
<i>Services provided by Sohu</i>			
Sales and marketing services provided by Sohu	\$1,039	\$ 802	\$ —
Interest expense on matching loans	3,065	3,648	8,250
<i>Services provided to Sohu</i>			
Interest income on matching loans	\$9,799	\$13,006	\$ 15,858
Interest income on loan between Changyou and Sohu	207	7,999	8,246

	For the year ended December 31, (in thousands)		
	2016	2017	2018
<b>Transactions with Fox Financial</b>			
<i>Services provided by Fox Financial</i>			
Interest expense on matching loans	\$ 662	\$ 724	\$ 519
<i>Services provided to Fox Financial</i>			
Interest income on matching loans	\$1,244	\$ 1,157	\$ 1,051

As of December 31, 2017 and 2018, significant amounts due to related parties were as follows:

	As of December 31, (in thousands)	
	2017	2018
Due to Sohu (matching loans from Sohu)	\$365,000	\$ 610,250
Due to Fox Financial (matching loans from Fox Financial)	31,192	32,718

As of December 31, 2017 and 2018, significant amounts due from related parties were as follows:

	As of December 31, (in thousands)	
	2017	2018
Due from Sohu (matching loans)	\$353,777	\$ 583,147
Due from Sohu (loans between Changyou and Sohu)	156,846	153,759
Due from Fox Financial (matching loans)	32,005	31,607

The transactions are measured at the amount of consideration established and agreed to by the related parties, which approximates amounts charged to third parties.

## 27. COMMITMENTS AND CONTINGENCIES

The Group has future rental commitments related to its bandwidth leasing charges, office rental, fees for operating rights for licensed games in development and certain other services as follows:

	Bandwidth leasing (in thousands)	Fees for office rental and property management (in thousands)	Fees for operating rights of licensed games in development (in thousands)	Interest payment commitment (in thousands)	Others (in thousands)
2019	\$ 2,303	\$ 2,088	\$ 585	\$ 8,419	\$ 240
2020	72	774	—	8,419	—
2021 and thereafter	—	—	—	7,062	—
<b>Total minimum payments required</b>	<b>\$ 2,375</b>	<b>\$ 2,862</b>	<b>\$ 585</b>	<b>\$ 23,900</b>	<b>\$ 240</b>

Rental expenses, including bandwidth leasing charges and office rental, were approximately \$19.6 million, \$11.2 million and \$11.5 million, respectively, for the years ended December 31, 2016, 2017 and 2018, and were charged to the statements of comprehensive income as incurred.

The total amount outstanding under the long-term bank loans as of December 31, 2018 was \$220.0 million, all of which carried a floating rate of interest based on the LIBOR. These bank loans were secured by an equivalent or greater amount of RMB deposits by Changyou in the onshore branches of such banks. The Company estimated the interest it expected to pay based on LIBOR as of December 31, 2018 would be \$8.4 million in 2019, \$8.4 million in 2020 and \$7.1 million in 2021. Outstanding principal of the bank loans totaling \$80.0 million was repaid in January 2019.

The Group estimated future capital commitments related to expenditures for rights to titles and characters for games in development, operating rights of licensed games with technological feasibility and pre-film advertising slot rights to be as follows:

	Expenditures for rights to titles and characters for games in development (in thousands)	Expenditures for operating rights of licensed games with technological feasibility (in thousands)	Pre-film advertising slot rights (in thousands)
2019	\$ 6,990	\$ 19,475	\$ 56,396
2020	725	1,098	40,579
2021 and thereafter	—	—	28,186
<b>Total minimum payments required</b>	<u>\$ 7,715</u>	<u>\$ 20,573</u>	<u>\$ 125,161</u>

The Group did not have any other significant capital or other commitments or guarantees as of December 31, 2018.

The Group did not have any material interest or penalties associated with tax positions, nor did the Group have any significant unrecognized uncertain tax positions as of December 31, 2018.

The Group is not currently a party to any legal proceeding, investigation or claim which, in the opinion of the Group's management, is likely to have a material adverse effect on the Group's business, financial condition or results of operations.

## 28. RESTRICTED NET ASSETS

Relevant PRC law and regulations permit payment of dividends by PRC-based operating entities such as AmazGame, Gamease, Gamespace, Guanyou Gamespace and Chuangxiang only out of their retained earnings, if any, as determined in accordance with PRC accounting standards and regulations. In addition, a PRC-based operating entity is required to annually appropriate 10% of net after-tax income to the statutory surplus reserve fund prior to payment of any dividends, unless the amount of the reserve fund has reached 50% of the entity's registered capital. As a result of these and other restrictions under PRC law and regulations, PRC-based operating entities are restricted in their ability to transfer a portion of their net assets to the Company either in the form of dividends, loans or advances, which restricted portion amounted to approximately \$256.5 million, or 31% of the Company's total consolidated net assets, as of December 31, 2018.

## 29. SUBSEQUENT EVENTS

On March 15, 2019, the Company's Board of Directors approved a plan for the Company to cease operation of RaidCall. The shutdown of RaidCall will not be recorded as a discontinued operation, and the Company does not expect to incur additional expenses for RaidCall, other than out-of-pocket expenses in connection with the shutdown process.

The Company has performed an evaluation of subsequent events through the date of this report, which is the date the financial statements were issued, with no other material events or transactions needing recognition or disclosure found.

## 30. ADDITIONAL INFORMATION — CONDENSED FINANCIAL STATEMENTS

The condensed financial statements of Changyou.com Limited have been prepared in accordance with Securities and Exchange Commission Regulation S-X Rule 5-04 and Rule 12-04.

The Company records its investments in subsidiaries under the equity method of accounting. Such investments and long-term loans to subsidiaries are presented on the balance sheet as "Interests in subsidiaries and variable interest entities" and the profit of the subsidiaries is presented as "Share of profit of subsidiaries and variable interest entities" in the statement of comprehensive income.

For the Company's VIEs, where the Company is the primary beneficiary, the amount of the Company's investment is included in the balance sheet as "Interests in subsidiaries and variable interest entities" and the profit or loss of the VIEs is included in "Share of profit of subsidiaries and variable interest entities" in the statement of comprehensive income.

The footnote disclosures contain supplemental information relating to the operations of the Company and, as such, these financial statements should be read in conjunction with the notes to the Consolidated Financial Statements of the Company. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted.

As of December 31, 2017 and 2018, there were no material contingencies, significant provisions for long-term obligations, or guarantees of the Company, except for those, if any, which have been separately disclosed in the consolidated financial statements.

Financial information of Changyou.com Limited

Condensed Balance Sheets

(In thousands, except par value)

	As of December 31,	
	2017	2018
	US\$	US\$
<b>Assets</b>		
Cash and cash equivalents	7,349	40,527
<b>Total current assets</b>	<b>7,349</b>	<b>40,527</b>
Interests in subsidiaries and variable interest entities	1,305,224	1,400,180
<b>Total assets</b>	<b>1,312,573</b>	<b>1,440,707</b>
<b>Liabilities and shareholders' equity</b>		
Matching loans	—	610,250
Accrued liabilities	568	722
<b>Total current liabilities</b>	<b>568</b>	<b>610,972</b>
<b>Total liabilities</b>	<b>568</b>	<b>610,972</b>
<b>Shareholders' equity</b>		
Class A ordinary shares (par value \$0.01; 200,000 authorized; 35,186 and 36,251 issued and outstanding as of December 31, 2017 and 2018, respectively)	379	390
Class B ordinary shares (par value \$0.01; 97,740 authorized; 70,250 and 70,250 issued and outstanding as of December 31, 2017 and 2018, respectively)	703	703
Additional paid-in capital	138,750	132,289
Treasury shares (2,730 and 2,730 shares, respectively, as of December 31, 2017 and 2018)	(35,323)	(35,323)
Statutory reserves	14,277	20,568
Retained earnings	1,197,617	775,972
Accumulated other comprehensive loss	(4,398)	(64,864)
<b>Total shareholders' equity</b>	<b>1,312,005</b>	<b>829,735</b>
<b>Total liabilities and shareholders' equity</b>	<b>1,312,573</b>	<b>1,440,707</b>

Financial information of Changyou.com Limited

Condensed Statements of Comprehensive Income

(In thousands)

	For the year ended		
	December 31,		
	2016	2017	2018
	US\$	US\$	US\$
<b>Operating expenses/(benefit)</b>			
General and administrative	11,937	18,900	(5,526)
<b>Total operating expenses/(benefit)</b>	<b>11,937</b>	<b>18,900</b>	<b>(5,526)</b>
<b>Operating profit/(loss)</b>	<b>(11,937)</b>	<b>(18,900)</b>	<b>5,526</b>
Share of profit of subsidiaries and variable interest entities	149,183	127,712	87,043
Interest income/(expense), net	(2,299)	22	(8,237)
Other non-operating income	10,000	—	—
<b>Income before income tax expense</b>	<b>144,947</b>	<b>108,834</b>	<b>84,332</b>
<b>Net income</b>	<b>144,947</b>	<b>108,834</b>	<b>84,332</b>
Other comprehensive income/(loss)	(66,325)	68,028	(60,466)
<b>Comprehensive income</b>	<b>78,622</b>	<b>176,862</b>	<b>23,866</b>

Condensed Statements of Cash Flows

(In thousands)

	For the year ended		
	December 31,		
	2016	2017	2018
	US\$	US\$	US\$
<b>Net cash (used in)/provided by operating activities</b>	<b>4,001</b>	<b>(1,422)</b>	<b>(759)</b>
<b>Cash flows from investing activities:</b>			
Proceeds from time deposits	478	—	—
Proceeds relating to loans to subsidiaries	343,674	—	—
Investments in subsidiaries	—	—	(68,377)
<b>Net cash (used in)/provided by investing activities</b>	<b>344,152</b>	<b>—</b>	<b>(68,377)</b>
<b>Cash flows from financing activities:</b>			
Proceeds from borrowings	—	—	602,000
Dividend distribution	—	—	(499,686)
Repayment of loans from offshore banks	(344,500)	—	—
<b>Net cash (used in)/provided by financing activities</b>	<b>(344,500)</b>	<b>—</b>	<b>102,314</b>
<b>Net increase/(decrease) in cash and cash equivalents</b>	<b>3,653</b>	<b>(1,422)</b>	<b>33,178</b>
<b>Cash and cash equivalents at beginning of year</b>	<b>5,118</b>	<b>8,771</b>	<b>7,349</b>
<b>Cash and cash equivalents at end of year</b>	<b>8,771</b>	<b>7,349</b>	<b>40,527</b>

Our Ref: LN/2018/094

Date: October 22, 2018

Changyou.com HK Limited  
Room 1901, 19/F., Lee Garden One,  
33 Hysan Avenue. Causeway Bay, Hong Kong

20/F-21/F Bank of America Tower  
12 Harcourt Road, Central, Hong  
Kong  
Tel: (852) 3118-8888  
Fax: (852) 3111-0801  
SWIFT: CMBCHKHH  
<http://hk.cmbchina.com>

Dear Sirs / Madam,

Re: Facility Letter

We, China Merchants Bank Co., Ltd., Hong Kong Branch (the "Bank"), are pleased to offer you (the "Borrower") the general banking facilities (the "Facilities") on the following terms and conditions. In this Facility Letter, words importing the plural shall include the singular and vice versa.

1. Facilities

- 1.1 The Facilities are available up to the earlier of (i) the date falling on 36 months from the first drawdown date and (ii) 5 business days prior to the expiry date of the standby letter of credit issued by China Merchants Bank Beijing Branch in favour of the Bank (the "Standby LC") (the "Maturity Date") by way of the following: Term Loan Facility up to (i) USD equivalent amount of RMB2,000,000,000.00 or (ii) the aggregate amount of the USD Standby LC, whichever is lower. Utilization of the Facilities is subject to the conditions as stated in APPENDIX A.
- 1.2 Subject to the terms and conditions of this Facility Letter, the Facilities shall become available for drawdown up to the date falling 3 months from the date of the Borrower's acceptance of this Facility Letter (the "Availability Period"). An Advance ("Advance") may be drawn down by and made to the Borrower following receipt by the Bank at least 1 business day's prior written notice.
- 1.3 The Borrower shall repay the Facilities in full together with all unpaid interest on the Maturity Date.
- 1.4 Subject to 5 business days' prior written notice to the Bank, the Borrower may prepay the Advance on the last day of any Interest Period. If any Advance is prepaid on a date other than the last day of any Interest Period, the Borrower shall pay to the Bank the break fund cost incurred as a consequence of such prepayment. The amount of any prepayment shall be in the minimum amount of USD30,000,000.00. No amount prepaid may be re-borrowed.

1.5 The Facilities will be subject to review periodically as the Bank deem fit at the Bank's sole and absolute discretion. The Facilities shall expire and be repayable forthwith as and when the Bank have given the Borrower notice of such. Nevertheless, the Bank reserve the right at the Bank's sole and absolute discretion to increase, reduce, cancel and / or demand repayment of the Facilities or any part thereof at any time by notice to the Borrower.

2. Interest

2.1 Interest Period. The Interest Period applicable to each Advance shall have duration of 3 months. No Interest Period shall extend beyond the Maturity Date, and if any Interest Period would extend beyond the Maturity Date, it shall end on the Maturity Date.

2.2 Rate and Calculation. The rate of interest applicable to each Advance or the relevant part thereof for each Interest Period shall be the rate per annum determined by the Bank to be the aggregate of 3-Month LIBOR for that Interest Period, plus 1 % p.a. Interest shall accrue from day to day, shall be calculated on the basis of the actual number of days elapsed and a 365-day year for Hong Kong Dollar or 360-day year for US Dollar or according to the market practice for calculation of other currencies, including the first day of the period during which it accrues but excluding the last, and shall be paid in arrears on the last day of each Interest Period.

2.3 Payments. Any payment to be made by the Borrower or which is otherwise due on a business day on which commercial banks are not open for business in Hong Kong or New York or other relevant place shall instead be due on the next business day in the same calendar month and, if none, on the immediately preceding business day.

3. Fees and Commissions

3.1 Arrangement fee: 0.3% p.a. shall be payable by the Borrower on the last day of each Interest Period.

3.2 Commissions and Fees shall be levied and payable as set out as above. Once paid, such fees shall not be refundable under any circumstances

4. Conditions Precedent

The Facilities will be available for drawing after the Bank have received the following documents in form and substance satisfactory to the Bank:

- a) The Bank's standard General Commercial Agreement duly executed by the Borrower.
- b) This Facility Letter duly executed by the Borrower and the Bank.
- c) Certified true copies of the resolutions of the board of directors of the Borrower approving the borrowing on the terms of this Facility Letter and authorising a person or persons to execute Facility Letter, the notice of drawing and any other notices or documents required in connection herewith.
- d) The Standby LC.
- e) Beijing AmazGame Age Internet Technology Co., Ltd. issue the commitment letter in the form acceptable to the Bank.



f) Such other documents relating to any of the matters contemplated herein as the Bank may reasonably request.

5. Security

5.1 The Facilities are granted against the following security (ies) (the "Security"):-

- The USD Standby LC in the aggregate amount up to USD equivalent amount of RMB2, 000,000,000.00.

5.2 The Bank reserve the right to request for any additional securities as the Bank may deem fit at the Bank's sole and absolute discretion from time to time.

5.3 Nothing in this Facility Letter shall release, terminate or invalidate any security given or security document signed before the date of this Facility Letter. If there is any such security or security document, the same shall continue to secure the Facilities granted or to be granted under this Facility Letter.

6. Default Interest

6.1 The Bank reserve the right to collect default interest on any sum (whether principal or interest) overdue and not paid under any of the Facilities at a rate being the aggregate of 5% p.a. and the interest rate as mentioned in Clause 2.2 above.

6.2 Default interest shall be calculated on the basis of the actual number of days elapsed and a 365-day year for Hong Kong Dollar or 360-day year for US Dollar or according to the market practice for calculation of other currencies.

7. Set Off

The Bank shall have the right without notice to the Borrower or any other person, to set off and apply any credit balance on any account (whether subject to notice or not and whether matured or not and in whatever currency) of the Borrower with the Bank against the liabilities of the Borrower under the Facilities, and the Bank are authorized to purchase with the monies standing to the credit of any such account such other currencies as may be necessary for this purpose.

8. Expenses

The Borrower shall pay to the Bank upon demand all costs, charges and expenses (including legal expenses on a full indemnity basis, stamp or other duties) incurred by the Bank in connection with the Facilities.

9. Taxes and Other Deductions

No Reductions or Withholdings. All sums payable by the Borrower under this Facility Letter shall be paid in full without set-off or counterclaim or any restriction or condition and free and clear of any tax or other deductions or withholdings of any nature. If the Borrower or any other person is required by any law or regulation to make any deduction or withholding (on account of tax or otherwise) from any payment for the account of the Bank, the Borrower shall, together with such payment, pay such additional amount as will ensure that the Bank receives (free and clear of any tax or other deductions or withholdings) the full amount which it would have received if no such deduction or withholding had been required. The Borrower shall promptly forward to the Bank copies of official receipts or other evidence showing that the full amount of any such deduction or withholding has been paid over to the relevant taxation or other authority.

10. Assignment and transfer

The Bank may without prior consent of the Borrower but having given notice to the Borrower assign, transfer or novate all or any part of its rights and obligations under this Facility Letter to another bank or financial institution.

11. General Commercial Agreement

The provisions of the General Commercial Agreement shall also apply to this Facility Letter as if incorporated herein. If there is any conflict between them, this Facility Letter shall prevail.

12. Declaration clause

You represent, declare and undertake to us that the utilization of any facility or use of proceeds drawn under this Facility Letter do not and will not conflict with any law or regulation applicable to you (including without limitation those in force in the Mainland). The above representation and declaration is deemed to be made by you by reference to the facts then existing during the period where the Facilities or any part thereof remain outstanding.

13. Governing Law

This Facility Letter shall be governed by the Laws of Hong Kong SAR. The Borrower hereby irrevocably submits to the non-exclusive jurisdiction of the courts of Hong Kong SAR or arbitration (As decided solely by the Bank) as regards any claims or matter arising hereunder. No person other than the Borrower and the Bank will have any rights under the Contracts (Rights of Third Parties) Ordinance to enforce or enjoy the benefit of any of the provisions of this Facility Letter.

Please signify your agreement and acceptance of this offer by signing and returning to us the duplicate of this Facility Letter within 30 days from the date of this Facility Letter, failing which this offer shall lapse at our discretion.

Should you have any queries, please do feel free to contact our Ms. Renee Yu, at (852) 3118 8577.

Yours faithfully,

For and on behalf of  
China Merchants Bank Co.,Ltd  
Hong Kong Branch

By: /s/ Fan WANG  
Authorized Signature(s)

We agree to accept the Facilities and undertakings and shall be bound by all the terms and conditions.

For and on behalf of  
Changyou.com HK Limited

By: /s/ Dewen CHEN  
Date: 29<sup>th</sup> October, 2018

#### APPENDIX A

Our Ref: LN/2018/094  
Borrower: Changyou.com HK Limited

#### Conditions for Utilization of the Facilities

1. Use of the loan: is limited to repaying the debt of an affiliated company; the original end use of such debt is used as dividends of the borrower Changyou.com Limited in 2012 and 2018;
2. The following materials shall be supplemented prior to the issuance of the loan: (i) reply of the Beijing Branch with respect to the standby letter of credit, reflecting that the pledge is a full-amount guarantee fund/deposit one in China; (ii) a certified true copy of the internal accounts of the borrower at the end of 2017 and the end of Jun. 2018 and those of [Beijing AmazGame Age Internet Technology Co., Ltd.] as of Jul. 2018; and (iii) a commitment letter issued by [Beijing AmazGame Age Internet Technology Co., Ltd.], reflecting that the amount of dividends given to the borrower is not lower than that of our loan.
3. During the term of credit, not less than a period of interest in the borrower's account with us shall be frozen as a guarantee for interest payment;
4. The parent company [Changyou.com Limited] (stock code: CYOU) shall wholly own the borrower and maintain its status as a US listed company, and may not suspend trading for 14 consecutive trading days (except for technical suspension of trading);
5. The borrower shall wholly own [Beijing AmazGame Age Internet Technology Co., Ltd.], and the undistributed profits of [Beijing AmazGame Age Internet Technology Co., Ltd.] shall not be less than the balance of our loan, and an amount for the distribution of after-tax dividends exceeding the sum of the loan balance shall be reserved;

6. Any change of shareholding, sale of major assets, or addition of foreign loans by the borrower or any subsidiary or VIE-structured company thereof shall be subject to our prior consent;
7. Within one month after withdrawal, the borrower shall open a dividend regulation account with us and undertake to deposit the dividends received with us and give priority to repaying our loan with the same;
8. The borrower shall provide its audit accounts for 2017 within two months after issuance;
9. The borrower shall ascertain the source and schedule of repayment of the loan at least three months prior to the expiry of the term of the loan and, if the dividends of any of its subsidiaries are used as the source of repayment, provide the resolution of the board of directors of [Beijing AmazGame Age Internet Technology Co., Ltd.] on the distribution of dividends to the borrower and the tax payment receipt, and the amount of dividends for distribution shall not be lower than that of our loan.

APPLICATION FOR AMENDMENT TO LETTER OF GUARANTEE/STANDBY LETTER OF CREDIT

No. of Credit Facility:

Date: 19<sup>th</sup> Feb, 2019

To: China Merchants Bank Beijing Branch

L/G OR STANDBY L/C No. 110LG1800032 Amount: USD220,000,000.00

Amendment No. 1.

Please amend the above L/G /STANDBY L/C by Swift/Telex as follows

<marked with ( X ) >:

( ) Expiry date is extended to:

( ) Increasing guarantee /credit amount by to

(X) Decreasing guarantee /credit amount by USD80,020,000.00 to USD139,980,000.00

Others:

( )

All other terms and conditions remain unchanged.

Charges and fees if any, are on our a/c No. .

Stamp and signature(s) of the applicant:

For and on behalf of

Beijing AmazGame Age Internet Technology Co., Ltd.

By:/s/ Xiaojian HONG

For and on behalf of

China Merchants Bank Beijing Branch

By: /s/ Zhiming QI

**Principal Subsidiaries and Consolidated Variable Interest Entities of the Registrant**

**Principal Subsidiaries:**

- Changyou.com (HK) Limited, incorporated in Hong Kong.
- Beijing AmazGame Age Internet Technology Co., Ltd., incorporated in the PRC.
- Shanghai Jingmao Culture Communication Co., Ltd, incorporated in the PRC.
- Beijing Changyou Gamespace Software Technology Co., Ltd., incorporated in the PRC.
- Beijing Yang Fan Jing He Information Consulting Co., Ltd, incorporated in the PRC.
- Beijing Changyou Jingmao Film & Culture Communication Co., Ltd., incorporated in the PRC.
- 7Road.com Limited, incorporated in the Cayman Islands.
- 7Road.com HK Limited, incorporated in Hong Kong.
- Changyou.com Webgames (HK) Limited, incorporated in Hong Kong.
- Shenzhen Brilliant Imagination Technologies Co., Ltd., incorporated in the PRC.
- Beijing Changyou Chuangxiang Software Technology Co.,Ltd., incorporated in the PRC.

**Principal Consolidated Variable Interest Entities:**

- Shanghai ICE Information Technology Co., Ltd., incorporated in the PRC.
- Beijing Gamease Age Digital Technology Co., Ltd., incorporated in the PRC.
- Beijing Guanyou Gamespace Digital Technology Co., Ltd., incorporated in the PRC.



www.changyou.com

I, Dewen Chen, certify that:

1. I have reviewed this annual report on Form 20-F of Changyou.com Limited;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;

4. The company's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the company and have:

- a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
- b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
- c) Evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
- d) Disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and

5. The company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of the company's board of directors (or persons performing the equivalent functions):

- a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
- b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control- over financial reporting.

Date: March 28, 2019

By: /s/ Dewen Chen  
Name: Dewen Chen  
Title: Chief Executive Officer





www.changyou.com

I, Yaobin Wang, certify that:

1. I have reviewed this annual report on Form 20-F of Changyou.com Limited;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;

4. The company's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the company and have:

- a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
- b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
- c) Evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
- d) Disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and

5. The company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of the company's board of directors (or persons performing the equivalent functions):

- a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
- b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

Date: March 28, 2019

By: /s/ Yaobin Wang

Name: Yaobin Wang

Title: Chief Financial Officer







[www.changyou.com](http://www.changyou.com)

**Certification Pursuant to Rule 13a-14(b) under the Securities Exchange Act of 1934**

In connection with the Annual Report on Form 20-F of Changyou.com Limited (the “Company”) for the year ended December 31, 2018 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Dewen Chen, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition of the Company as of December 31, 2018 and results of operations of the Company for the year ended December 31, 2018.

/s/ Dewen Chen

Name: Dewen Chen

Title: Chief Executive Officer

Date: March 28, 2019





[www.changyou.com](http://www.changyou.com)

**Certification Pursuant to Rule 13a-14(b) under the Securities Exchange Act of 1934**

In connection with the Annual Report on Form 20-F of Changyou.com Limited (the “Company”) for the year ended December 31, 2018 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Yaobin Wang, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition of the Company as of December 31, 2018 and results of operations of the Company for the year ended December 31, 2018.

/s/ Yaobin Wang

Name: Yaobin Wang  
Title: Chief Financial Officer

Date: March 28, 2019



**Consent of Independent Registered Public Accounting Firm**

We hereby consent to the incorporation by reference in the Registration Statements on Form S-8 (No. 333-161727 and No. 333-202065) of Changyou.com Limited of our report dated March 28, 2019 relating to the consolidated financial statements and the effectiveness of internal control over financial reporting, which appears in this Form 20-F.

/s/ PricewaterhouseCoopers Zhong Tian LLP

PricewaterhouseCoopers Zhong Tian LLP

Beijing, the People's Republic of China  
March 28, 2019



March 28, 2019

Changyou.com Limited  
Changyou Creative Industrial Park  
65 Bajiao East Road, Shijingshan District  
Beijing 100043  
People’s Republic of China

Subject: Consent of Haiwen & Partners

We hereby consent to the filing of this consent letter as an exhibit to the annual report on Form 20-F of Changyou.com Limited (the “Company”) for the Company’s fiscal year ended December 31, 2018, to be filed with the U.S. Securities and Exchange Commission (the “SEC”) on or about March 28, 2019 (the “Form 20-F”).

We also hereby consent to the use of our firm name and summaries of our firm’s opinions under the headings “Business Overview – PRC Regulation” and “Organizational Structure” in the Form 20-F and to the incorporation by reference in the Company’s Registration Statements on Form S-8 (File No. 333-161727 and File No. 333-202065), initially filed with the SEC on September 4, 2009 and February 13, 2015, respectively, of such references to our firm and summaries of our firm’s opinions included under such headings.

Yours faithfully,

/s/ Haiwen & Partners

**Haiwen & Partners**

海问律师事务所 HAIWEN & PARTNERS

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