Giant Interactive Group Inc.
Form 20-F
April 29, 2014
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549.

FORM 20-F

(Mark One)

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

OR

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

For the fiscal year ended December 31, 2013

OR

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

For the transition period from __________ to __________.

OR

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

Date of event requiring this shell company report

Commission file number: 001-33759

Giant Interactive Group Inc.

(Exact name of Registrant as specified in its charter)

Not applicable

(Translation of Registrant s name into English)

Cayman Islands

(Jurisdiction of incorporation or organization)

11/F, No. 3 Building, 700 Yishan Road

Shanghai, 200233, People s Republic of China

(Address of principal executive offices)

Jazy Zhang Chief Financial Officer

12/F, No. 3 Building, 700 Yishan Road

Shanghai, 200233,

People s Republic of China

Telephone: (86 21) 3397 9999

Facsimile: (86 21) 3397 9948

(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	Name of each exchange on which registered
American Depositary Shares, each representing one ordinary share, par value US$0.0000002 per share	New York Stock Exchange

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

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: 240,499,872 ordinary shares, par value US$0.0000002 per share.

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

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

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

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

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

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

U.S. GAAP x 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 x No

GIANT INTERACTIVE GROUP INC.

TABLE OF CONTENTS

Table of Contents

INTRODUCTION

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

- we, us, our company, and our refer to Giant Interactive Group Inc., and, unless the context requires otherwise, its predecessor entities and subsidiaries, and its consolidated affiliated entities;

- Eddia International refers to Eddia International Group Limited;

- Giant HK refers to Giant Interactive (HK) Limited;

- Giant Network refers to Shanghai Giant Network Technology Co., Ltd.;

- PRC subsidiaries refers to subsidiaries of our Company that are organized and existing under the laws of PRC, consisting of:

  - Beijing Giant Zhengtu Network Technology Co., Ltd., or Beijing Giant Zhengtu,

  - Hangzhou Snow Wolf Software Co., Ltd., or Snow Wolf Software,

  - Shanghai Juhuan Network Technology Co., Ltd., or Juhuan Network,

  - Shanghai Juhuo Network Technology Co., Ltd., or Juhuo Network,

  - Shanghai Jujia Network Technology Co., Ltd., or Jujia Network,

  - Shanghai Jujia Network Technology Co., Ltd. (II), or Jujia Network II,

  - Shanghai Jumao Culture Creativity Co., Ltd., or Jumao Culture,

  - Shanghai Juquan Network Technology Co., Ltd., or Juquan Network, Shanghai Juxiao Real Estate Co, Ltd., or Juxiao Real Estate (formerly known as Giant Jiante (Shanghai) Real Estate Co., Ltd., or Jiante Real Estate),

Shanghai Juyan Network Technology Co., Ltd., or Juyan Network,

Shanghai Zhengduo Information Technology Co., Ltd., or Zhengduo Information,

Shanghai Zhengju Information Technology Co., Ltd., or Zhengju Information,

Shanghai Zhengtu Information Technology Co., Ltd., or Zhengtu Information, and

Zhuhai Zhengtu Information Technology Co., Ltd., or Zhuhai Zhengtu;

PRC entities refers to PRC subsidiaries, and Giant Network and its subsidiaries, as defined hereinafter;

Giant Network and its subsidiaries refers to Giant Network and its subsidiaries, consisting of:

Beijing Haishen Network Technology Co., Ltd., or Haishen Network,

Beijing Julun Network Information Technology Co., Ltd., or Julun Network,

Giant Mobile Technology Co., Ltd., or Giant Mobile,

Shanghai Juhe Network Technology Co., Ltd., or Juhe Network,

Shanghai Jujia Network Technology Co., Ltd. (III), or Jujia Network III,

Shanghai Juxin Network Technology Co., Ltd., or Juxin Network, and

Shanghai Juzi Information Technology Co., Ltd., or Juzi Information;

China or PRC refers to the People s Republic of China, excluding, for purposes of this annual report only, Taiwan and the Special Administrative Regions of Hong Kong and Macau;

monthly average concurrent users, or monthly ACU, of any of our games is determined as follows: we first determine the number of users logged onto the game at five-minute intervals, and average that data over the course of a day to derive the daily average. The daily average data are then averaged over the monthly period to derive the monthly average concurrent users;

quarterly active paying accounts, or APA, is the aggregate number of accounts for our games that have been charged at least once during the quarterly period;

quarterly average concurrent users, or quarterly ACU, of any of our games is the average of monthly average concurrent users, as defined above, of such game during the quarterly period;

1

Table of Contents

quarterly average revenues per user, or ARPU, is our online game net revenues during the quarterly period divided by the quarterly active paying accounts of these games during the quarterly period; our definition of ARPU may not be comparable to similarly titled measures presented by other online game companies;

quarterly peak concurrent users, or PCU, of any of our games is the peak concurrent users of such game during the quarterly period;

a shard is, with respect to an online game, one of multiple independent copies of the game world. In a sharded game, such as Zheng Tu Online, or ZT Online, or Giant Online, players may only interact with other players in one shard at one time;

all references to Renminbi or RMB are to the legal currency of China, all references to US dollars , dollars or US$ are to the legal currency of the United States, and all references to HK$ are to the legal currency of the Hong Kong Special Administrative Region of China;

ordinary shares refers to our ordinary shares, par value US$0.0000002 per share;

ADSs refers to our American depositary shares, each of which represents one ordinary share;

ADRs refers to American depositary receipts, which, if issued, evidence our ADSs;

PRC GAAP refers to accounting principles and the relevant financial regulations applicable to PRC enterprises;

US GAAP refers to generally accepted accounting principles in the United States;

virtual currency refers to a form of online platform currency which is made available for purchase through game operator s platform, website or prepaid cards and which may be exchanged for virtual coins within different games but which has no real value and may not be converted or exchanged for any real world goods, real world services or hard currency. By way of example and clarification, game points are virtual currency in our game platform; and

virtual coins refer to our in-game currency which exists in each specific game, upon redemption of game points by players at a fixed exchange rate determined by the Company, and can be used to purchase in-game virtual items and services within the game.

This annual report on Form 20-F includes our audited consolidated balance sheets as of December 31, 2012 and 2013, and the related consolidated statements of operation and comprehensive income, cash flows and changes in shareholders equity of each of the years ended December 31, 2011, 2012 and 2013.

We and certain of our shareholders completed the initial public offering of 65,777,036 ADSs, each representing one ordinary share, on November 6, 2007. Our ADSs are listed on the New York Stock Exchange under the symbol GA.

Table of Contents

FORWARD-LOOKING STATEMENTS

This annual report on Form 20-F contains forward-looking statements that relate to our current expectations and views of future events. The forward-looking statements are contained principally in the items entitled Risk Factors, Information on the Company, and Operating and Financial Review and Prospects. Our forward-looking statements relate to events that involve known and unknown risks, uncertainties and other factors, including those listed under Risk Factors, which may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements.

In some cases, these forward-looking statements can be identified by words or phrases such as may, will, expect, anticipate, aim, estimate, intend, plan, believe, potential, continue, is/are likely to or other similar ex have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. These forward-looking statements include, among other things, statements relating to:

- our expectations with respect to our future revenues, including continued growth of our MMORPG revenue, continued reliance on the ZT Online franchise and the growth of our licensing revenue;
- our expectations with respect to growth strategies, including our expansion into webgames and mobile games;
- our expectations with respect to the impact of our studio reorganization;
- our expectations with respect to the future mix of direct and indirect sales of our game cards and game points;
- our ability to license our online games to third party operators and to expand our distribution channels;
- competition from other online game developers and operators, including the increase of foreign games licensed for operation in China;
- our expectations regarding future capital expenditures and other costs, including compensation expenses, research and development expenses and co-location and internet access fees;
- our intentions regarding management of our employees, including future increases or decreases in the number of our employees;
- our expectations regarding the expansion of our business through strategic acquisitions; and

our expectations with respect to the completion of our proposed going private transaction.

If any one or more of the assumptions underlying these forward-looking statements turns out to be incorrect, actual results may differ from the results suggested by the forward-looking statements based on these assumptions. You should not place undue reliance on these forward-looking statements.

The forward-looking statements in this annual report relate only to events or information as of the date of this annual report. Except as required by law, we undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this annual report. You should read this annual report, and the documents that we reference in this annual report, with the understanding that our actual future results may be materially different from the results we currently expect to achieve as described in our forward-looking statements.

Table of Contents

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

A. Selected Financial Data

The selected consolidated statement of comprehensive income data for each of the three years in the period ended December 31, 2013, and the selected consolidated balance sheet data as of December 31, 2012 and 2013, were derived from our consolidated financial statements, which have been audited by Ernst & Young Hua Ming LLP, an independent registered public accounting firm. The report of Ernst & Young Hua Ming LLP, as well as our audited consolidated financial statements for the years ended December 31, 2011, 2012 and 2013, are included elsewhere in this annual report. The selected consolidated statements of comprehensive income data for the years ended December 31, 2009 and 2010, and our consolidated balance sheets data as of December 31, 2009, 2010 and 2011, have been derived from our audited consolidated financial statements that are not included in this annual report.

Our consolidated financial statements are prepared and presented in accordance with U.S. GAAP. Our historical results do not necessarily indicate our results expected for any future periods. You should read the selected consolidated financial data in conjunction with the consolidated financial statements and the related notes included under Item 18. Financial Statements and Item 5. Operating and Financial Review and Prospects

Table of Contents

Consolidated Statement of Comprehensive Income Data:

	Year Ended December 31,					
	2009	2010	2011	2012	2013	
	RMB	RMB	RMB	RMB	RMB	US$
	(In thousands, except per share and per ADS data)					
Net revenue:						
Online games	1,293,018	1,289,481	1,701,343	2,074,950	2,309,281	381,466
Licensing revenues	10,687	42,667	54,538	52,186	41,902	6,922
Other revenue, net	130	668	36,336	24,758	4,288	708
Total net revenue	1,303,835	1,332,816	1,792,217	2,151,894	2,355,471	389,096
Cost of services	(204,070)	(199,122)	(257,246)	(288,361)	(298,660)	(49,335)
Gross profit	1,099,765	1,133,694	1,534,971	1,863,533	2,056,811	339,761
Operating (expenses) income:						
Research and product development	(113,354)	(186,037)	(230,209)	(326,793)	(320,981)	(53,022)
Sales and marketing	(119,600)	(143,006)	(169,982)	(146,452)	(175,769)	(29,035)
General and administrative	(121,446)	(119,447)	(103,727)	(148,708)	(135,748)	(22,424)
Government financial incentives	88,460	57,386	47,746	63,644	44,766	7,395
Impairment of intangible assets		(46,558)				
Total operating expenses	(265,940)	(437,662)	(456,172)	(558,309)	(587,732)	(97,086)
Income from operations	833,825	696,032	1,078,799	1,305,224	1,469,079	242,675
Interest income	102,200	136,098	141,587	105,833	128,619	21,246
Investment income (loss)	(5,971)		3,048	(243,627)	8,231	1,360
Other income, net	14,025	65,466	43,558	34,844	32,861	5,428
Income before income tax expenses	944,079	897,596	1,266,992	1,202,274	1,638,790	270,709
Income tax expenses	(85,060)	(89,322)	(352,378)	(124,204)	(296,622)	(48,999)
Share of losses of equity investees		(648)	(8,218)	(6,117)	(6,389)	(1,055)
Net income	859,019	807,626	906,396	1,071,953	1,335,779	220,655
	295	3,563	(26,429)	(78,234)	(82,812)	(13,679)

Net income (loss) attributable to noncontrolling interests						
Net income attributable to the Company s shareholders	859,314	811,189	879,967	993,719	1,252,967	206,976
Other comprehensive income (loss), net of tax						
Foreign currency translation	(12,769)	(73,194)	(84,728)	2,735	(2,927)	(483)
Reclassification adjustment	(1,814)					
Unrealized holding gains (losses)	(30,951)	(14,540)	(15,998)	29,771	(1,615)	(267)
Total other comprehensive income (loss), net of tax	(45,534)	(87,734)	(100,726)	32,506	(4,542)	(750)
Comprehensive income	813,780	723,455	779,241	1,026,225	1,248,425	206,226
Net earnings per ordinary shares, basic	3.80	3.57	3.79	4.20	5.23	0.86
Net earnings per ordinary shares, diluted	3.67	3.47	3.79	4.13	5.08	0.84
Net earnings per ADS(1), basic	3.80	3.57	3.79	4.20	5.23	0.86
Net earnings per ADS, diluted	3.67	3.47	3.79	4.13	5.08	0.84
Shares used in computation, basic	226,278,227	227,308,854	232,004,879	236,796,818	239,652,597	239,652,597
Shares used in computation, diluted	233,960,556	233,928,400	232,004,879	240,821,127	246,835,259	246,835,259

(1) Each ADS represents one ordinary share

Table of Contents

Selected Consolidated Balance Sheets Data:

	Year Ended December 31					
	2009 (RMB)	2010 (RMB)	2011 (RMB)	2012 (RMB)	2013 (RMB)	2013 (US$)
	(in thousands)					
Assets						
Cash and cash equivalents(1)	1,097,155	2,776,936	950,321	1,943,062	1,021,372	168,719
Short-term investments(1)	3,802,050	3,253,362	919,775	739,315	2,799,686	462,475
Total current assets(1)	5,102,972	6,304,005	2,179,246	3,096,518	4,280,015	707,008
Property and equipment, net	178,670	143,286	349,668	340,242	355,801	58,774
Long-term investments(2)		55,621	380,895	426,088	437,637	72,292
Available-for-sale security(3)(4)	450,967	423,303	386,851	78,741	74,773	12,352
Total non-current assets	1,349,690	804,138	1,371,985	1,225,711	1,085,289	179,277
Total assets	6,452,662	7,108,143	3,551,231	4,322,229	5,365,304	886,285
Deferred revenue	321,291	442,795	529,204	486,025	365,784	60,423
Total current liabilities	547,448	700,314	1,014,916	1,026,670	1,712,984	282,965
Total liabilities	547,869	700,500	1,029,798	1,058,982	1,715,913	283,449
Total Giant Interactive Group Inc. s equity	5,897,185	6,392,860	2,495,648	3,217,728	3,585,387	592,264
Noncontrolling interests	7,608	14,783	25,785	45,519	64,004	10,572
Total liabilities and shareholders equity	6,452,662	7,108,143	3,551,231	4,322,229	5,365,304	886,285

(1) In the third quarter of 2011, we declared and paid out a special dividend of US$3.00 per share to our ADS and ordinary share shareholders, out of which the payout was financed partially through the declaration and payout of dividends to the Company by one of its PRC subsidiaries. As such, the dividends were subject to a 10% withholding tax and, therefore, we accrued an one-time withholding income tax in the amount of RMB259.4 million associated with the repatriation of cash for the special dividend paid during the third quarter 2011.

(2) In September 2011, we invested US$50.0 million in the Yunfeng E-Commerce Funds for the purpose of purchasing shares of the Alibaba Group, a leading Chinese e-commerce company. In February 2014, we entered into an agreement to sell all of our limited partnership interest in Yunfeng E-Commerce Fund A, L.P. and Yunfeng E-Commerce Fund B, L.P. (which collectively known as Yunfeng E-Commerce Funds and collectively hold all of our interest in the ordinary shares of Alibaba Group Holding Limited) to Tiger Global Mauritius Fund for approximately US$199.1 million. The sale was completed on February 12, 2014.

(3) During the fourth quarter of 2012, we recorded an impairment charge of RMB240.7 million, which related to our 2008 investment in Five One Network Development Co. Ltd., or 51.com, as the decline in the fair value of this investment was determined to be other-than-temporary. 51.com was formerly a China-based social networking

company which transitioned into an online game developer and operator in recent years. This investment loss resulted from 51.com s lower than expected core business revenue and operating cash flow, and delay in its research and development activities and planned promotion campaigns of its newly launched games.

(4) In May 2012, the Company recharacterized its RMB27.3 million investment in Mobile Embedded Technology Inc. from available-for-sale securities to a cost-method investment.

Exchange Rate Information

Our business is conducted in China and substantially all of our net revenues are denominated in Renminbi. This annual report contains translations of Renminbi amounts into U.S. dollars at specific rates solely for the convenience of the reader. Conversions of Renminbi into U.S. dollars in this annual report are based on the noon buying rate in The City of New York for cable transfers of Renminbi as certified for customs purposes by the Federal Reserve Bank of New York. Unless otherwise noted, all translations from Renminbi to U.S. dollars and from U.S. dollars to Renminbi in this annual report were made at a rate of RMB6.0537 to US$1.00, the noon buying rate in effect as of December 31, 2013. We make no representation that any Renminbi or U.S. dollar amounts could have been, or could be, converted into U.S. dollars or Renminbi, as the case may be, at any particular rate, the rates stated below, or at all. The PRC government imposes control over its foreign currency reserves in part through direct regulation of the conversion of Renminbi into foreign exchange and through restrictions on foreign trade. On April 25, 2014, the noon buying rate was RMB6.2534 to US$1.00.

Table of Contents

The following table sets forth information concerning exchange rates between the Renminbi and the U.S. dollar for the periods indicated.

Period	Period End	Noon Buying Rate Average[(1)]	High	Low
	(RMB per US$1.00)			
2009	6.8259	6.8307	6.8176	6.8470
2010	6.6000	6.7696	6.6000	6.8330
2011	6.2939	6.4475	6.2939	6.6364
2012	6.2301	6.2990	6.2221	6.3879
2013	6.0537	6.1412	6.0537	6.2438
October 2013	6.0943	6.1032	6.0815	6.1209
November 2013	6.0922	6.0929	6.0903	6.0993
December 2013	6.0537	6.0738	6.0537	6.0927
2014				
January 2014	6.0590	6.0509	6.0402	6.0600
February 2014	6.1448	6.0816	6.0591	6.1448
March 2014	6.2164	6.1730	6.1183	6.2273
April 2014 (through April 25, 2014)	6.2534	6.2196	6.1966	6.2534

(1) Annual averages are calculated by using the average of the exchange rates on the end of each month during the year. Monthly averages are calculated by using the average of the daily rates during the relevant month.

B. Capitalization and Indebtedness

Not applicable.

C. Reasons for the Offer and Use of Proceeds

Not applicable.

D. Risk Factors

Risks Relating to Our Business and Industry

The ZT Online franchise of massively multiplayer online role playing games, or MMORPGs, have historically accounted for the substantial majority of our net revenues. Any decrease in the popularity of these games would materially and adversely affect our results of operations.

The ZT Online franchise, which consists of the ZT Online 1 Series and ZT Online 2, accounted for 89%, 89% and 79% of our net revenue in 2011, 2012 and 2013, respectively. In 2006 we commercially launched ZT Online, which together with ZT Online Classic Edition, and ZT Online Green Edition, constitutes the ZT Online 1 Series. In 2011 we commercially launched ZT Online 2, which is part of the ZT Online franchise but differs from the ZT Online 1 Series games in a number of ways, including its story, gameplay, graphics, maps, quests, and characters. The most significant change in ZT Online 2 is its in-game economy. ZT Online 2 s next generation in-game economy, the transaction-based revenue model which allows players to purchase in-game items from other players that have earned such items by leveling up their in-game characters and accomplishing in-game objectives, is designed to target lower spending and non-spending users as compared to that of ZT Online 1 Series, in which revenue is generated from the players consumption of game points to purchase items sold by the in-game store. Although we currently operate fifteen games, eleven of which are not part of the ZT Online franchise, we expect that we will continue to derive the substantial majority of our net revenues from the ZT Online franchise in the near term. Our business prospects, financial condition and results of operations would therefore be materially and adversely affected by any factor that contributes to a decline in revenue from the ZT Online franchise, including:

- any reduction in purchases of virtual items or services by players of the ZT Online franchise games;
- any decrease in the popularity of the ZT Online 1 Series or ZT Online 2 due to competition or otherwise;
- failure to improve, update or enhance the ZT Online franchise games in a timely or effective manner; or
- any lasting or prolonged server interruption due to network failures or other factors.

Table of Contents

As with other online games, the ZT Online franchise games have finite commercial lifespans. Although our ongoing release of new version of the ZT Online franchise games helps to extend the commercial life of the games, to ensure the continued popularity of the ZT Online 1 Series and ZT Online 2, we will need to expend considerable resources to improve and update the games on a timely basis with new content and features that appeal to our players. Any decline in the popularity of the ZT Online franchise games, whether as a result of the failure to provide timely and popular updates or otherwise, would materially and adversely affect our business prospects, financial condition and results of operation.

If we are unable to successfully develop and license new popular online games, our business and revenues may be adversely affected.

In order to maintain our long-term profitability and financial and operational success, we must continually develop or license new online games that are attractive to our players. While many new online game products are regularly introduced to the market, only a small number of hit titles account for a significant portion of total revenue in our industry. As the online game market is limited in size, if our newly developed games are not widely accepted by the players, or if successful hit products are launched by our competitors, our market share may be adversely affected and revenues generated by our products may fall below our expectations.

The success of our internally developed games will largely depend on our ability to anticipate and effectively respond to changing tastes and preferences of our players and to continually make technical advances to our platform. Developing games internally requires substantial initial investment prior to commercial launch of the games as well as a significant commitment of future resources. In addition, identifying new third party developed online games with strong market potential, and obtaining license to those online games on commercially reasonable terms, requires a significant degree of effort. If we are not able to successfully develop or license new hit online games that attract large numbers of players and result in substantial online game revenues, our business, financial condition and results of operations may be materially and adversely affected.

We are substantially dependent upon the MMORPG segment of China s online game industry. Any decline in the size of the MMORPG market segment, due to competition from other video game products, other entertainment products or otherwise, would adversely affect our revenues.

The MMORPG segment of China s online game industry, from which we derive substantially all of our revenues, is both rapidly evolving and subject to competition from other forms of video games and other entertainment products. The future prospects for the MMORPG market segment in China will depend on a number of factors beyond our control, including:

- the growth of personal computer, internet and broadband users and their penetration in China;
- whether the MMORPG segment of China s online game industry continues to grow and the rate of any such growth;
- the availability and popularity of other forms of video game products, such as social networking games, mobile games, and console games playable on game consoles;

- the availability and popularity of other forms of online and offline entertainment, such as movies, television programs and other video content;

- changes in consumer demographics and consumer tastes and preferences; and

- general economic conditions, particularly economic conditions adversely affecting discretionary consumer spending.

Although MMORPGs are currently popular in China, there is no assurance that they will continue to be popular in China or elsewhere. A decline in the popularity of online games in general, or the MMORPG market segment in particular, will materially and adversely affect our business prospects, financial condition and results of operations.

We face significant competition, which could reduce our market share and adversely affect our business and net revenues.

The online game market in China is highly competitive. In recent years, numerous competitors have entered the online game market in China, and we expect more companies to enter the market and a wider range of online games to be introduced to the market. Our principal competitors include China-based online game companies such as Tencent Holdings, Ltd., Changyou.com Limited, Perfect World Co., Ltd., Shanda Games Limited and NetEase.com. In addition, we expect international game developers to continue to license more of their games for operation in China.

Table of Contents

Many of our competitors have longer operating histories, greater brand name recognition, larger player bases and significantly greater game development, technical, financial and marketing resources than we have. Furthermore, any of our competitors may be acquired by, receive investments from or enter into other cooperative relationships with larger, more well-financed companies and therefore obtain greater financial, marketing and development and licensing resources than we have. This may allow them to devote greater resources than we can to the development and promotion of new online games and technologies similar to or better than our own. These competitors may engage in more extensive research and development, undertake more far-reaching marketing campaigns, adopt more aggressive pricing policies and make more attractive offers of employment to our existing and potential employees than we can. In addition, our international competitors may establish cooperative relationships with our local competitors, which may significantly enhance their competitiveness in the online game market in China.

New and increased competition may result in larger discounts demanded by our distributors, or price reductions in our virtual items and services, any of which could adversely affect our net revenues. In addition, the increased competition in the online game market in China could make it difficult for us to retain and expand our existing player base, which could reduce the number of dedicated players and players with high disposable incomes that play our games and from whom we derive most of our net revenues. If we are unable to compete effectively in the online game market in China, our business, financial condition and results of operations would be materially and adversely affected.

Our games are currently accessed primarily through personal computers. As devices other than personal computers are increasingly used to access the internet, successful development of games for such devices will be imperative if we are to maintain or increase our revenues, and our inability to do so may result in lower growth of or a decline in revenues.

Devices other than personal computers, such as mobile phones and tablets, are used increasingly in China and in overseas markets to access the internet. We believe that for our business to be successful we will need to develop versions of our existing games, our pipeline 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 creation, support, and maintenance of games for such devices. If we are unable to successfully expand the types of devices on which our existing and future games are available, or if the versions of our games that we create for such devices do not function well or are not attractive to game players, our revenues may fail to grow and may decline.

Our operating results fluctuate from period to period, making them difficult to predict.

We have experienced significant fluctuations in our operating results from period to period due to a variety of factors, many of which are beyond our control. Significant fluctuations in our operating results could be caused by any of the following factors, among others:

- our ability to retain existing users of our games and attract new users;

- the introduction of new games or expansion packs by us or our competitors;

changes in our game features and the corresponding impact on player behavior and purchasing patterns;

the adoption of new, or changes in existing government regulations;

the quality, variety, popularity and mix of virtual items and services available for purchase in our free-to-play games and related in-game promotional efforts;

game development costs for our self-developed games, and license costs and royalty payments for licensed games;

the amount of overseas licensing net revenues generated through our licensing arrangements with operators of our games;

the mix of sales through our distributors (who purchase prepaid game cards at a discount to their face value) and direct sales of game points to players through our website;

the success of our advertising and promotional efforts;

seasonality effect during holidays in the first quarter and fourth quarter, when fewer of our targeted players play our games; and

economic conditions in general and specifically with respect to the online game industry in China.

For example, our net revenues declined 18% in 2009, which we believe was primarily due to new regulations promulgated by the PRC government in connection with certain game features, and corresponding changes to our in-game monetization features. However, our net revenues increased 2.2%, 34.5%, 20.0% and 9.5%, in 2010, 2011, 2012 and 2013, respectively.

As a result, our operating results may vary from period to period, be difficult to predict for any given period, be adversely affected from period to period, and not be indicative of our future performance. In the event that our operating results do not meet our expectations or those of the public market analysts and investors, the price of our ADSs may decline.

We may not be able to successfully implement our growth strategies, which would materially and adversely affect our revenue, profitability and competitiveness.

We are pursuing a number of growth strategies, including broadening our user base by diversifying our game portfolio, expanding our distribution channels by leveraging our strong relationships with internet platform partners, acquiring additional licenses to operate third party developed overseas games in China, pursuing additional licensing opportunities for operating our games overseas, and expanding into non-MMORPG market segments by developing web games, and games for operation on mobile and tablet devices.

For example, in order to expand our user base, in September 2012 we released the micro-client version of ZT Online 2 on Qihoo 360 s platform. In 2012, we also licensed several of our new games, including Genesis of the Empire, Marine Tycoon, The Sky and World of Xianxia, to overseas partners for operations outside of China. In addition, we are expanding into web games and mobile games, and in 2013 we launched several web games on partner platforms in China including Genesis of the Empire, The Sky and the Supreme Tai Chi. In 2013, we also expanded our portfolio of licensed games by entering into an agreement to operate in China Cang Tian 2, a 3D MMORPG developed by WeMade Entertainment.

Our experience with our various new growth strategies is limited. Accordingly, we cannot assure you whether all or any of these strategies will be successful. If we are unable to implement our growth strategies, our revenue and profitability may not grow as we expect, and our competitiveness may be materially and adversely affected.

We may not sustain our historical profitability levels.

Historically we have achieved a relatively high gross profit margin and net income margin. Our gross profit margin was 85.6%, 86.6% and 87.3% in 2011, 2012, and 2013, respectively, and our net income attributable to the company s shareholders as a percentage of net revenue was 49.1%, 46.2% and 53.2% in 2011, 2012 and 2013, respectively. Our relatively high gross profit margin and net income margin are attributable to a number of factors, including the success of our online games, the fact that our leading games are self-developed rather than licensed from third parties and our historic ability to effectively control costs. We might not, however, be able to sustain our historical profitability levels in future periods due to a number of different factors, including, among others, economic factors out of our control, competitiveness in the online game industry, in which market share can be quickly acquired or lost, the need to increase our research and product development expenses in order to develop new and successful games, the potential need to expend greater amounts in order to license or acquire new games, changes in regulations or other factors that result in a decline of our net revenue, our inability to prevent our other costs and operating expenses from increasing, and an increase in net income attributable to non-controlling interests as a result of the success of games supported by our 51% owned game development studios. Accordingly, you should not rely on the results of any prior period as an indication of our future operating performance.

Our business may be materially harmed if our games are not featured in a sufficient number of internet cafés in China.

A substantial number of players access our game through internet cafés. Due to limited storage space on the computer hard drives for client side game software, internet cafés generally only feature a select number of games on their computers. We thus compete with a growing number of other online game operators to ensure that our games are featured on these computers.

To help ensure that our games are featured in a sufficient number of internet cafés, we enter into advertising distribution agreements with companies that operate and distribute internet café management software, which most internet cafés in China install. These management software distributors both display advertisements for our games on PCs that use their software, and help to ensure that the client side software for our games are installed on the PCs that use their software.

Our agreements with the internet café management software companies are not on an exclusive basis, and therefore these firms can and do advertise for other game companies and ensure that the client side software for other companies games are pre-loaded on many of the PCs that use their software. If we fail to renew our advertising distribution agreements with the internet café management software companies, or if the terms including cost for such arrangement materially deteriorate, our business, financial condition and operating results may be materially and adversely affected.

Table of Contents

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

Although the use of personal computers in China has increased in recent years, the penetration rate for personal computers in China is much lower than in the United States. In addition, despite a decrease in the cost of internet access in China due to a decrease in the cost of personal computers and the introduction and expansion of broadband access, the cost of personal internet access remains relatively high in comparison to the average per capita income in China. The PRC government has also promulgated a number of regulations to curb the growth of internet cafés. The limited use of personal computers in China, the relatively high cost of personal internet access and increased restrictions on internet cafés may limit the growth of our business. Furthermore, any internet access or telecommunications fee increase could reduce the number of players that play our online games and materially and adversely affect our business, financial condition and results of operations.

We rely on our nationwide distribution network for a significant portion of our net revenues. Failure to maintain good relationships with our distributors, or failure of our distributors to comply with the terms of our distribution agreements, could materially disrupt our business and harm our net revenues.

Online payment systems in China are still in a relatively early stage of development and are not as widely used by customers in China as in the United States. Although online purchase of game points through our official game website has become more popular in recent years, our business is still dependent on the performance of our regional distributors, who are composed of independent third parties. In 2013, 45.7% of our sales proceeds were generated through sales of prepaid game cards to our distributors, compared to 55.4% in 2012. Our largest distributor accounted for 2.8% of our sales proceeds in 2013. Maintaining relationships with existing distributors may be difficult and time-consuming. Although we typically enter into annual contracts with our distributors, our distribution agreements are not exclusive and do not prohibit our distributors from selling our competitors game cards. Failure to maintain good relationships with our distributors could restrict our sales channels or encourage our distributors to seek to distribute our competitors products, each of which could materially and adversely disrupt our business and harm our net revenues.

In addition, our distributors and internet cafés and other outlets in which they sell our prepaid game cards may violate our distribution agreements. Examples of violations include:

- failure to meet minimum sales targets or penetration targets, or failure to maintain minimum price levels for our prepaid game cards;

- failure to properly promote our online games in local internet cafés and other important outlets, or failure to cooperate with our sales and marketing team s efforts in their designated territories; and

- selling our prepaid game cards outside their designated territories, possibly in violation of the exclusive distribution rights that we have granted to other distributors.

Some of our distributors have committed these types of violations in the past, which resulted in us terminating their existing distribution agreements. If we decide to fine, suspend or terminate our distributors for acting in violation of our distribution agreements, or if the distributors fail to address material violations committed by any of their retail outlets, our ability to effectively sell our prepaid game cards in any given territory could be negatively impacted. We may also be liable in China for legal or regulatory violations by any of our distributors.

We could be liable for breaches of security of our website and third-party online payment system, which may have a material adverse effect on our reputation and business.

In 2013, 54.3% of our sales proceeds were generated by players purchasing our game points directly through our official game website, and the remaining 45.7% from purchasing physical or virtual game cards through our distributors. The direct game point purchasing through our official game website is processed by a variety of third-party online payment service providers, including Alipay.com Co., Ltd, Shanghai China UnionPay E-Payment Service Co., Ltd, 99Bill Corporation, China Payment and Remittance Service Co., Ltd. and several major commercial banks. In such transactions, secure transmission of our players confidential billing information over public networks, including our official game website, is essential for maintaining consumer confidence. We currently provide password protection for all of our player accounts. In addition to the general password protection, we also sell a dynamic password generator, which can be used for multiple accounts under a player s name, to better ensure the security of our players accounts. While we have not experienced any breach of our security measures to date, current security measures may be inadequate. We must therefore be prepared to increase our security measures and efforts so that our customers have confidence in the reliability of the online payment systems we use.

Table of Contents

In addition, we do not have control over the security measures of our third-party online payment service providers, and those security measures may not be adequate at present or may not be adequate with the expected increased usage of online payment systems. For example, hackers have in the past used viruses to corrupt the computers of online shoppers using Taobao, a leading e-commerce website in China that allows shoppers to purchase goods from different vendors online. In addition, through a process known as phishing, hackers have created fake webpages on Taobao that appear to be selling legitimate goods online. In both situations, when an unsuspecting online shopper attempts to submit a purchase order and payment to a third party vendor on Taobao, that purchase order and payment is redirected to our website and changed into a legitimate purchase order and payment for our game points on behalf of the hacker and not the unsuspecting online shopper. Accordingly, our systems are then misled into accepting such payment and unintentionally issuing the corresponding game points to the hacker, who then uses these game points to purchase virtual items in our games with the intention of later exchanging the virtual items for cash on offline third party trading platforms. In a few instances, online shoppers on Taobao that were misled by hackers have resorted to litigation against us in order to recover their losses. Although the amount of damages we paid in connection with this litigation was immaterial, and we have implemented stricter security measures and cooperated with local authorities to apprehend the hackers, we could be exposed to further litigation and possible liability if we fail to detect fraudulent transactions, which could harm our reputation, ability to attract customers and ability to encourage players to purchase our game points.

Unexpected network interruptions, security breaches or computer virus attacks could have a material adverse effect on our business and reduce player satisfaction.

Any failure to maintain satisfactory performance, reliability, security and availability of our network infrastructure, including issues arising from the internet infrastructure in China, security breaches caused by hacking and transmission of computer viruses, and natural disasters such as floods and earthquakes, may cause significant harm to our reputation and our ability to retain existing and attract new game players. In addition, all of the game servers operating our games, and all of the servers handling log-in, billing and data back-up matters for us are hosted and maintained by third-party service providers. Major risks involved in such network infrastructure include any break-downs or system failures resulting in a sustained shutdown of all or a material portion of our servers, including failures which may be attributable to sustained power shutdowns, or efforts to gain unauthorized access to our systems causing loss or corruption of data or malfunctions of software or hardware.

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

Changes in our lifespan estimates for the virtual items sold within our games may have a negative impact on our net revenue and results of operations.

We generally recognize revenues from virtual items sold to players of our free-to-play online games over the estimated lifespan of the relevant virtual items as determined by historical player usage patterns and playing behavior. We are committed to continually monitoring each of our games actual operational statistics and usage patterns, comparing these actual statistics with our original estimates and refining our estimates and assumptions when they are materially differ from the actual statistics. Any adjustment in the estimated lifespan of these virtual items may cause our revenues to be recognized over a significantly different time period, which may have a negative impact on our net revenue and results of operations.

Undetected programming errors or defects in our games and the proliferation of cheating programs could adversely affect our business reputation and result in a decline in our active paying accounts.

Our online games may contain undetected programming errors or other defects. In addition, parties unrelated to us have in the past, and may again in the future, develop internet cheating programs that enable users to acquire superior features for their game characters for which they would otherwise be required to pay or otherwise earn through game play. In addition, certain cheating programs could cause the loss of a character s superior features acquired by a player. The occurrence of undetected errors or defects in our games, and our failure to discover and disable cheating programs affecting the fairness of our game environment, could damage our reputation and result in a decline in our active paying accounts. This could materially and adversely affect our business, financial condition and results of operations.

Table of Contents

We depend on our key personnel, and our business and growth prospects may be severely disrupted if we lose their services or are unable to attract new key employees.

Our future success is heavily dependent upon the continued service of our key executive officers and other key employees. In particular, we rely on the expertise, experience and leadership of Mr. Yuzhu Shi, our founder and chairman, Ms. Wei Liu, our chief executive officer, and Mr. Xuefeng Ji, our president, in connection with our business operations and game development. We also rely on their personal relationships with our employees, the relevant regulatory authorities, and our distributors. In addition, we are dependent on a number of key technology officers and staff for the development and operation of our online games. Furthermore, we need to continue to attract and retain skilled and experienced online game development personnel to maintain our competitiveness.

If one or more of our key personnel are unable or unwilling to continue in their present positions, we may not be able to replace them easily or at all and may incur additional expenses to recruit and train new personnel. These difficulties may disrupt our business, and our financial condition and results of operations could be materially and adversely affected. We do not maintain key-person life insurance for any of our key personnel. In addition, if any of our executive officers or key employees joins a competitor or forms a competing company, we may lose know-how, trade secrets, suppliers and key professionals and staff. We enter into non-compete agreements with officers, managers and senior level employees, which generally prohibit them from engaging in activities that compete with our business for two years after their employment with us provided that we satisfy certain payment obligations. Although non-compete agreements are generally enforceable under PRC laws, PRC legal practice regarding the enforceability of such provisions may not be as well-developed, and therefore we cannot assure you that a PRC court would enforce such provisions. Furthermore, since the demand and competition for talent is intense in our industry, particularly for online game development personnel and related technical personnel, we may need to offer higher compensation and other benefits in order to attract and retain key personnel in the future, which could increase our compensation expenses.

In 2008, we introduced Win@Giant, an incubation program designed to attract and retain talented employees, developers and business partners. Under Win@Giant, we have reorganized several of our game development studios by establishing various subsidiaries that are generally 51% owned by us and 49% owned by the relevant key development team members, with an aim to facilitate our development of new online games. Each reorganized studio only focuses on producing and supporting internally developed games, which we believe gives them greater incentive to make their games commercially successful. While this program is intended to supplement and not to replace our normal hiring efforts, we cannot assure you that this program will be successful or that we will be able to attract or retain qualified game developers or other key personnel that we will need to achieve our business objectives.

The reorganization of our game development studios could materially and adversely affect our results of operations as a portion of the profits from games developed or operated by these studios will be shared with the non-controlling shareholders of these studios.

In 2008, we introduced Win@Giant, an incubation program designed to, among other things, identify, recruit and incentivize talented individuals in the areas of game design and development. In 2009, in connection with our Win@Giant initiative, we began to reorganize our game development studios by establishing various subsidiaries that are 51% owned by us and 49% owned by the relevant development team members, which we believe provides greater incentive to the game development teams to make their games commercially successful. Following this game development studio reorganization, ZT Online 2 and World of Xianxia, two of our most successful MMORPGs, are supported by Jujia Network and Juhuo Network, respectively, each of which is 51% owned by us and 49% owned by the relevant development team members. For additional information regarding this reorganization, see Item 4. Information on the Company Business Overview Game Development and Sourcing Game Development.

As a result of our game development studio reorganization, a portion of the net income generated by games developed or supported by these game development studios will be attributable to the non-controlling shareholders of the studios. The company consolidates its financial results with those of the reorganized studios, and then presents the net income or loss attributable to the non-controlling shareholders as a separate non-controlling interest line item under the heading net income or loss attributable to non-controlling interests . The company s consolidated income attributable to its shareholders is arrived at after deducting this non-controlling interest. Total non-controlling interest related to our reorganized studios increased 5.9% from RMB78.2 million in 2012 to RMB82.8 million (US$13.7 million) in 2013, primarily due to an increase in revenue generated by games developed and supported by reorganized studios. If our games developed and/or supported by these studios become more popular and profitable in the future, this non-controlling interest amount will increase, which may result in a lower net income attributable to company s shareholders and may materially and adversely affect our results of operations.

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

We intend to continue expanding our business through selective acquisitions in the future. We do not, however, have significant experience in completing acquisitions or integrating new companies into our existing operations. In the event that we pursue acquisition opportunities in the future, we will face a number of risks that could materially and adversely affect our business and results of operations, including overpaying for the acquisitions, an inability to realize the synergies contemplated at the time of executing the transactions, difficulties in integrating the acquired companies, the diversion of management resources from other strategic and operational issues, the inability to retain the key employees of the acquired companies, and unknown or unforeseen assumed liabilities.

Unauthorized use of our intellectual property by third parties, and the expenses incurred in protecting our intellectual property rights, may adversely affect our business.

We regard our copyrights, trademarks, trade secrets and other intellectual property as critical to our success. Unauthorized use of our intellectual property may adversely affect our business and reputation.

We have historically relied on a combination of trademark and copyright law, trade secret protection, internal security measures and restrictions on disclosure to protect our intellectual property rights. Although we enter into confidentiality agreements with all of our employees, and our standard employment agreements include an invention assignment clause, we cannot assure you that these confidentiality agreements will not be breached, that we will have adequate remedies for any breach, or that our proprietary technology will not otherwise become known to, or be independently developed by, third parties.

As of December 31, 2013, we own a total of 769 registered trademarks in China and overseas and are in the process of applying for the registration of 304 trademarks in China and 28 trademarks overseas. We cannot assure you that any of these trademark applications will ultimately be successful or will provide adequate protection for our business. Some of our pending applications or registrations may also be successfully challenged or invalidated by others. If our trademark applications or registrations are not successful, we may have to use different marks or otherwise enter into arrangements with third parties.

In addition, China s online game market often faces challenges from pirate servers, which are game servers operating unauthorized copies of online games that enable players to play those games without purchasing prepaid game cards or game points from the authorized operators. We mitigate the risk of pirate servers by maintaining stringent security controls over our server side software at our offices and insisting upon high security standards at the various internet data centers where our servers are housed. In addition, once pirate servers are identified, we work with local government authorities to shut the servers down. If pirate game servers continue to operate any of our games, our business, financial condition and results of operations may be materially and adversely affected.

Implementation of intellectual property laws in China has historically been lacking, primarily because of difficulties in enforcement. Accordingly, intellectual property right protection in China may not be as effective as in the United States or other developed countries. Policing unauthorized use of our proprietary technology, trademarks and other intellectual property is difficult and expensive, and litigation may be necessary in the future to enforce our intellectual property rights. Future litigation could result in substantial costs and diversion of our resources, and could disrupt our business, as well as have a material adverse effect on our financial condition and results of operations.

We may be subject to infringement and misappropriation claims in the future, which may cause us to incur significant expenses, pay substantial damages and be prevented from providing our services or technologies.

Our success depends in part on our ability to carry out our business without infringing the intellectual property rights of third parties. We may be subject to litigation involving claims of patent, copyright or trademark infringement, or other violations of intellectual property rights of third parties. In particular, the patent field covering online games and related technology is rapidly evolving and surrounded by a great deal of uncertainty, and therefore we cannot assure you that our technologies, processes or methods do not infringe upon third-party patents, either now existing or to be issued in the future. Future litigation may cause us to incur significant expenses, and third-party claims, if successfully asserted against us, may cause us to pay substantial damages, seek licenses from third parties, pay ongoing royalties, redesign our services or technologies, or prevent us from providing services or technologies subject to these claims. Even if we were to prevail, any litigation would likely be costly and time-consuming and divert the attention of our management and key personnel from our business operations.

Table of Contents

We have limited business insurance coverage, which may result in our incurring substantial costs and the diversion of resources.

Insurance companies in China offer limited business insurance products. We have purchased a public liability insurance policy, which would cover certain third party personal injury or property damage incurred in connection with the operation of our business. We also understand that business interruption insurance is available to a limited extent in China, but we have determined that the risks of disruption, cost of such insurance and the difficulties associated with acquiring such insurance on commercially reasonable terms make it impractical for us to purchase for such insurance. As a result, other than the public liability insurance policy described above, we do not have any business liability, disruption or litigation insurance coverage for our operations in China. Except for the public liability insurance policy described above, property insurance for our offices and fixed assets, and legally required automobile liability insurance, we do not carry any other property or casualty insurance. Any business disruption or litigation, or any liability or damage to, or caused by, our facilities or our personnel may result in our incurring substantial costs and the diversion of resources.

If we fail to maintain an effective system of internal control over financial reporting, our investors may lose confidence in our financial statements.

We are subject to provisions of the Sarbanes-Oxley Act of 2002. Section 404 of the Sarbanes-Oxley Act requires that we include a report from management on the effectiveness of our internal control over financial reporting in our annual reports on Form 20-F. In addition, our independent registered public accounting firm must attest to and report on the operating effectiveness of our internal control over financial reporting. Our management has concluded that our internal control over financial reporting is effective as of December 31, 2013, and our independent registered public accounting firm concurred with our management s conclusion. However, if we fail to maintain effective internal control over financial reporting in the future, our management and our independent public accounting firm may not be able to conclude that our internal control over financial reporting is effective. This in turn could result in a loss of investor confidence in the reliability of our reporting processes, which could materially and adversely affect the trading price of our ADSs. Furthermore, we have incurred considerable costs, management time and other resources in an effort to comply with Section 404 and other requirements of the Sarbanes-Oxley Act.

We are exempt from certain corporate governance requirements of the NYSE. This may afford less protection to the holders of our ADSs.

We are exempt from certain corporate governance requirements of the NYSE by virtue of being a foreign private issuer. As a foreign private issuer, we are permitted to follow home country practice in lieu of certain corporate governance requirements of the NYSE. We are required to provide a brief description of the significant differences between the corporate governance practices of our home country, the Cayman Islands, and the corporate governance practices required to be followed by U.S. domestic companies under the NYSE rules. The standards applicable to us are considerably different than the standards applied to U.S. domestic issuers. The significantly different standards applicable to us do not require us to, among other things:

- have a majority of the board be independent (other than due to the requirements for the audit committee under the United States Securities Exchange Act of 1934, as amended, or the Exchange Act); or obtain shareholder approval for the implementation and material revisions of the terms of our equity compensation plans.

We are committed to a high standard of corporate governance and as such we endeavor to comply with most of the NYSE corporate governance practices. We do, however, intend to rely on each of the foreign private issuer exemptions noted above. As a result, you may not be provided with the benefits of certain corporate governance requirements of the NYSE.

As an online game company, our experience with investment activities is limited.

We explore selected investment opportunities that may have strategic value to us or that are purely financial in nature, with the primary objective of providing us with a more favorable rate of return than is customary for ordinary bank deposits.

For example, as of December 31, 2011, 2012 and 2013, we held short-term investments with a more favorable rate of return than is customary for ordinary bank deposits and long-term held-to-maturity investments in the amount of RMB700.0 million, RMB790.0 million and RMB2,559.2 million (US$422.7 million), respectively. In May 2011, we invested RMB100.0 million in a trust arrangement with China Resources SZITIC Trust Co., Ltd., which in turn invested in certain real estate development projects in the PRC cities of Ningbo and Chengdu for a the second unit private placement is required to close within the next ninety days after the signing of the definitve agreement which occurred on Oct 24, 2016.

Investor Awareness and Mangagement Services Agreement: On October 24, 2016, the Company entered into an Investor Awareness Services and Management Agreement with Mining Clip, LLC and Ariston Capital Corp. dated October 15, 2016, to provide additional investor relations services. The Mining Clip Agreement terminates on January 15, 2017 and will renew for additional periods of three months each unless terminated by either party. In addition to a monthly cash retainer, the Company will issue an aggregate of 62,500 shares of common stock every 90 days until the Mining Clip Agreement is terminated.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

We use the terms Magellan, we, our, and us to refer to Magellan Gold Corporation.

The following discussion and analysis provides information that management believes is relevant for an assessment and understanding of our results of operations and financial condition. This information should be read in conjunction with our audited financial statements, which are included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015, and our interim unaudited condensed financial statements and notes thereto included with this report in Part I, Item 1.

Forward-Looking Statements

Some of the information presented in this Form 10-Q constitutes forward-looking statements . These forward-looking statements include, but are not limited to, statements that include terms such as may, will, intend, anticipate, esti expect, continue, believe, plan, or the like, as well as all statements that are not historical facts. Forward-look statements are inherently subject to risks and uncertainties that could cause actual results to differ materially from current expectations. Although we believe our expectations are based on reasonable assumptions within the bounds of our knowledge of our business and operations, there can be no assurance that actual results will not differ materially from expectations.

All forward-looking statements speak only as of the date on which they are made. We undertake no obligation to update such statements to reflect events that occur or circumstances that exist after the date on which they are made.

Overview

We were incorporated on September 28, 2010, in Nevada. Our principal business is the acquisition and exploration of mineral resources. We have not presently determined whether the properties to which we have mineral rights contain mineral reserves that are economically recoverable.

We have only had limited operations to date and we rely upon the sale of our securities and borrowings from significant investors to fund our operations, as we have not generated any revenue.

In August 2012, we entered into an option agreement and subsequently purchased the Silver District project consisting of 85 unpatented lode mining claims, 4 patented lode claims, a Arizona State Exploration Permit of 154.66 acres and 23 unpatented mill site claims, totaling over 2,000 acres in La Paz County, Arizona. Since our acquisition, we have increased our land position in the Silver District by staking two unpatented lode mining claims, leased two additional patented claims and have increased our Arizona State Exploration Permit to 334.85 acres.

On September 30, 2014, we formed and organized a new wholly-owned subsidiary, Gulf + Western Industries, Inc., a Nevada corporation (Gulf+Western or G+W), to own our Silver District mining interests. On October 1, 2014 we completed the transfer of those assets from Magellan to G+W. At the time of the transfer, Magellan owned all the outstanding common stock of G+W. Effective December 31, 2014, Magellan pledged all its ownership interest in G+W to Mr. John D. Gibbs, a significant shareholder in the Company, as security for outstanding amounts under a line of credit agreement between Magellan and Mr. Gibbs. As of September 30, 2016, the total amount owed under the credit agreement was $1,076,251, which includes $932,500 of principal and $143,751 of accrued interest.

On June 1, 2015, we transferred 15% of our ownership interest in G+W to Dr. Pierce Carson in exchange for one year of service as President, Chief Executive Officer and Director of G+W. As a result of the transaction, Magellan s ownership interest in G+W was reduced to 85%. The transaction was valued at $50,000 representing deferred compensation for the one-year period June 2015, through May 2016. On June 1, 2016 Magellan entered into a one-year employment agreement with Dr. Carson in which he assumes the positions of President and Chief Executive Officer of Magellan. As a result, Mr. John Power resigned his positions as President and Chief Executive Officer concurrent with the execution of Dr. Carson s employment agreement. Mr. Power has retained the positions of Chief Financial Officer and Director of Magellan. Dr. Carson was appointed a Director of Magellan effective June 30, 2016.

In July 2016, the Company completed a share exchange with Dr. Carson in which Dr. Carson surrendered his 15% interest in G+W in exchange for 8,623,957 shares of Magellan Gold Corporation. As a result of this transaction, G+W became a wholly owned subsidiary of Magellan Gold Corporation.

On October 24, 2016, the Company entered into a Mining Option Agreement (Agreement) between and among Rio Silver Inc., a Canadian company (Rio Silver), Minera Rio Plata S.A.C., a Peruvian company and subsidiary of Rio Silver (Minera), and Magellan Gold Peru S.A.C., a Peruvian company and wholly owned subsidiary of the Company (Magellan Peru) pursuant to which Rio Silver through Minera, shall grant to the Company the sole and exclusive option to acquire an undivided 50% interest in and to property located in central Peru. Under the terms of the Agreement, the Company has the right to earn an undivided 50% interest in the Niñobamba Silver/Gold Project in central Peru. To earn its 50% interest, the Company must spend $2.0 million in exploration over three years. The Niñobamba project is comprised of four concessions that total 31 square kilometers (7,660 acres).

Our primary focus during the next twelve months, and depending on available resources, will be to further explore our mineral properties.

Results of Operations

Results of Operations for the three months Ended September 30, 2016 and 2015

	Three Months Ended September 30, 2016	2015
Operating expenses:	$	$
Exploration costs	15,056	13,337
General and administrative expenses	91,309	60,967
Total operating expenses	106,365	74,304
Operating loss	(106,365)	(74,304)
Other income (expense):		
Interest expense	(15,684)	(14,498)
Loss on change in derivative liability	70,680	(8,270)
	$	$
Net loss	(51,369)	(97,072)

Operating expenses

During the three months ended September 30, 2016, our total operating expenses were $106,365 as compared to $74,304 during the three months ended September 30, 2015.

During the three months ended September 30, 2016 we incurred $15,056 of exploration costs as compared to $13,337 in 2015. Exploration costs for the three months ended September 30, 2016 are comprised of $11,000 of royalty and lease payments associated with out Silver District claims, and approximately $4,000 of professional geologic expenses, also associated with our Silver District claims. Exploration costs for the three months ended September 30, 2015 are comprised of $13,000 of advance royalty payments associated with our Silver District claims and $337 of professional geologic expenses.

General and administrative expenses for the three months ended September 30, 2016 totaling $91,309 were comprised professional fees including accounting and audit fees of $11,011, legal fees totaling $4,970, management fees to Mr. Power totaling $7,500, other professional fees including investor relations and website fees of $14,000, and other expenses totaling $28,319 mainly comprised of travel expenses, rent, licenses and BLM claim renewal fees for the Silver District of $17,050 and other administrative related expenses.

In additon, on June 1, 2016 we executed an employment agreement with Dr. Carson in which Dr. Carson assumed the positions of President and Chief Executive Officer of Magellan Gold Corporation. The term of the agreement covers the period from June 1, 2016 to May 31, 2017. During the term of the agreement, Dr. Carson will be paid a base salary in equal semi-monthly installments. Dr. Carson s salary is set at $6,667 per month during the three-month period from June 1, 2016 through August 31, 2016, and thereafter at $10,000 per month during the nine-month period from September 1, 2016 through May 31, 2017. A total of $25,509 representing Dr. Carson s base salary and applicable payroll taxes was expensed and is included in general and administrative expenses for the three months ended September 30, 2016.

General and administrative expenses for the three months ended September 30, 2015 totaling $60,967 were comprised professional fees including accounting and audit fees of $9,508, legal fees totaling $5,635, management fees to Mr. Power totaling $7,500, other professional fees of $1,240, and other expenses totaling $24,584 mainly comprised of travel expenses, claim renewal and other fees paid to the BLM ($17,050 Silver District and $2,170 Sacramento Project), licenses and other administrative related expenses.

In addition, in June 2015, we transferred 15% of our ownership interest in G+W to Dr. Pierce Carson in exchange for one year of service as President, Chief Executive Officer and Director of G+W. The transaction was valued at $50,000 representing deferred compensation for the one-year period June 2015, through May 2016. General and administrative expenses for the three months ended September 30, 2015 includes $12,500 of compensation expense representing the amortization of deferred compensation for the three months ended September 30, 2015.

Interest expense for the three months ended September 30, 2016 and 2015 totaled $15,684 and $14,498, respectively, and is primarily attributable to our related party line of credit, which accrues interest at the rate of 6.0% per year, and our related party notes payable which accrue interest at a weighted average interest rate of 6.38%.

In addition, in October 2014 we converted certain amounts payable to a legal services provider into a Convertible Note Payable. Interest accrues quarterly on the outstanding principal and interest balances of the Note at 6% per annum.

The Note contains certain anti-dilution provisions that would reduce the conversion price should the Company issue common stock equivalents at a price less than the Note conversion price. Accordingly, the conversion features of the Note are considered a discount to the Note. The Note is evaluated quarterly, and upon any quarterly valuations in which the value of the discount changes, we recognize a gain or loss due to a decrease or increase, respectively, in the fair value of the derivative liability. As a result of this evaluation, for the three months ended September 30, 2016 we recorded a gain on the change in the derivative liability of $70,680, as compared to a loss on the change in the derivative liability of $8,270 for the three months ended September 30, 2015.

We estimated the fair value of the derivative at September 30, 2016 and December 31, 2015 using the Black-Scholes option pricing model, which includes assumptions for expected dividends, expected share price volatility, risk-free interest rate, and expected life of the Note. Our expected volatility assumption is based on our historical weekly closing price of our stock over a period equivalent to the expected remaining life of the Note.

The following table summarizes the assumptions used to value the derivative liability at September 30, 2016:

Fair value assumptions derivative:	**September 30, 2016**
Risk free interest rate	0.59%
Expected term (years)	1.0
Expected volatility	134%
Expected dividends	0%

The following table summarizes the assumptions used to value the derivative liability at December 31, 2015:

Fair value assumptions derivative:	**December 31, 2015**
Risk free interest rate	0.65%
Expected term (years)	1.0
Expected volatility	155%
Expected dividends	0%

Results of Operations for the nine months Ended September 30, 2016 and 2015

	Nine Months Ended September 30, 2016	2015
Operating expenses:	$	$
Exploration costs	34,220	17,496
General and administrative expenses	231,983	133,736
Total operating expenses	266,203	151,232
Operating loss	(266,203)	(151,232)
Other income (expense):		
Interest expense	(46,387)	(40,995)
Loss on change in derivative liability	(75,854)	(16,890)

	$	$
Net loss	(388,444)	(209,117)

23

Operating expenses

During the nine months ended September 30, 2016, our total operating expenses were $266,203 as compared to $151,232 during the nine months ended September 30, 2015.

During the nine months ended September 30, 2016 we incurred $34,220 of exploration costs as compared to $17,496 in 2015. Exploration costs for the nine months ended September 30, 2016 are primarily comprised of $11,860 of royalty and lease payments and legal title work associated with our Silver District claims, as well as $22,360 of geologic related expenses including a contracted ground magnetic survey, laboratory soil analysis and geologist consulting fees associated with our Silver District project. Exploration costs for the nine months ended September 30, 2015 are primarily comprised of $13,000 of advance royalty payments associated with our Silver District claims, and geologist fees associated with oversight of our holdings and review of potential opportunities.

General and administrative expenses for the nine months ended September 30, 2016 totaling $231,983 were comprised professional fees including accounting and audit fees of $38,637, legal fees totaling $20,388, management fees to Mr. Power totaling $22,500, executive compensation expense of $53,630, other professional fees including investor relations and website fees of $55,507, and other expenses totaling $41,321 mainly comprised of travel expenses, rent, licenses, BLM renewal fees, and other administrative related expenses.

On June 1, 2015, we transferred 15% of our ownership interest in G+W to Dr. Pierce Carson in exchange for one year of service as President, Chief Executive Officer and Director of G+W. The transaction was valued at $50,000 representing deferred compensation for the one-year period June 2015, through May 2016. Executive compensation expenses for the nine months ended September 30, 2016 includes $20,833 of compensation expense representing the amortization of the deferred compensation.

On June 1, 2016 we executed an employment agreement with Dr. Pierce Carson in which Dr. Carson assumed the positions of President and Chief Executive Officer of Magellan Gold Corporation. The term of the agreement covers the period from June 1, 2016 to May 31, 2017. During the term of the agreement, Dr. Carson will be paid a base salary in equal semi-monthly installments. Dr. Carson s salary is set at $6,667 per month during the three-month period from June 1, 2016 through August 31, 2016, and thereafter at $10,000 per month during the nine-month period from September 1, 2016 through May 31, 2017. A total of $32,797 representing Dr. Carson s base salary and applicable payroll taxes was expensed and is included in general and administrative expenses for the nine months ended September 30, 2016.

General and administrative expenses for the nine months ended September 30, 2015 totaling $133,736 were comprised professional fees including accounting and audit fees of $34,143, legal fees totaling $22,148, management fees to Mr. Power totaling $22,500, other professional fees of $5,998, and other expenses totaling $32,280 mainly comprised of travel expenses, claim renewal and other fees paid to the BLM ($17,050 Silver District and $2,170 Sacramento Project), licenses and other administrative related expenses. In addition, it includes executive compensation expense of $16,667 representing the amortization of the deferred compensation as discussed above.

Interest expense for the nine months ended September 30, 2016 and 2015 totaled $46,387 and $40,995, respectively, and is primarily attributable to our related party line of credit, which accrues interest at the rate of 6.0% per year, and our related party notes payable which accrue interest at a weighted average interest rate of 6.38%.

In addition, in October 2014 we converted certain amounts payable to a legal services provider into a Convertible Note Payable. Interest accrues quarterly on the outstanding principal and interest balances of the Note at 6% per annum.

The Note contains certain anti-dilution provisions that would reduce the conversion price should the Company issue common stock equivalents at a price less than the Note conversion price. Accordingly, the conversion features of the Note are considered a discount to the Note. The Note is evaluated quarterly, and upon any quarterly valuations in which the value of the discount changes, we recognize a gain or loss due to a decrease or increase, respectively, in the fair value of the derivative liability. As a result of this evaluation, for the nine months ended September 30, 2016 and 2015, we recorded a loss on the change in the derivative liability of $75,854 and $16,890, respectively.

We estimated the fair value of the derivative at September 30, 2016 and December 31, 2015 using the Black-Scholes option pricing model, which includes assumptions for expected dividends, expected share price volatility, risk-free interest rate, and expected life of the Note. Our expected volatility assumption is based on our historical weekly closing price of our stock over a period equivalent to the expected remaining life of the Note.

The following table summarizes the assumptions used to value the derivative liability at September 30, 2016:

Fair value assumptions derivative:	**September 30, 2016**
Risk free interest rate	0.59%
Expected term (years)	1.0
Expected volatility	134%
Expected dividends	0%

The following table summarizes the assumptions used to value the derivative liability at December 31, 2015:

Fair value assumptions derivative:	**December31, 2015**
Risk free interest rate	0.65%

Expected term (years)	1.0
Expected volatility	155%
Expected dividends	0%

Liquidity and Capital Resources:

Our consolidated financial statements have been prepared on a going concern basis, which assumes that we will be able to meet our obligations and continue our operations during the next fiscal year. Asset realization values may be significantly different from carrying values as shown in our consolidated financial statements and do not give effect to adjustments that would be necessary to the carrying values of assets and liabilities should we be unable to continue as a going concern. At September 30, 2016, we had not yet generated any revenues or achieved profitable operations and we have accumulated losses of $1,750,200. We expect to incur further losses in the development of our business, all of which casts substantial doubt about our ability to continue as a going concern. Our ability to continue as a going concern depends on our ability to generate future profits and/or to obtain the necessary financing to meet our obligations arising from normal business operations when they come due.

We intend to meet our cash requirements for the next 12 months primarily through the utilization of our line of credit, as well as the private placement of debt or equity instruments.

We maintain a line of credit arrangement with John D. Gibbs, a significant investor, to facilitate timely cash flows for the Company s operations. This agreement was initiated in 2012 and has been amended at various times since its inception to increase the amount available under the credit line. In 2014, we amended the agreement to include a pledge of all our equity interests in G+W, which owns the Silver District properties, as security for all amounts outstanding under the credit agreement. As of September 30, 2016 the credit line had a borrowing limit of $1,000,000 and accrues interest at 6% per annum. At September 30, 2016 a total of $932,500 was outstanding under this line of credit. In addition, a total of $143,751 of interest has been accrued on this obligation.

In June 2016, we closed a private placement of our securities in which we sold 4,875,000 units consisting of common stock and warrants. We realized net proceeds totaling $194,325. The funds received were generally used for general working capital as well as to fund our efforts to expand our portfolio of exploration opportunities.

Our primary priority is to retain our reporting status with the SEC, which means that we will first ensure that we have sufficient capital to cover our legal and accounting expenses. Once these costs are accounted for, in accordance with how much financing we are able to secure, we will focus on further exploration and development of our mineral properties. We will likely not expend funds on the remainder of our planned activities unless we have the required capital.

Cash Flows

A summary of our cash provided by and used in operating, investing and financing activities is as follows:

	Nine Months Ended September 30, 2016	2015
	$	$
Net cash used in operating activities	(199,417)	(127,244)
Net cash used in investing activities	(71,753)	-
Net cash provided by financing activities	274,325	127,150
Net increase (decrease) in cash and cash equivalents	3,155	(94)
Cash and cash equivalents beginning of period	867	94
	$	$
Cash and cash equivalents end of period	4,022	0

At September 30, 2016, we had $4,022 in cash and a $1,371,618 working capital deficit. This compares to cash of $867 and a working capital deficit of $1,193,037 at December 31, 2015.

Net cash used in operating activities during the nine months ended September 30, 2016 was $199,417 and was mainly comprised of our $388,444 net loss during the period, adjusted by a non-cash charge of $20,833 representing the amortization of deferred compensation, and the loss on an increase in our derivative liability of $75,854. In addition, it reflects a cash adjusted increase in prepaid expenses and other assets totaling $733, as well as increases in accounts payable and accrued expenses totaling $49,186, and increases in accrued interest totaling $43,887 representing accrued interest on our related party line of credit and related party and other notes payable.

Net cash used in operating activities during the nine months ended September 30, 2015 was $127,244 and was mainly comprised of our $209,117 net loss during the period, which was partially offset with the change in our derivative liability and the amortization of deferred compensation. We also had an increase in prepaid expenses of $4,109 as well as increases in accounts payable and accrued expenses totaling $18,680, and increases in accrued interest totaling $33,745 representing accrued interest on our related party line of credit and notes payable.

On June 30, 2016 the Company signed a non-binding Letter of Intent (LOI) with Rio Silver Inc., pursuant to which Magellan is granted the option to earn an undivided 50% interest in the Niñobamba Silver-Gold Property, located in Peru. The parties intend to replace the LOI with a definitive agreement containing industry standard terms following a 45-day due diligence period. As part of the agreement, the Company paid a refundable $12,000 deposit. This payment was recorded as a deposit and represents an investment activity during the nine months ended September 30, 2016.

27

In addition to the deposit, the Company is obliged to subscribe to two private placement unit financings in Rio Silver, each for aggregate proceeds of Cdn$75,000. The Company completed the first unit private placement on August 23, 2016. The first placement unit includes one share of Rio Silver common stock and one warrant to purchase one share of Rio Silver common stock for Cdn$0.05. The cost of the units totaled USD $59,753 and was recorded as an investment in Rio Silver equity securities.

We engaged in no investing activities during the nine months ended September 30, 2015.

During the nine months ended September 30, 2016, net cash provided by financing activities was $274,325, and included $45,000 of additional borrowings under our credit agreement with Mr. Gibbs, as well as $35,000 cash received from Mr. Power represented by a 6% note payable due December 31 2016. In addition, we received $12,650 in advances from Mr. Power, all of which were repaid during the period.

Also, in June 2016, we completed a private placement of equity securities in which we sold 4,875,000 units priced at $0.04 per unit. Each unit was comprised of one share of common stock, one Class A warrant and one Class B warrant. Each Class A warrant entitles the holder to purchase one share of common stock at a price of $0.07 per share in cash, and expire December 30, 2016. Each Class B warrant entitles the holder to purchase one share of common stock at a price of $0.10 per share, exercisable in either cash or pursuant to a cashless exercise. The sale was concluded on June 30, 2016 and resulted in net proceeds of $194,325, which were net of $675 of direct offering costs.

During the nine months ended September 30, 2015, net cash provided by financing activities was $127,150, which primarily reflects additional borrowings totaling $130,000 under our credit agreement with Mr. Gibbs. In addition, we received $5,350 and subsequently repaid $8,200 in outstanding advances made by Mr. Power.

Other non-cash transaction: On September 1, 2016 the Company executed an Investor Relations Engagement Agreement (Agreement) with Intuitive Pty Ltd (Intuitive), an investor relations firm located in Australia. The Agreement provides for Intuitive to undertake an investor relations and communications program that will focus on potential investors outside the United States. The term of the Agreement runs for two years beginning on September 1, 2016. As consideration for the services, the Company issued 500,000 shares of its common stock. The transaction was valued at $65,000 based on the $0.13 per share closing price of the Company s common stock on September 1, 2016. The transaction is being amortized monthly over the life of the Agreement. For both the three and nine months ended September 30, 2016 a total of $2,708 was charged to general and administrative expenses. The balance of the contract is included in prepaid expenses on the accompanying balance sheet at September 30, 2016.

Off Balance Sheet Arrangements

We do not have and have never had any off-balance sheet arrangements.

Recent Accounting Pronouncements:

Recently issued Financial Accounting Standards Board Accounting Standards Codification guidance has either been implemented or is not significant to us.

Critical Accounting Policies

The preparation of financial statements in conformity with U.S. GAAP requires us to make estimates, assumptions and judgments that affect the amounts reported in our financial statements. The accounting positions described below are significantly affected by critical accounting estimates.

We believe that the significant estimates, assumptions and judgments used when accounting for items and matters such as capitalized mineral rights, asset valuations, recoverability of assets, asset impairments, taxes, and other provisions were reasonable, based upon information available at the time they were made. Actual results could differ from these estimates, making it possible that a change in these estimates could occur in the near term.

Mineral Rights

We have determined that our mining rights meet the definition of mineral rights, as defined by accounting standards, and are tangible assets. As a result, our direct costs to acquire or lease mineral rights are initially capitalized as tangible assets. Mineral rights include costs associated with: leasing or acquiring patented and unpatented mining claims; leasing mining rights including lease signature bonuses, lease rental payments and advance minimum royalty payments; and options to purchase or lease mineral properties.

If we establish proven and probable reserves for a mineral property and establish that the mineral property can be economically developed, mineral rights will be amortized over the estimated useful life of the property following the commencement of commercial production or expensed if it is determined that the mineral property has no future economic value or if the property is sold or abandoned. For mineral rights in which proven and probable reserves have not yet been established, we assess the carrying values for impairment at the end of each reporting period and whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

The net carrying value of our mineral rights represents the fair value at the time the mineral rights were acquired less accumulated depletion and any impairment losses. Proven and probable reserves have not been established for mineral rights as of September 30, 2016. No impairment loss was recognized during either the nine months ended September 30, 2016 and 2015.

Impairment of Long-lived Assets

We continually monitor events and changes in circumstances that could indicate that our carrying amounts of long-lived assets, including mineral rights, may not be recoverable. When such events or changes in circumstances occur, we assess the recoverability of long-lived assets by determining whether the carrying value of such assets will be recovered through their undiscounted expected future cash flows. If the future undiscounted cash flows are less than the carrying amount of these assets, we recognize an impairment loss based on the excess of the carrying amount over the fair value of the assets.

Exploration Costs

Mineral exploration costs are expensed as incurred. When it has been determined that it is economically feasible to extract minerals and the permitting process has been initiated, exploration costs incurred to further delineate and develop the property are considered pre-commercial production costs and will be capitalized and included as mine development costs in our consolidated balance sheets.

Share-based Payments

We measure and recognize compensation expense or professional services expense for all share-based payment awards made to employees, directors and non-employee consultants based on estimated fair values. We estimate the fair value of stock options on the date of grant using the Black-Scholes-Merton option pricing model, which includes assumptions for expected dividends, expected share price volatility, risk-free interest rate, and expected life of the options. Our expected volatility assumption is based on our historical weekly closing price of our stock over a period equivalent to the expected life of the options.

We expense share-based compensation, adjusted for estimated forfeitures, using the straight-line method over the vesting term of the award for our employees and directors and over the expected service term for our non-employee consultants. We estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from our estimates. Our excess tax benefits, if any, cannot be credited to stockholders equity until the deduction reduces cash taxes payable; accordingly, we realized no excess tax benefits during any of the periods presented in the accompanying consolidated financial statements.

Income Taxes

We account for income taxes through the use of the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis, and for income tax carry-forwards. A valuation allowance is recorded to the extent that we cannot conclude that realization of deferred tax assets is more likely than not. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in operations in the period that includes the enactment date.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 4. CONTROLS AND PROCEDURES

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures:

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s (SEC) rules and forms, and that such information is accumulated and communicated to management, including John C. Power, our President who is also our Principal Accounting Officer, as appropriate, to allow timely decisions regarding required disclosure. Management necessarily applied its judgment in assessing the costs and benefits of such controls and procedures, which, by their nature, can provide only reasonable assurance regarding management s control objectives.

Our management, with the participation of our CEO, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based upon this evaluation, our CEO concluded that our disclosure controls and procedures were not effective as of such date as a result of a material weakness in our internal control over financial reporting due to lack of segregation of duties and a limited corporate governance structure as discussed in Item 9A of our Form 10-K for the fiscal year ended December 31, 2015.

While we strive to segregate duties as much as practicable, there is an insufficient volume of transactions at this point in time to justify additional full time staff. We believe that this is typical in many exploration stage companies. We may not be able to fully remediate the material weakness until we commence mining operations at which time we would expect to hire more staff. We will continue to monitor and assess the costs and benefits of additional staffing.

Changes in Internal Control Over Financial Reporting:

There were no changes in our internal control over financial reporting that occurred during the last fiscal quarter covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 1A. RISK FACTORS

There have been no material changes from the risk factors disclosed in Item 1A. to Part I. of our Annual Report on Form 10-K for the year ended December 31, 2015.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

All sales of unregistered securities were reported on Form 8-K during the period.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

None.

ITEM 5. OTHER INFORMATION

None.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: November 15, 2016.

MAGELLAN GOLD CORPORATION

By: /s/ W. Pierce Carson

W. Pierce Carson

President, Chief Executive Officer

(Principal Executive Officer),

By: /s/ John C. Power

John C. Power

Chief Financial Officer

(Principal Accounting Officer)