

ZYNGA INC  
Form 10-Q  
May 08, 2012  
Table of Contents

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

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended March 31, 2012

OR

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

For the transition period from            to

Commission File Number: 001-35375

**Zynga Inc.**

(Exact name of registrant as specified in its charter)

Edgar Filing: ZYNGA INC - Form 10-Q

|  |  |
|--|--|
| <b>Delaware</b><br>(State of Incorporation)  | <b>42-1733483</b><br>(IRS Employer Identification No.) |
| <b>699 Eighth Street</b><br><b>San Francisco, CA</b><br>(Address of Principal Executive Offices) | <b>94103</b><br>(Zip Code)                             |
| <b>(855) 449-9642</b><br><br>(Telephone No.)   |  |

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

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

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

|   |  |
|---|--|
| Large accelerated filer <input type="checkbox"/>  | Accelerated filer <input type="checkbox"/>         |
| Non-accelerated filer <input checked="" type="checkbox"/> (Do not check if a smaller reporting company) | Smaller reporting company <input type="checkbox"/> |

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes  No

As of April 15, 2012, there were 218,969,756 shares of the Registrant's Class A common stock outstanding, 496,552,654 shares of the Registrant's Class B common stock outstanding and 20,517,472 shares of the Registrant's Class C common stock outstanding.

**Table of Contents**

**Zynga Inc.**

**Form 10-Q Quarterly Report**

**TABLE OF CONTENTS**

|  | <b>Page</b> |
|--|-------------|
| <u>Special Note Regarding Forward-Looking Statements</u>   | 2           |
| PART I. FINANCIAL INFORMATION  |             |
| Item 1. <u>Financial Statements (Unaudited)</u>  | 3           |
| <u>Consolidated Balance Sheets as of March 31, 2012 and December 31, 2011</u>  | 3           |
| <u>Consolidated Statements of Operations and Comprehensive Income for the Three Months Ended March 31, 2012 and 2011</u> | 4           |
| <u>Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2012 and 2011</u>                          | 6           |
| <u>Notes to Consolidated Financial Statements</u>  | 7           |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                     | 17          |
| Item 3. <u>Quantitative and Qualitative Disclosure About Market Risk</u>   | 29          |
| Item 4. <u>Controls and Procedures</u>   | 29          |
| PART II. OTHER INFORMATION   |             |
| Item 1. <u>Legal Proceedings</u>   | 29          |
| Item 1A. <u>Risk Factors</u>   | 30          |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>   | 44          |
| Item 6. <u>Exhibits</u>  | 45          |
| <u>Signatures</u>  | 46          |
| <u>Exhibit Index</u>   | 47          |

Zynga, the Zynga logo and other trademarks or service marks of Zynga appearing in this report are the property of Zynga. Trade names, trademarks and service marks of other companies appearing in this report are the property of their respective holders.

References in this report to DAUs mean daily active users of our games, MAUs mean monthly active users of our games, MUUs mean monthly unique users of our games, MUPs mean monthly unique payers for our games and ABPU means average daily bookings per average DAU. Unless otherwise indicated, these metrics are based on internally-derived measurements across all platforms on which our games are played. For further information about DAUs, MAUs, MUUs, MUPs and ABPU as measured by us, see the section titled Management's Discussion and Analysis of Financial Condition and Results of Operations Key Metrics.

**Table of Contents**

**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q contains forward-looking statements. In some cases you can identify these statements by forward-looking words such as believe, may, will, estimate, continue, anticipate, intend, could, would, project, plan, expect, or the negative words or similar expressions. These forward-looking statements include, but are not limited to, statements concerning the following:

our future relationship with Facebook;

our corporate strategy and initiatives;

launching new games and enhancements to games that are commercially successful;

user traffic to Zynga.com and publishing games from third-party developers on Zynga.com;

continued growth in demand for virtual goods and in the social games industry;

building and sustaining our franchise games;

the ability of our games to generate revenue and bookings for a significant period of time after launch;

capital expenditures and investment in our network infrastructure, including data centers;

our use of working capital in general;

retaining and adding players and increasing the monetization of our player base;

maintaining a technology infrastructure that can efficiently and reliably handle increased player usage, fast load times and the deployment of new features and products;

attracting and retaining qualified employees and key personnel;

designing games for mobile and other non-PC devices, and pursuing mobile initiatives generally;

our successful growth internationally and in advertising revenue;

## Edgar Filing: ZYNGA INC - Form 10-Q

our evaluation of new business opportunities, including online gambling;

maintaining, protecting and enhancing our intellectual property;

protecting our players' information and adequately addressing privacy concerns; and

successfully acquiring and integrating companies and assets.

These forward-looking statements are subject to a number of risks, uncertainties and assumptions, including those described in Part II, Item 1A, Risk Factors in this Quarterly Report on Form 10-Q. Moreover, we operate in a very competitive and rapidly changing environment. New risks emerge from time to time. It is not possible for our management to predict all risks, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements we may make. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this Quarterly Report on Form 10-Q may not occur and actual results could differ materially and adversely from those anticipated or implied in the forward-looking statements.

You should not rely upon forward-looking statements as predictions of future events. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee that the future results, levels of activity, performance or events and circumstances reflected in the forward-looking statements will be achieved or occur. Moreover, except as required by law, neither we nor any other person assumes responsibility for the accuracy and completeness of the forward-looking statements. We undertake no obligation to update publicly any forward-looking statements for any reason to conform these statements to actual results or to changes in our expectations.

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements (Unaudited)****Zynga Inc.****Consolidated Balance Sheets***(In thousands, except par value)**(Unaudited)*

|  | March 31,<br>2012   | December 31,<br>2011 |
|--|---------------------|----------------------|
| <b>Assets</b>  |                     |                      |
| Current assets:  |                     |                      |
| Cash and cash equivalents  | \$ 361,074          | \$ 1,582,343         |
| Marketable securities  | 701,662             | 225,165              |
| Accounts receivable, net of allowance of \$163 at March 31, 2012 and December 31, 2011   | 146,746             | 135,633              |
| Income tax receivable  | 6,430               | 18,583               |
| Deferred tax assets  | 21,794              | 23,515               |
| Restricted cash  | 260,021             | 3,846                |
| Other current assets   | 47,674              | 34,824               |
| <b>Total current assets</b>  | <b>1,545,401</b>    | <b>2,023,909</b>     |
| Long-term marketable securities  | 458,731             | 110,098              |
| Goodwill   | 195,796             | 91,765               |
| Other intangible assets, net   | 143,426             | 32,112               |
| Property and equipment, net  | 255,251             | 246,740              |
| Restricted cash  | 60                  | 4,082                |
| Other long-term assets   | 7,281               | 7,940                |
| <b>Total assets</b>  | <b>\$ 2,605,946</b> | <b>\$ 2,516,646</b>  |
| <b>Liabilities and stockholders' equity</b>  |                     |                      |
| Current liabilities:   |                     |                      |
| Accounts payable   | \$ 44,312           | \$ 44,020            |
| Other current liabilities  | 181,899             | 167,271              |
| Deferred revenue   | 478,303             | 457,394              |
| <b>Total current liabilities</b>   | <b>704,514</b>      | <b>668,685</b>       |
| Deferred revenue   | 10,534              | 23,251               |
| Deferred tax liabilities   | 53,020              | 13,950               |
| Other non-current liabilities  | 62,508              | 61,221               |
| <b>Total liabilities</b>   | <b>830,576</b>      | <b>767,107</b>       |
| Stockholders' equity:  |                     |                      |
| Common stock, \$.00000625 par value, and additional paid in capital authorized: 2,020,517 shares; outstanding: 732,178 shares (Class A, 158,317, Class B, 553,344, Class C, 20,517) as of March 31, 2012 and 721,592 shares (Class A, 121,381, Class B, 579,694 Class C, 20,517) as of December 31, 2011 | 2,537,103           | 2,426,168            |
| Treasury stock   | (282,924)           | (282,897)            |
| Accumulated other comprehensive income   | 636                 | 362                  |
| Accumulated deficit  | (479,445)           | (394,094)            |

Edgar Filing: ZYNGA INC - Form 10-Q

|  |              |              |
|--|--------------|--------------|
| Total stockholders' equity                 | 1,775,370    | 1,749,539    |
| Total liabilities and stockholders' equity | \$ 2,605,946 | \$ 2,516,646 |

*See accompanying notes.*

**Table of Contents****Zynga Inc.****Consolidated Statements of Operations***(In thousands, except per share data)**(Unaudited)*

|   | <b>Three Months Ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2012</b>                             | <b>2011</b> |
| Revenue   | \$ 320,972                              | \$ 242,890  |
| Costs and expenses:   |   |             |
| Cost of revenue   | 90,122                                  | 67,662      |
| Research and development  | 186,876                                 | 71,760      |
| Sales and marketing   | 56,837                                  | 40,156      |
| General and administrative  | 72,715                                  | 27,110      |
| Total costs and expenses  | 406,550                                 | 206,688     |
| Income (loss) from operations   | (85,578)                                | 36,202      |
| Interest income   | 1,291                                   | 518         |
| Other (expense), net  | (1,142)                                 | (736)       |
| Income (loss) before income taxes   | (85,429)                                | 35,984      |
| (Provision for) / benefit from income taxes   | 78                                      | (19,226)    |
| Net income (loss)   | \$ (85,351)                             | \$ 16,758   |
| Net income attributable to participating securities   |   | 15,416      |
| Net income (loss) attributable to common stockholders   | \$ (85,351)                             | \$ 1,342    |
| Net income (loss) per share attributable to common stockholders   |   |             |
| Basic   | \$ (0.12)                               | \$ 0.01     |
| Diluted   | \$ (0.12)                               | \$ 0.00     |
| Weighted average common shares used to compute net income (loss) per share attributable to common stockholders: |   |             |
| Basic   | 707,693                                 | 258,168     |
| Diluted   | 707,693                                 | 358,312     |

*See accompanying notes.*



**Table of Contents**

**Zynga Inc.**

**Consolidated Statements of Comprehensive Income (Loss)**

*(In thousands)*

*(Unaudited)*

|   | <b>Three Months Ended</b> |             |
|---|---------------------------|-------------|
|   | <b>March 31,</b>          |             |
|   | <b>2012</b>               | <b>2011</b> |
| Net income (loss)   | \$ (85,351)               | \$ 16,758   |
| Other comprehensive income (loss):  |                           |             |
| Change in foreign currency translation adjustment                                     | 121                       | (3)         |
| Net change on unrealized gains (losses) on available-for-sale investments, net of tax | 153                       | (74)        |
| <b>Other comprehensive income (loss)</b>  | <b>274</b>                | <b>(77)</b> |
| Comprehensive income (loss)   | \$ (85,077)               | \$ 16,681   |

*See accompanying notes.*

**Table of Contents****Zynga Inc.****Consolidated Statements of Cash Flows***(In thousands)**(Unaudited)*

|  | <b>Three Months Ended<br/>March 31,</b> |              |
|--|---|--------------|
|  | <b>2012</b>                             | <b>2011</b>  |
| <b>Operating activities:</b>   |   |              |
| Net income (loss)  | \$ (85,351)                             | \$ 16,758    |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |   |              |
| Depreciation and amortization  | 29,398                                  | 17,847       |
| Stock-based expense  | 133,851                                 | 14,506       |
| Accretion and amortization on marketable securities                                      | 2,836                                   | 868          |
| Loss from sale of property and equipment   | 12                                      |              |
| Deferred income taxes  | (1,286)                                 |              |
| Changes in operating assets and liabilities:   |   |              |
| Accounts receivable, net   | (5,617)                                 | (21,791)     |
| Income tax receivable  | 14,242                                  | 14,661       |
| Other assets   | (4,818)                                 | 4,346        |
| Accounts payable   | (283)                                   | 5,074        |
| Deferred revenue   | 8,192                                   | 43,708       |
| Other liabilities  | (12,359)                                | 7,680        |
| Net cash provided by operating activities  | 78,817                                  | 103,657      |
| <b>Investing activities:</b>   |   |              |
| Purchases of marketable securities   | \$ (964,741)                            | \$ (272,418) |
| Sales of marketable securities   | 16,747                                  | 1,501        |
| Maturities of marketable securities  | 116,126                                 | 285,699      |
| Acquisition of property and equipment  | (34,994)                                | (50,222)     |
| Acquisition of purchased technology and other intangible assets                          | (3,139)                                 | (1,640)      |
| Business acquisitions, net of cash acquired  | (182,164)                               | (10,438)     |
| Restricted cash  | (224,952)                               | (8,020)      |
| Purchases of other investments   | (38)                                    |              |
| Net cash used in investing activities  | (1,277,155)                             | (55,538)     |
| <b>Financing activities:</b>   |   |              |
| Taxes paid related to net share settlement of ZSUs                                       | \$ (23,500)                             | \$           |
| Repurchases of common stock  |   | (261,270)    |
| Exercise of stock options  | 533                                     | 1,205        |
| Net proceeds from issuance of preferred stock  |   | 485,314      |
| Net cash provided by (used in) financing activities                                      | (22,967)                                | 225,249      |
| Effect of exchange rate changes on cash and cash equivalents                             | 36                                      | 21           |
| Net increase (decrease) in cash and cash equivalents                                     | (1,221,269)                             | 273,389      |
| Cash and cash equivalents, beginning of period   | 1,582,343                               | 187,831      |
| Cash and cash equivalents, end of period   | \$ 361,074                              | \$ 461,220   |

*See accompanying notes.*

**Table of Contents**

**Zynga Inc.**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**1. Overview and Summary of Significant Accounting Policies**

***Organization and Description of Business***

Zynga Inc. ( Zynga, we or the Company ) develops, markets and operates online social games as live services played over the Internet and on social networking sites and mobile platforms. We generate revenue primarily through the in-game sale of virtual goods. Our operations are headquartered in San Francisco, California, and we have several operating locations in the United States as well as various international office locations in Asia and Europe.

We were originally organized in April 2007 as a California limited liability company under the name Presidio Media LLC, converted to a Delaware corporation in October 2007 and changed our name to Zynga Inc. in November 2010. We completed our initial public offering in December 2011 and our Class A common stock is listed on the NASDAQ Global Select Market under the symbol ZNGA.

***Basis of Presentation and Consolidation***

The accompanying consolidated financial statements are presented in accordance with United States generally accepted accounting principles ( U.S. GAAP ). The consolidated financial statements include the operations of Zynga and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

The consolidated financial statements and related notes should be read in conjunction with the consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2011. There have been no significant changes to our accounting policies since our Annual Report that have had a significant impact on our consolidated financial statements and related notes.

***Unaudited Interim Financial Information***

The accompanying interim consolidated balance sheet as of March 31, 2012, the consolidated statements of operations and comprehensive income (loss) for the three months ended March 31, 2012 and 2011, the consolidated statements of cash flows for the three months ended March 31, 2012 and 2011 and the related footnote disclosures are unaudited. These unaudited interim financial statements have been prepared in accordance with U.S. GAAP. In management's opinion, the unaudited interim financial statements have been prepared on the same basis as the audited financial statements and include all adjustments of a normal recurring nature necessary for the fair presentation of the Company's statement of financial position as of March 31, 2012, the consolidated statements of operations and comprehensive income (loss) for the three months ended March 31, 2012 and 2011 and the consolidated statements of cash flows for the three months ended March 31, 2012 and 2011. The results for the three months ended March 31, 2012 are not necessarily indicative of the results expected for the full fiscal year or any interim period.

***Use of Estimates***

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and notes thereto. Significant estimates and assumptions reflected in the financial statements include, but are not limited to, the estimated lives of virtual goods that we use for revenue recognition, the chargeback reserve for our third-party payment processors, the allowance for doubtful accounts, useful lives of property and equipment and intangible assets, accrued liabilities, income taxes, accounting for business combinations, stock-based expense and evaluation of goodwill and long-lived assets for impairment. Actual results could differ materially from those estimates.

***Recently Adopted Accounting Pronouncements***

***Presentation of Comprehensive Income***

## Edgar Filing: ZYNGA INC - Form 10-Q

In June 2011, the Financial Accounting Standards Board ( FASB ) issued an amendment to an existing accounting standard which requires companies to present net income and other comprehensive income in one continuous statement or in two separate but consecutive statements. We adopted this standard effective in the first quarter of 2012.

**Table of Contents***Common Fair Value Measurement and Disclosure Requirements*

In May 2011, the FASB issued an amendment to provide a consistent definition of fair value and ensure that the fair value measurement and disclosure requirements are similar between U.S. GAAP and International Financial Reporting Standards. The amendment changes certain fair value measurement principles and enhances the disclosure requirements particularly for Level 3 fair value measurements. We adopted this standard effective in the first quarter of 2012 with no material impact on our consolidated financial statements and disclosures.

*Testing of Goodwill Impairment*

In September 2011, the FASB issued an amendment to an existing accounting standard which provides entities an option to perform a qualitative assessment to determine whether further impairment testing on goodwill is necessary, thereby only requiring the current two-step test to be completed if management's qualitative assessment indicates a reporting unit's carrying value is in excess of its fair value. We adopted this standard effective in the first quarter of 2012 with no material impact on our consolidated financial statements and disclosures.

**2. Marketable Securities**

The following tables summarize the Company's amortized cost, gross unrealized gains and losses and fair value of its available-for-sale investments in marketable securities (in thousands):

|                                 | <b>March 31, 2012</b> |                    |                   |                     |
|---------------------------------|-----------------------|--------------------|-------------------|---------------------|
|                                 | <b>Amortized</b>      | <b>Gross</b>       | <b>Gross</b>      | <b>Aggregate</b>    |
|                                 | <b>Cost</b>           | <b>Unrealized</b>  | <b>Unrealized</b> | <b>Fair Value</b>   |
|                                 |                       | <b>Gains</b>       | <b>Losses</b>     |                     |
|                                 |                       | <b>(unaudited)</b> |                   |                     |
| U.S. government debt securities | \$ 779,654            | \$ 70              | \$ (278)          | \$ 779,446          |
| Corporate debt securities       | 380,677               | 529                | (259)             | 380,947             |
| <b>Total</b>                    | <b>\$ 1,160,331</b>   | <b>\$ 599</b>      | <b>\$ (537)</b>   | <b>\$ 1,160,393</b> |

|                                 | <b>December 31, 2011</b> |                   |                   |                   |
|---------------------------------|--------------------------|-------------------|-------------------|-------------------|
|                                 | <b>Amortized</b>         | <b>Gross</b>      | <b>Gross</b>      | <b>Aggregate</b>  |
|                                 | <b>Cost</b>              | <b>Unrealized</b> | <b>Unrealized</b> | <b>Fair Value</b> |
|                                 |                          | <b>Gains</b>      | <b>Losses</b>     |                   |
| U.S. government debt securities | \$ 267,635               | \$ 53             | \$ (53)           | \$ 267,635        |
| Corporate debt securities       | 67,657                   | 35                | (64)              | 67,628            |
| <b>Total</b>                    | <b>\$ 335,292</b>        | <b>\$ 88</b>      | <b>\$ (117)</b>   | <b>\$ 335,263</b> |

The estimated fair value of available-for-sale marketable securities, classified by their contractual maturities was as follows (in thousands):

|                              | <b>March 31,</b>    |
|------------------------------|---------------------|
|                              | <b>2012</b>         |
|                              | <b>(unaudited)</b>  |
| Due within one year          | \$ 701,662          |
| One year through three years | 458,731             |
| <b>Total</b>                 | <b>\$ 1,160,393</b> |

Changes in market interest rates and bond yields cause certain of our investments to fall below their cost basis, resulting in unrealized losses on marketable securities. As of March 31, 2012, we had unrealized losses of \$0.5 million related to marketable securities with a fair value of \$806.7 million. As of December 31, 2011, we had unrealized losses of \$0.1 million related to marketable securities with a fair value of \$111.1 million.

## Edgar Filing: ZYNGA INC - Form 10-Q

None of these securities were in a continuous unrealized loss position for more than 12 months.

As of March 31, 2012 and December 31, 2011, we did not consider any of our marketable securities to be other-than-temporarily impaired. When evaluating our investments for other-than-temporary impairment, we review factors such as the length of time and extent to which fair value has been below its cost basis, the financial condition of the issuer, the Company's ability and intent to hold the security and whether it is more likely than not that the Company will be required to sell the investment before recovery of its cost basis.

**Table of Contents**

**3. Fair Value Measurements**

Our financial instruments consist of cash equivalents, short-term and long-term marketable securities and accounts receivable. Accounts receivable, net of bad debt allowance, are stated at their carrying value, which approximates fair value due to the short time to expected receipt of cash.

Cash equivalents and short-term and long-term marketable securities, consisting of money market funds and U.S. government and corporate debt securities, are carried at fair value, which is defined as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between knowledgeable and willing market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that knowledgeable and willing market participants would use in pricing an asset or liability. We use a three-tier value hierarchy, which prioritizes based on the inputs used in measuring fair value as follows:

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

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

Level 3 Unobservable inputs that are supported by little or no market activity.



**Table of Contents**

The composition of our securities among the three levels of the fair value hierarchy is as follows (in thousands):

|                                 | Level 1           | March 31, 2012         |           | Total               |
|---------------------------------|-------------------|------------------------|-----------|---------------------|
|                                 |                   | Level 2<br>(unaudited) | Level 3   |                     |
| <b>Assets:</b>                  |                   |                        |           |                     |
| Money market funds              | \$ 214,913        | \$                     | \$        | \$ 214,913          |
| U.S. government debt securities |                   | 779,447                |           | 779,447             |
| Corporate debt securities       |                   | 403,447                |           | 403,447             |
| <b>Total</b>                    | <b>\$ 214,913</b> | <b>\$ 1,182,894</b>    | <b>\$</b> | <b>\$ 1,397,807</b> |

|                                 | Level 1             | December 31, 2011 |           | Total               |
|---------------------------------|---------------------|-------------------|-----------|---------------------|
|                                 |                     | Level 2           | Level 3   |                     |
| <b>Assets:</b>                  |                     |                   |           |                     |
| Money market funds              | \$ 1,375,918        | \$                | \$        | \$ 1,375,918        |
| U.S. government debt securities |                     | 267,635           |           | 267,635             |
| Corporate debt securities       |                     | 68,334            |           | 68,334              |
| <b>Total</b>                    | <b>\$ 1,375,918</b> | <b>\$ 335,969</b> | <b>\$</b> | <b>\$ 1,711,887</b> |

**4. Property and Equipment**

Property and equipment consist of the following (in thousands):

|  | March 31,<br>2012<br>(unaudited) | December 31,<br>2011 |
|--|----------------------------------|----------------------|
| Computer equipment                       | \$ 266,686                       | \$ 243,986           |
| Software                                 | 26,693                           | 25,119               |
| Furniture and fixtures                   | 11,909                           | 9,474                |
| Leasehold improvements                   | 71,299                           | 67,456               |
|  | 376,587                          | 346,035              |
| Less accumulated depreciation            | (121,336)                        | (99,295)             |
| <b>Total property and equipment, net</b> | <b>\$ 255,251</b>                | <b>\$ 246,740</b>    |

In April 2012, we purchased our corporate headquarters building in San Francisco, California for \$233.7 million. Pursuant to the agreement, we agreed to acquire (i) the building located at 650 Townsend Street, San Francisco, California consisting of approximately 670,000 square feet of space, (ii) fee title to the real property where the building is located, (iii) property located in the building which was owned by the seller and used to operate and maintain the building and (iv) leases and other intangible property related to the building and real property. At March 31, 2012, we deposited \$229 million in escrow, which is classified as short-term restricted cash as of March 31, 2012. The purchase will be accounted for as a business combination pursuant to (ASC) 805, *Business Combinations*.

**5. Acquisitions**

*Acquisition of OMGPOP.* On March 21, 2012, we acquired 100% of the outstanding stock of OMGPOP, Inc., a provider of social games for mobile phones, tablets, PCs and social network sites, for purchase consideration of approximately \$183.1 million in cash. We acquired OMGPOP to expand our social games offerings, particularly on mobile platforms.

## Edgar Filing: ZYNGA INC - Form 10-Q

As a result of this acquisition, we recorded \$82.3 million of developed technology, \$33.3 million of branding intangible assets, \$5.5 million of net tangible assets acquired, \$42.1 million of deferred tax liabilities assumed and \$104.3 million of residual goodwill. Goodwill from the acquisition represents the excess of the purchase price over the net tangible and intangible assets acquired and is not deductible for tax purposes. Goodwill recorded in connection with this acquisition is primarily attributable to the assembled workforce of the acquired business and the synergies expected to arise after our acquisition of the business. The preliminary fair values of assets acquired and liabilities assumed for the acquisition are subject to change as we obtain additional information for our

**Table of Contents**

estimates during the respective measurement period, up to one year. The primary areas that are not yet finalized relate to certain tangible assets and liabilities, acquired income and non-income based taxes and residual goodwill. The results of OMGPOP have been included in our consolidated results of operations from the date of acquisition and were not material.

The useful lives for the developed technology and branding intangible assets acquired in the OMGPOP acquisition are expected to be three years and seven years, respectively, and will be amortized on a straight-line basis.

**6. Goodwill and Other Intangible Assets**

Changes in the carrying value of goodwill from December 31, 2011 to March 31, 2012 are as follows (in thousands, unaudited):

|  |                   |            |
|--|-------------------|------------|
| Goodwill                                 | December 31, 2011 | \$ 91,765  |
| Additions                                |                   | 104,327    |
| Foreign currency translation adjustments |                   | (297)      |
| Goodwill                                 | March 31, 2012    | \$ 195,796 |

Amortization expense of acquisition-related intangible assets for the three months ended March 31, 2012 and 2011 was \$7.0 million and \$6.1 million, respectively. As of March 31, 2012, future amortization expense related to the intangible assets will be recognized in the periods shown below (in thousands, unaudited):

|                          |            |
|--------------------------|------------|
| Year ending December 31: |            |
| 2012                     | \$ 39,652  |
| 2013                     | 37,051     |
| 2014                     | 33,222     |
| 2015                     | 11,891     |
| 2016 and thereafter      | 15,511     |
|                          | \$ 137,327 |

**7. Income Taxes**

The benefit from / (provision for) income taxes decreased \$19.3 million in the first quarter of 2012. The decrease was attributable to the decrease in pre-tax income of \$121.4 million in the first quarter of 2012, which was primarily driven by higher stock-based expense. The income tax expense for the three months ended March 31, 2011 was impacted by non-deductible stock-based expense and the costs of implementing our international structure.

For the foreseeable future, our effective tax rate will be impacted by additional tax expense associated with the implementation of our international tax structure and the deductibility of stock-based expense. As the implementation of our international tax structure is completed, we anticipate that our effective tax rate will be lower than the U.S. statutory rate.

**8. Other Current Liabilities**

Other current liabilities consist of the following (in thousands):

|                  |                 |
|------------------|-----------------|
|                  | <b>December</b> |
| <b>March 31,</b> | <b>31,</b>      |
| <b>2012</b>      | <b>2011</b>     |

## Edgar Filing: ZYNGA INC - Form 10-Q

|                                   | (unaudited) |            |
|-----------------------------------|-------------|------------|
| Customer deposits                 | \$ 44,471   | \$ 50,140  |
| Accrued payable from acquisitions | 36,099      | 7,242      |
| Other current liabilities         | 101,329     | 109,889    |
| <br>                              |             |            |
| Total other current liabilities   | \$ 181,899  | \$ 167,271 |

Customer deposits represent amounts received for unredeemed game cards as well as advanced payments from various customers. Accrued payable from acquisitions mainly relates to amounts held in escrow under the terms of certain of our merger agreements. Other current liabilities include various expenses accrued by the Company for transaction taxes, acquisition-related expenses, compensation liabilities and accrued accounts payable.

**Table of Contents****9. Stockholders' Equity**

We recorded stock-based expense related to grants of employee and consultant stock options, warrants, restricted stock and restricted stock units ( ZSUs ) in our consolidated statements of operations as follows (in thousands):

|                                   | <b>Three Months Ended March 31,</b> |                  |
|-----------------------------------|-------------------------------------|------------------|
|                                   | <b>2012</b>                         | <b>2011</b>      |
|                                   | <b>(unaudited)</b>                  |                  |
| Cost of revenue                   | \$ 6,818                            | \$ 551           |
| Research and development          | 78,146                              | 9,333            |
| Sales and marketing               | 12,915                              | 2,440            |
| General and administrative        | 35,972                              | 2,182            |
| <b>Total stock-based expenses</b> | <b>\$ 133,851</b>                   | <b>\$ 14,506</b> |

The following table shows stock option activity for the three months ended March 31, 2012 (in thousands, except weighted-average exercise price and contractual term):

|  | <b>Shares</b> | <b>Weighted-Average Exercise Price</b> | <b>Outstanding Options Aggregate Intrinsic Value of Stock Options Outstanding (unaudited)</b> | <b>Weighted Average Contractual Term (In years)</b> |
|--|---------------|--|---|---|
| Balance as of December 31, 2011            | 102,314       | \$ 0.69                                | \$ 892,135  | 7.04  |
| Stock option grants                        |               |  |   |   |
| Stock option forfeitures and cancellations | (947)         | 0.47                                   |   |   |
| Stock option exercises                     | (2,906)       | 0.19                                   |   |   |
| <b>Balance as of March 31, 2012</b>        | <b>98,461</b> | <b>\$ 0.71</b>                         | <b>\$ 1,225,126</b>   | <b>7.05</b>   |

The following table shows a summary of ZSU activity for the three months ended March 31, 2012 (in thousands, except weighted-average fair value and remaining term):

|                                      | <b>Shares</b> | <b>Weighted-Average Grant Date Fair Value</b> | <b>Outstanding ZSUs Aggregate Intrinsic Value of Unvested ZSUs (unaudited)</b> | <b>Weighted Average Remaining Term (In years)</b> |
|--------------------------------------|---------------|---|--|---|
| Unvested as of December 31, 2011     | 79,818        | \$ 11.24                                      | \$ 751,090   | 1.45  |
| Granted                              | 11,014        | 13.89   |  |   |
| Vested                               | (9,166)       | 11.57   |  |   |
| Forfeited and cancelled              | (4,937)       | 10.86   |  |   |
| <b>Unvested as of March 31, 2012</b> | <b>76,729</b> | <b>\$ 11.61</b>                               | <b>\$ 1,008,986</b>  | <b>1.62</b>                                       |

In March 2012, we donated one million shares of Class A common stock to Zynga.org, an unaffiliated non-profit organization that was formed in March 2012 to support charitable causes in the communities in which we conduct business. Zynga.org is a separate legal entity in which we have no financial interest and do not exercise control and, accordingly, is not consolidated in our consolidated financial statements. For our

## Edgar Filing: ZYNGA INC - Form 10-Q

contribution of Class A common stock we recorded \$13.1 million of stock-based expense, which is included in general and administrative expenses, equal to the fair value of the shares of Class A common stock issued.

**Table of Contents**

**10. Net Income (Loss) Per Share of Common Stock**

We compute net income (loss) per share of common stock using the two-class method required for participating securities. Prior to the date of the initial public offering, we considered all series of our convertible preferred stock to be participating securities due to their non-cumulative dividend rights. Additionally, we consider shares issued upon the early exercise of options subject to repurchase and unvested restricted shares to be participating securities, because holders of such shares have non-forfeitable dividend rights in the event of our declaration of a dividend for common shares. In accordance with the two-class method, earnings allocated to these participating securities, which include participation rights in undistributed earnings, are subtracted from net income to determine total undistributed earnings to be allocated to common stockholders.

Basic net income (loss) per common share is computed by dividing total undistributed earnings attributable to common stockholders by the weighted-average number of common shares outstanding during the period. In computing diluted net income (loss) attributable to common stockholders, undistributed earnings are re-allocated to reflect the potential impact of dilutive securities, including stock options, warrants and unvested ZSUs. Diluted net income (loss) per share attributable to common stockholders is computed by dividing net income (loss) attributable to common stockholders by the weighted-average number of common shares outstanding, including potential dilutive common shares including outstanding stock options, warrants and ZSUs.

**Table of Contents**

The following table sets forth the computation of basic and diluted net income (loss) per share of common stock (in thousands, except per share data):

|   | Three Months Ended March 31, |                    |            |            |                    |            |
|---|------------------------------|--------------------|------------|------------|--------------------|------------|
|   | Class<br>A                   | 2012<br>Class<br>B | Class<br>C | Class<br>A | 2011<br>Class<br>B | Class<br>C |
| <b>BASIC:</b>   |                              |                    |            |            |                    |            |
| Net income (loss)   | \$ (15,208)                  | \$ (67,668)        | \$ (2,475) | \$         | \$ 15,426          | \$ 1,332   |
| Net income attributable to participating securities   |                              |                    |            |            | 14,191             | 1,225      |
| Net income (loss) attributable to common stockholders   | \$ (15,208)                  | \$ (67,668)        | \$ (2,475) | \$         | \$ 1,235           | \$ 107     |
| Weighted-average common shares outstanding  | 126,102                      | 561,074            | 20,517     |            | 237,651            | 20,517     |
| Basic net income per share  | \$ (0.12)                    | \$ (0.12)          | \$ (0.12)  | \$         | \$ 0.01            | \$ 0.01    |
| <b>DILUTED:</b>   |                              |                    |            |            |                    |            |
| Net income (loss) attributable to common stockholders   | \$ (15,208)                  | \$ (67,668)        | \$ (2,475) | \$         | \$ 1,235           | \$ 107     |
| Reallocation of net income attributable to participating securities   |                              |                    |            |            | 259                |            |
| Reallocation of net income (loss) as a result of conversion of Class C shares to Class B and Class A shares | (2,475)                      |                    |            |            | 107                |            |
| Reallocation of net income (loss) as a result of conversion of Class B shares to Class A shares             | (67,668)                     |                    |            |            |                    |            |
| Reallocation of net income (loss) to Class B and Class C shares   |                              |                    |            |            |                    | (15)       |
| Net income (loss) attributable to common stockholders for diluted net income (loss) per share               | \$ (85,351)                  | \$ (67,668)        | \$ (2,475) | \$         | \$ 1,601           | \$ 92      |
| Number of shares used in basic computation  | 126,102                      | 561,074            | 20,517     |            | 237,651            | 20,517     |
| Conversion of Class C to Class A common shares outstanding  | 20,517                       |                    |            |            |                    |            |
| Conversion of Class C to Class B common shares outstanding  |                              |                    |            |            | 20,517             |            |
| Conversion of Class B to Class A common shares outstanding  | 561,074                      |                    |            |            |                    |            |
| Weighted-average effect of dilutive securities:   |                              |                    |            |            |                    |            |
| Employee stock options  |                              |                    |            |            | 88,488             |            |
| Warrants  |                              |                    |            |            | 11,656             |            |
| Number of shares used in diluted net income (loss) per share  | 707,693                      | 561,074            | 20,517     |            | 358,312            | 20,517     |
| Diluted net income (loss) per share   | \$ (0.12)                    | \$ (0.12)          | \$ (0.12)  | \$         | \$                 | \$         |



**Table of Contents**

The following weighted-average employee equity awards were excluded from the calculation of diluted net income (loss) per share attributable to common stockholders because their effect would have been anti-dilutive for the periods presented (in thousands):

|                   | Three Months Ended March 31, |            |
|-------------------|------------------------------|------------|
|                   | 2012                         | 2011       |
|                   | (unaudited)                  |            |
| Stock options     | 99,458                       | 940        |
| Warrants          | 695                          |            |
| Restricted shares | 19,424                       |            |
| ZSUs              | 75,003                       |            |
| <b>Total</b>      | <b>194,580</b>               | <b>940</b> |

**11. Commitments and Contingencies***Lease Commitments*

We have entered into operating leases for facilities, including data center space. In 2010, we executed an operating lease agreement for 267,000 square feet of office space for our headquarters in San Francisco, California. The lease term is seven years from the defined commencement date, with options to renew for two five-year terms. Under the terms of the lease we were provided \$13.6 million in leasehold incentives and \$9.8 million in rent abatements. In 2011, this agreement was amended to add an aggregate of approximately 140,000 square feet of additional office space. Under the terms of the amendments, we were provided an aggregate of \$4.9 million in leasehold incentives and \$5.2 million in rent abatements. In April 2012, we completed the purchase of our corporate headquarters building in San Francisco, California for \$233.7 million from 650 Townsend Associates LLC and terminated the lease agreement for the facilities. Because the lease termination did not occur until April 2012, the minimum lease commitments for our corporate headquarters building are included in the table below. Future minimum lease payments that have initial or remaining non-cancelable lease terms as of March 31, 2012, are as follows (in thousands, unaudited):

|                          |                   |
|--------------------------|-------------------|
| Year ending December 31: |                   |
| 2012                     | \$ 24,446         |
| 2013                     | 37,398            |
| 2014                     | 40,115            |
| 2015                     | 38,781            |
| 2016 and thereafter      | 110,092           |
|                          | <b>\$ 250,832</b> |

Included in the table above are \$2.2 million, \$7.4 million, \$10.2 million, \$10.6 million and \$26.4 million of future minimum lease payments associated with the lease of our corporate headquarters building in the years ending December 31, 2012, 2013, 2014, 2015 and 2016 and thereafter, respectively. These lease commitments were cancelled in April 2012 after the purchase of the building was completed.

*Legal Matters*

From time to time, we may become subject to legal proceedings, claims, and litigation arising in the ordinary course of business. In addition, we may receive notification alleging infringement of patent or other intellectual property rights. Adverse results in litigation, legal proceedings or claims may include awards of substantial monetary damages, costly royalty or licensing agreements, or orders preventing us from offering certain games, features, or services, and may also result in changes in our business practices, which could result in additional costs or a loss of revenues for us and otherwise harm our business. Although the results of litigation cannot be predicted with certainty, we believe that the amount or range of reasonably possible loss related to any pending or threatened litigation will not have a material adverse effect on our business, operating results, cash flows, or financial condition should such litigation be resolved unfavorably. We recognize legal expenses as incurred.



**Table of Contents****12. Revenue by Type and Geographical Information****Revenue by Type**

The following table presents the components of revenue (in thousands):

|                      | Three Months Ended<br>March 31, |                   |
|----------------------|---------------------------------|-------------------|
|                      | 2012                            | 2011              |
|                      | (unaudited)                     |                   |
| Online game          | \$ 292,780                      | \$ 229,898        |
| Advertising          | 28,192                          | 12,992            |
| <b>Total revenue</b> | <b>\$ 320,972</b>               | <b>\$ 242,890</b> |

**Geographical Information**

The following represents our geographic revenue based on the location of our players (in thousands):

| Revenue                            | Three Months Ended<br>March 31, |                   |
|------------------------------------|---------------------------------|-------------------|
|                                    | 2012                            | 2011              |
|                                    | (unaudited)                     |                   |
| United States                      | \$ 196,454                      | \$ 159,529        |
| All other countries <sup>(1)</sup> | 124,518                         | 83,361            |
| <b>Total revenue</b>               | <b>\$ 320,972</b>               | <b>\$ 242,890</b> |

(1) No country exceeded 10% of our total revenue for any periods presented.

The following represents our property and equipment, net by location (in thousands):

| Property and equipment, net              | March 31,         | December 31,      |
|--|-------------------|-------------------|
|  | 2012              | 2011              |
|  | (unaudited)       |                   |
| United States                            | \$ 250,827        | \$ 242,552        |
| All other countries                      | 4,424             | 4,188             |
| <b>Total property and equipment, net</b> | <b>\$ 255,251</b> | <b>\$ 246,740</b> |

**13. Subsequent Events**

In April 2012, we completed a secondary offering that allowed certain of our stockholders to sell 49.4 million shares of Class A common stock for approximately \$593 million, net of underwriting discounts and commissions of approximately \$18 million, including the full exercise of the underwriters' option to purchase additional shares. The Company did not receive any proceeds from the sale of the shares. The principal purpose of the offering was to facilitate an orderly distribution of shares and to increase our public float.



**Table of Contents**

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

*You should read the following discussion of our financial condition and results of operations in conjunction with the consolidated financial statements and the related notes included elsewhere in this Quarterly Report on Form 10-Q. The following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to these differences include those discussed below and elsewhere in this Quarterly Report on Form 10-Q, particularly in Special Note Regarding Forward-Looking Statements and Risk Factors.*

**Overview**

We are the world's leading online social game developer with 292 million average MAUs in 175 countries. We have launched the most successful social games in the industry in each of the last three years. Our games are accessible on Facebook and other social networks, mobile platforms and Zynga.com, wherever and whenever our players want. All of our games are free to play, and we generate revenue through the in-game sale of virtual goods and advertising.

We are a pioneer and innovator of social games and a leader in making play a core activity on the Internet. Our objective is to become the worldwide leader in play by connecting the world through games.

Consistent with our free-to-play business model, compared to all players who play our games in any period, only a small portion are payers. Because the opportunity for social interactions increases as the number of players increases, we believe that maintaining and growing our overall number of players, including the number of players who may not purchase virtual goods, is important to the success of our business. As a result, we believe that the number of players who choose to purchase virtual goods will continue to constitute a small portion of our overall players as our business grows.

---

## **Table of Contents**

### **How We Generate Revenue**

We operate our games as live services that allow players to play for free. We generate revenue primarily from the in-game sale of virtual goods and advertising.

*Online Game.* We provide our players with the opportunity to purchase virtual goods that enhance their game-playing experience. We believe players choose to pay for virtual goods for the same reasons they are willing to pay for other forms of entertainment. They enjoy the additional playing time or added convenience, the ability to personalize their own game boards, the satisfaction of leveling up and the opportunity for sharing creative expressions. We believe players are more likely to purchase virtual goods when they are connected to and playing with their friends, whether those friends play for free or also purchase virtual goods.

Facebook is the primary distribution, marketing, promotion and payment platform for our games. We generate substantially all of our revenue and players through the Facebook platform and expect to continue to do so for the foreseeable future.

We are subject to Facebook's standard terms and conditions for application developers, which govern the promotion, distribution and operation of games and other applications on the Facebook platform. We have entered into an addendum to these terms and conditions pursuant to which we have agreed to use Facebook Credits, Facebook's proprietary payment method, as the primary means of payment within our games played through Facebook. This addendum expires in May 2015.

We began migrating to Facebook Credits in July 2010, and in April 2011, we completed this migration. Under the addendum, Facebook remits to us an amount equal to 70% of the face value of Facebook Credits purchased by our players for use in our games. We recognize revenue net of amounts retained by Facebook. Prior to this addendum, we used third-party payment processors and paid these processors service fees ranging from 2% to 10% of the purchase price of our virtual goods which were recorded in cost of revenue. Players can purchase Facebook Credits from Facebook, directly through our games or through game cards purchased from retailers and distributors.

On platforms other than Facebook, players purchase our virtual goods through various widely accepted payment methods offered in the games, including credit cards, PayPal, Apple iTunes accounts and direct wires. Players can purchase game cards from retailers and distributors for use on these platforms.

*Advertising.* Advertising revenue primarily includes branded virtual goods and sponsorships, engagement ads and offers, mobile ads, display ads and licensing. We generally report our advertising revenue net of amounts due to advertising agencies and brokers.

Revenue growth will depend largely on our ability to attract and retain players and more effectively monetize our player base through the sale of virtual goods and advertising. We intend to do this through the launch of new games, enhancements to current games and expansion into new markets and distribution platforms.

### **Recent Developments**

*Game Launches.* We launched six games during the first quarter of 2012, including two titles on web-based platforms: *Hidden Chronicles*, our first game in the hidden object category, and *Zynga Slingo*, our first game in the arcade category. We released four titles on mobile platforms: *Scramble with Friends*, *Dream PetHouse*, *Dream Heights* and *Draw Something*, which we acquired in March in connection with the acquisition of OMGPOP.

*Zynga Platform.* On March 1, 2012, we announced the Zynga Platform, which includes Zynga.com, a new destination for social games, and Zynga Platform Partners, a program that allows third-party game developers to create and publish games on Zynga.com. On March 5, 2012 we launched the beta version of Zynga.com. As a destination dedicated to social games, Zynga.com allows players to play with existing friends and connect with other players who share a common interest in our games, such as *CityVille*, *CastleVille* and *Words With Friends*, and, in the future, games from other third-party developer partners. In addition, because Zynga.com is integrated with Facebook, our players can continue to log in with their Facebook ID, easily play games with their existing Facebook friends and use Facebook Credits to purchase virtual goods.

*Acquisition of OMGPOP.* On March 21, 2012, we acquired 100% of the outstanding stock of OMGPOP, Inc., a provider of social games, including *Draw Something*, for mobile phones, tablets, PCs and social network sites, for purchase consideration of approximately \$183.1 million in cash. We acquired OMGPOP to expand our social games offerings, particularly on mobile platforms.



## Table of Contents

**Building Purchase.** In March 2012, we entered into an agreement to purchase our corporate headquarters building in San Francisco, California for \$233.7 million from 650 Townsend Associates LLC. Pursuant to the agreement, on April 2, 2012, we acquired (i) the building located at 650 Townsend Street, San Francisco, California consisting of approximately 670,000 square feet of space, (ii) fee title to the real property (i.e. land) where the building is located, (iii) personal property located in the building which was previously owned by the seller and used in the operation and maintenance of the building and (iv) leases and other intangible property related to the building and real property. Our remaining lease commitments for the building were cancelled in April 2012 after the purchase was completed.

**Secondary Offering.** On April 3, 2012, we completed an underwritten public offering of 49,414,526 shares of our Class A common stock. All of the shares were sold by selling stockholders at a price to the public of \$12.00 per share. As part of the offering, all selling stockholders, as well as all officers and directors, agreed to lock-up agreements that extended the transfer restrictions on their remaining shares owned until at least 90 days following the offering. The principal purposes of the offering were to facilitate an orderly distribution of shares and to increase the company's public float. We did not receive any proceeds from the sale of shares in the offering.

**Zynga.org.** In March 2012, we donated one million shares of Class A common stock to Zynga.org, an unaffiliated non-profit organization that was formed in March 2012 to support charitable causes in the communities in which we conduct business.

### **Key Metrics**

We regularly review a number of metrics, including the following key financial and operating metrics, to evaluate our business, measure our performance, identify trends in our business, prepare financial projections and make strategic decisions.

#### **Key Financial Metrics**

**Bookings.** Bookings is a non-GAAP financial measure that is equal to revenue recognized during the period plus the change in deferred revenue during the period. We record the sale of virtual goods as deferred revenue and then recognize that revenue over the estimated average life of the purchased virtual goods or as the virtual goods are consumed. Advertising sales which consist of certain branded virtual goods and sponsorships is also deferred and recognized over the estimated average life of the branded virtual good, similar to online game revenue. Bookings, as opposed to revenue, is the fundamental top-line metric we use to manage our business, as we believe it is a better indicator of the sales activity in a given period. Over the long term, the factors impacting our bookings and revenue are the same. However, in the short term, there are factors that may cause revenue to exceed or be less than bookings in any period.

We use bookings to evaluate the results of our operations, generate future operating plans and assess the performance of our company. While we believe that this non-GAAP financial measure is useful in evaluating our business, this information should be considered as supplemental in nature and is not meant as a substitute for revenue recognized in accordance with US GAAP. In addition, other companies, including companies in our industry, may calculate bookings differently or not at all, which reduces its usefulness as a comparative measure.

The following table presents a reconciliation of revenue to bookings for each of the periods presented:

|   | <b>Three Months Ended March 31,</b> |             |
|---|-------------------------------------|-------------|
|   | <b>2012</b>                         | <b>2011</b> |
|   | <b>(in thousands)</b>               |             |
| <b>Reconciliation of Revenue to Bookings:</b> |                                     |             |
| Revenue                                       | \$ 320,972                          | \$ 242,890  |
| Change in deferred revenue                    | 8,192                               | 43,708      |
| Bookings                                      | \$ 329,164                          | \$ 286,598  |

In July 2010, we began migrating to Facebook Credits as the primary payment method for our games played through Facebook, and by April 2011, we had completed this migration. Facebook remits to us an amount equal to 70% of the face value of Facebook Credits purchased by our players for use in our games. We record bookings and recognize revenue net of the amounts retained by Facebook. Prior to adoption of Facebook Credits, we recorded a majority of our online game revenue at the gross price charged to the customer.

**Adjusted EBITDA.** Adjusted EBITDA is a non-GAAP financial measure that we calculate as net income (loss), adjusted for (provision for) / benefit from income taxes; other income (expense), net; interest income; gain (loss) from legal settlements; depreciation and amortization;



## Edgar Filing: ZYNGA INC - Form 10-Q

stock-based expense and change in deferred revenue. We believe that adjusted EBITDA provides useful information to investors and others in understanding and evaluating our operating results in the same manner as our management and board of directors.

**Table of Contents**

We have included adjusted EBITDA in this Quarterly Report on Form 10-Q because it is a key measure we use to evaluate our financial and operating performance, generate future operating plans and make strategic decisions for the allocation of capital. Accordingly, we believe that adjusted EBITDA provides useful information to investors and others in understanding and evaluating our operating results in the same manner as our management and board of directors. While we believe that this non-GAAP financial measure is useful in evaluating our business, this information should be considered as supplemental in nature and is not meant as a substitute for the related financial information prepared in accordance with US GAAP.

The following table presents a reconciliation of net income (loss) to adjusted EBITDA for each of the periods indicated:

|  | Three Months Ended March 31, |            |
|--|------------------------------|------------|
|  | 2012                         | 2011       |
|  | (in thousands)               |            |
| <b>Reconciliation of Net Income (Loss) to Adjusted EBITDA:</b> |                              |            |
| Net income (loss)  | \$ (85,351)                  | \$ 16,758  |
| (Provision for) / benefit from income taxes                    | (78)                         | 19,226     |
| Other income (expense), net                                    | 1,142                        | 736        |
| Interest income  | (1,291)                      | (518)      |
| Gain (loss) from legal settlements                             | 889                          |            |
| Depreciation and amortization                                  | 29,398                       | 17,847     |
| Stock-based expense  | 133,851                      | 14,506     |
| Change in deferred revenue                                     | 8,192                        | 43,708     |
| Adjusted EBITDA  | \$ 86,752                    | \$ 112,263 |

**Limitations of Bookings and Adjusted EBITDA**

Some limitations of bookings and adjusted EBITDA are:

adjusted EBITDA does not include the impact of stock-based expense;

bookings and adjusted EBITDA do not reflect that we defer and recognize online game revenue and revenue from certain advertising transactions over the estimated average life of virtual goods or as virtual goods are consumed;

adjusted EBITDA does not reflect income tax expense;

adjusted EBITDA does not include other income and expense, which includes foreign exchange gains and losses as well as interest income;

adjusted EBITDA excludes depreciation and amortization and although these are non-cash charges, the assets being depreciated and amortized may have to be replaced in the future;

adjusted EBITDA does not include gains and losses associated with legal settlements; and

## Edgar Filing: ZYNGA INC - Form 10-Q

other companies, including companies in our industry, may calculate bookings and adjusted EBITDA differently or not at all, which reduces their usefulness as a comparative measure.

Because of these limitations, you should consider bookings and adjusted EBITDA along with other financial performance measures, including revenue, net income (loss) and our financial results presented in accordance with US GAAP.

## Table of Contents

### *Key Operating Metrics*

We manage our business by tracking several operating metrics: DAUs, which measures daily active users of our games, MAUs, which measures monthly active users of our games, MUUs, which measures monthly unique users of our games, MUPs, which measure monthly unique payers in our games, and ABPU, which measures our average daily bookings per average DAU, each of which is recorded by our internal analytics systems.

*DAUs.* We define DAUs as the number of individuals who played one of our games during a particular day. Under this metric, an individual who plays two different games on the same day is counted as two DAUs. Similarly, an individual who plays the same game on two different platforms (e.g., web and mobile) or on two different social networks on the same day would be counted as two DAUs. Average DAUs for a particular period is the average of the DAUs for each day during that period. We use DAU as a measure of audience engagement.

*MAUs.* We define MAUs as the number of individuals who played a particular game in the 30-day period ending with the measurement date. Under this metric, an individual who plays two different games in the same 30-day period is counted as two MAUs. Similarly, an individual who plays the same game on two different platforms (e.g., web and mobile) or on two different social networks in a 30-day period would be counted as two MAUs. Average MAUs for a particular period is the average of the MAUs at each month-end during that period. We use MAUs as a measure of total game audience size.

*MUUs.* We define MUUs as the number of unique individuals who played any of our games on a particular platform in the 30-day period ending with the measurement date. An individual who plays more than one of our games in a given 30-day period would be counted as a single MUU. However, because we cannot always distinguish unique individuals playing across multiple platforms, an individual who plays any of our games on two different platforms (e.g., web and mobile) in a given 30-day period may be counted as two MUUs in the event that we do not have data that allows us to de-duplicate the player. Because many of our players play more than one game in a given 30-day period, MUUs are always lower than MAUs in any given time period. Average MUUs for a particular period is the average of the MUUs at each month-end during that period. We use MUUs as a measure of total audience reach across our network of games.

*MUPs.* We define MUPs as the number of unique players who made a payment at least once during the applicable month through a payment method for which we can quantify the number of unique payers, including payers from certain of our mobile games. MUPs does not include payers who use certain smaller web-based payment methods or payers from certain of our mobile games for which we cannot quantify the number of unique payers. If a player made a payment in our games on two separate platforms (e.g. Facebook and Google+) in a period, the player would be counted as two unique payers in that period. Monthly unique payers are presented as a quarterly average of the three months in the applicable quarter.

*Average Bookings per User (ABPU).* We define ABPU as (i) our total bookings in a given period, divided by (ii) the number of days in that period, divided by, (iii) the average DAUs during the period. We believe that ABPU provides useful information to investors and others in understanding and evaluating our results in the same manner as our management and board of directors. We use ABPU as a measure of overall monetization across all of our players through the sale of virtual goods and advertising.

Our business model for social games is designed so that, as there are more players that play our games, social interactions increase and the more valuable the games and our business becomes. All engaged players of our games help drive our bookings and, consequently, both online game revenue and advertising revenue. Virtual goods are purchased by players who are socializing with, competing against or collaborating with other players, most of whom do not buy virtual goods. Accordingly, we primarily focus on bookings, DAUs, MAUs, MUUs, MUPs and ABPU, which together we believe best reflect the economic value of all of our players.

|              | <b>Three Months Ended March 31,</b>   |             |
|--------------|---------------------------------------|-------------|
|              | <b>2012</b>                           | <b>2011</b> |
|              | <b>(users and payers in millions)</b> |             |
| Average DAUs | 65                                    | 62          |
| Average MAUs | 292                                   | 236         |
| Average MUUs | 182                                   | 146         |
| Average MUPs | 3.5                                   | NA          |
| ABPU         | \$ 0.055                              | \$ 0.051    |

NA means data is not available.



---

## **Table of Contents**

Future growth in audience and engagement will depend on our ability to retain current players, attract new players, launch new games and expand into new markets and distribution platforms and the success of Zynga.com. Our operating metrics may not correlate directly to quarterly bookings or revenue trends in the short term. For instance, revenue has grown every quarter since our inception, including in quarters where DAU, MAU and MUU did not grow.

### **Factors Affecting Our Performance**

*Launch of new games and release of enhancements.* Our bookings and revenue growth have been driven by the launch of new games and the release of fresh content and new features in existing games. Although the amount of revenue and bookings we generate from a new game or an enhancement to an existing game can vary significantly, we expect our revenue and bookings growth to be correlated to the success of our new games and our success in releasing engaging content and features.

*Game monetization.* We generate most of our bookings and revenue from the sale of virtual goods in our games. The degree to which our players choose to pay for virtual goods in our games is driven by our ability to create content and virtual goods that enhance the game-play experience. Our bookings, revenue and overall financial performance are affected by the number of players and the effectiveness of our monetization of players through the sale of virtual goods and advertising. In addition, international players have historically lagged the monetization that we achieve for U.S. players, and the percentage of paying international players may increase or decrease based on a number of factors, including growth in overall international players, localization of content and the availability of payment options.

*Changes in Facebook or other platforms.* Facebook is the primary distribution, marketing, promotion and payment platform for our social games. We generate substantially all of our bookings, revenue and players through the Facebook platform and expect to continue to do so for the foreseeable future. Facebook and other platforms have broad discretion to change their platforms, terms of service and other policies with respect to us or other developers, and those changes may be unfavorable to us. For the three months ended March 31, 2012 and 2011, we estimate that 85% and 93% of our quarterly bookings, respectively, were generated through the Facebook platform. For the three months ended March 31, 2012 and 2011, we estimate that 92% and 93% of our quarterly revenue, respectively, were generated through the Facebook platform. We have had to estimate this information because certain payment methods used do not allow us to determine the platform used.

*Investment in game development.* In order to develop new games and enhance the content and features in our existing games, we must invest in a significant amount of engineering and creative resources. These expenditures generally occur months in advance of the launch of a new game or the release of new content, and the resulting revenue may not equal or exceed our development costs.

*Investment in technology stack.* We host a significant portion of our game traffic on our own network infrastructure. We will continue to invest in our network infrastructure, with the goal of reducing our reliance on third-party web hosting services and moving towards the use of self-operated data centers. Under this approach, we host data and traffic for our games on servers located in the data centers that we lease, build and operate. Investment in our network infrastructure will require capital expenditures for equipment. We believe that over the long term this investment will produce further operating leverage by reducing our game operation costs and will enhance our games and player experience. However, as we continue to grow, the capital investment necessary to build our infrastructure will be significant and will require that we successfully migrate our games to ensure the best customer service for our players.

*Player acquisition costs.* Although we acquire most of our players through unpaid channels, we also utilize advertising and other forms of player acquisition and retention to grow and retain our player audience. These expenditures generally relate to the promotion of new game launches and ongoing performance-based programs to drive new player acquisition and lapsed player reactivation. Over time, these acquisition and retention-related programs may become either less effective or more costly, negatively impacting our operating results.

*New market development.* We are investing in new distribution channels such as mobile and other platforms, including other social networks and in international markets to expand our reach and grow our business. For example, we have continued to hire additional employees and acquire companies with experience developing mobile applications. We have also invested resources in integrating and operating some of our games on additional platforms, including Google+, mixi, and Tencent. As we expand into new markets and distribution channels, we expect to incur headcount, marketing and other operating costs in advance of the associated bookings and revenue. Our financial performance will be impacted by our investment in these initiatives and their success.

*Stock-based Expense Related to Outstanding ZSUs.* Prior to our initial public offering, we granted ZSUs to our employees that generally vest upon the satisfaction of both a service-period condition of up to four years and a liquidity event condition, the latter of which was satisfied following our initial public offering. Because the liquidity event condition was not met until our initial public offering, prior to the fourth quarter of 2011, we had not recorded any expense relating to our ZSUs. In the first quarter of 2012, we recognized \$93.7 million of stock-based expense related to ZSUs.



**Table of Contents****Results of Operations**

The following table sets forth our results of operations for the periods presented as a percentage of revenue for those periods.

|  | For The Three Months Ended<br>March 31, |      |
|--|---|------|
|  | 2012                                    | 2011 |
| <b>Consolidated Statements of Operations Data:</b> |   |      |
| Revenue  | 100%                                    | 100% |
| Costs and expenses:                                |   |      |
| Cost of revenue                                    | 28                                      | 28   |
| Research and development                           | 58                                      | 30   |
| Sales and marketing                                | 18                                      | 17   |
| General and administrative                         | 23                                      | 11   |
| Total costs and expenses                           | 127                                     | 86   |
| Income (loss) from operations                      | (27)                                    | 14   |
| Interest income                                    |   |      |
| Other income (expense), net                        |   |      |
| Income (loss) before income taxes                  | (27)                                    | 14   |
| (Provision for) / benefit from income taxes        |   | (8)  |
| Net income (loss)                                  | (27)%                                   | 6%   |

**Revenue**

|                        | Three Months Ended March 31, |            | % Change |
|------------------------|------------------------------|------------|----------|
|                        | 2012                         | 2011       |          |
| (dollars in thousands) |                              |            |          |
| Revenue by type:       |                              |            |          |
| Online game            | \$ 292,780                   | \$ 229,898 | 27%      |
| Advertising            | 28,192                       | 12,992     | 117%     |
| Total                  | \$ 320,972                   | \$ 242,890 | 32%      |

Total revenue increased \$78.1 million in the first quarter of 2012, as a result of growth in both online game and advertising revenue. Bookings increased by \$42.6 million in the first quarter of 2012. ABPU increased from \$0.051 to \$0.055, reflecting improved overall monetization of our players, while average DAUs increased from 62 million to 65 million.

Online game revenue increased \$62.9 million in the first quarter of 2012. *CityVille*, *FarmVille* and *CastleVille* accounted for \$28.5 million, \$24.2 million and \$18.1 million of the increase, respectively. *FarmVille* was launched in June 2009, and the increase in revenue reflects an increase in bookings due to the release of new content, as well as the recognition of revenue derived from deferred revenue built up over a longer period of time. The increase in revenue from *CityVille* and *CastleVille* was the result of the launch of these games in December 2010 and November 2011, respectively. The growth in online game revenue was offset by a decrease of \$26.5 million from *Mafia Wars*. All other games accounted for the remaining net increase of \$18.6 million.

International revenue as a percentage of total revenue accounted for 39% and 34% in the three months ended March 31, 2012 and 2011, respectively.





**Table of Contents**

In the three months ended March 31, 2012, *FarmVille*, *CityVille*, *Zynga Poker* and *FrontierVille* were our top revenue-generating games and comprised 29%, 17%, 16% and 10%, respectively, of our online game revenue. In the three months ended March 31, 2011, *FarmVille*, *Zynga Poker* and *Mafia Wars* were our top revenue-generating games and comprised 27%, 19% and 18%, respectively, of online game revenue. No other game generated more than 10% of online game revenue during either of these quarterly periods.

Consumable virtual goods accounted for 29% and 35% of online game revenue in the three months ended March 31, 2012 and 2011, respectively. Revenue from consumable virtual goods accounted for 9% of the increase in online game revenue in the first quarter of 2012.

Durable virtual goods accounted for 71% and 65% of online game revenue in the three months ended March 31, 2012 and 2011, respectively. Revenue from durable virtual goods accounted for 91% of the increase in online game revenue in the first quarter of 2012. The estimated weighted-average life of durable virtual goods was 13 months for the first quarter of 2012 compared to 17 months for the first quarter of 2011. In addition, changes in our estimated average life of durable virtual goods during the first quarter of 2012 for various games resulted in an increase in revenue of \$10 million, which is the result of adjusting the remaining recognition period of deferred revenue generated in prior periods at the time of the change in estimate.

Advertising revenue increased \$15.2 million in the first quarter of 2012, due to a \$9.3 million increase in revenue from in-game offers, sponsorships, engagement ads and other in-game display ads, and a \$5.9 million increase in revenue from licensing and other advertising activity.

**Table of Contents****Cost of revenue**

|                 | <b>Three Months Ended March 31,</b> |             |                 |
|-----------------|-------------------------------------|-------------|-----------------|
|                 | <b>2012</b>                         | <b>2011</b> | <b>% Change</b> |
|                 | <b>(dollars in thousands)</b>       |             |                 |
| Cost of revenue | \$ 90,122                           | \$ 67,662   | 33%             |

Cost of revenue increased \$22.5 million in the first quarter of 2012. The increase was primarily attributable to an increase in third-party payment processing fees of \$8.8 million, an increase of \$7.0 million in depreciation and amortization related to new fixed assets to support our network infrastructure and acquired intangibles, an increase of \$3.6 million in consulting costs primarily related to third-party customer support required as a result of higher player activity and an increase of \$6.3 million in stock-based expense mainly due to expense recognized for ZSUs, as prior to our December 2011 initial public offering, these expenses had not been recorded. These increases in costs of revenue were partially offset by a decrease of \$2.8 million in maintenance and hosting costs in the first quarter of 2012.

**Research and development**

|                          | <b>Three Months Ended March 31,</b> |             |                 |
|--------------------------|-------------------------------------|-------------|-----------------|
|                          | <b>2012</b>                         | <b>2011</b> | <b>% Change</b> |
|                          | <b>(dollars in thousands)</b>       |             |                 |
| Research and development | \$ 186,876                          | \$ 71,760   | 160%            |

Research and development expenses increased \$115.1 million in the first quarter of 2012. The increase was primarily attributable to a \$69.6 million increase in stock-based expenses, mainly due to the expense recognized for ZSUs, an increase of \$34.7 million in headcount-related expenses, an increase of \$6.5 million in facilities and other overhead support costs and an increase of \$3.5 million in consulting costs.

**Sales and marketing**

|                     | <b>Three Months Ended March 31,</b> |             |                 |
|---------------------|-------------------------------------|-------------|-----------------|
|                     | <b>2012</b>                         | <b>2011</b> | <b>% Change</b> |
|                     | <b>(dollars in thousands)</b>       |             |                 |
| Sales and marketing | \$ 56,837                           | \$ 40,156   | 42%             |

Sales and marketing expenses increased \$16.7 million in the first quarter of 2012. The increase was primarily attributable to a \$10.5 million increase in stock-based expenses, mainly due to the expense recognized for ZSUs, a \$3.6 million increase in player acquisition costs and an increase in headcount-related expenses of \$2.5 million.

**Table of Contents****General and administrative**

|                            | Three Months Ended March 31, |           | % Change |
|----------------------------|------------------------------|-----------|----------|
|                            | 2012                         | 2011      |          |
|                            | (dollars in thousands)       |           |          |
| General and administrative | \$ 72,715                    | \$ 27,110 | 168%     |

General and administrative expenses increased \$45.6 million in the first quarter of 2012. The increase was primarily attributable to an increase of \$33.8 million in stock-based expense, including the expense recognized for ZSUs as well as \$13.1 million in stock-based expense recognized for one million shares of Class A common stock that we donated to Zynga.org, which is an unaffiliated third party. The increase in general and administrative expenses was also due to a \$7.0 million increase in headcount-related expenses, a \$4.3 million increase in depreciation expense and a \$2.8 million increase in consulting expense, which was offset by a decrease of \$5.0 million in facilities and other overhead and office costs.

**(Provision for) / benefit from income taxes**

|   | Three Months Ended March 31, |             | % Change |
|---|------------------------------|-------------|----------|
|   | 2012                         | 2011        |          |
|   | (dollars in thousands)       |             |          |
| (Provision for) / benefit from income taxes | \$ 78                        | \$ (19,226) | NM       |

The provision for income taxes decreased by \$19.3 million in the first quarter of 2012. This decrease was attributable to the decrease in pre-tax income of \$121.4 million in the first quarter of 2012, which was primarily driven by stock-based expense. The income tax expense for the three months ended March 31, 2011 was impacted by non-deductible stock-based expense and the costs of implementing our international structure.

For the foreseeable future, our effective tax rate will be impacted by additional tax expense associated with the implementation of our international tax structure and the deductibility of stock-based expense. As the implementation of our international tax structure is completed, we anticipate that our effective tax rate will be lower than the U.S. statutory rate.

**Liquidity and Capital Resources**

|  | Three Months Ended March 31, |             |
|--|------------------------------|-------------|
|  | 2012                         | 2011        |
|  | (in thousands)               |             |
| <b>Consolidated Statements of Cash Flows Data:</b> |                              |             |
| Acquisition of property and equipment              | \$ (34,994)                  | \$ (50,222) |
| Depreciation and amortization                      | 29,398                       | 17,847      |
| Cash flows provided by operating activities        | \$ 78,817                    | \$ 103,657  |
| Cash flows used in investing activities            | (1,277,155)                  | (55,538)    |
| Cash flows provided by financing activities        | (22,967)                     | 225,249     |

As of March 31, 2012, we had cash, cash equivalents and marketable securities of approximately \$1.5 billion, which consisted of cash, money market funds, U.S. government debt securities and corporate debt securities. Additionally, we had \$260 million of restricted cash, \$229 million of which was held in escrow pursuant to the terms of an agreement to purchase our corporate headquarters. For the full year ended December 31, 2012, we expect to make capital expenditures of up to \$410 million, which includes the purchase and build out of our corporate headquarters as well as additional investments in network infrastructure to support our expected growth and to continue to improve the player experience. We believe that our existing cash, cash equivalents and marketable securities, together with cash generated from operations, will be sufficient to fund our operations and capital expenditures for at least the next 12 months.

## **Table of Contents**

### ***Operating Activities***

Operating activities provided \$78.8 million of cash during the three months ended March 31, 2012, primarily driven by our net loss of \$85.4 million, adjusted to exclude non-cash items. Significant non-cash items included stock-based expense of \$133.9 million and depreciation and amortization of \$29.4 million. Stock-based expense was composed primarily of employee ZSU and stock option expense and increased from the three months ended March 31, 2011 due to expense incurred related to ZSUs; as the first quarter of 2011 contained no ZSU expense because at that time the liquidity event-based vesting criteria had not occurred. Depreciation and amortization increased from the three months ended March 31, 2011 as a result of our continued investment in property and equipment and business acquisitions.

### ***Investing Activities***

Investing activities resulted in a cash outflow of \$1.3 billion during the three months ended March 31, 2012. The primary uses of cash associated with investing activities were \$964.7 million for the purchase of marketable securities, as we continued to invest the proceeds received from our initial public offering; \$229 million of escrow payments made in connection with our agreement to purchase our corporate headquarters; and \$182.2 million, net of cash acquired, for the acquisition of 100% of the outstanding common stock of OMGPOP, Inc. Capital expenditures were \$35.0 million for the quarter, as we continued to invest in our data centers and other hardware and software to support our growth. These uses of cash were partially offset by the sale and maturity of \$132.9 million of marketable securities.

### ***Financing Activities***

For the three months ended March 31, 2012, our financing activities consisted of tax payments made in connection with the vesting of stock awards and cash received from the exercise of employee stock options. In the three months ended March 31, 2011, we issued 34.9 million shares of Series C preferred stock for net proceeds of \$485.3 million. In addition, we repurchased 23.7 million shares of our outstanding capital stock for a total purchase price of \$261.3 million during the three months ended March 31, 2011.

### ***Credit Facility***

In July 2011, we executed a revolving credit agreement with certain lenders to borrow up to \$1.0 billion in revolving loans. The interest rate for the credit facility is determined based on a formula using certain market rates. As of March 31, 2012, we had not drawn down any amounts on the credit facility.

### ***Off-Balance Sheet Arrangements***

We did not have any off-balance sheet arrangement in the first quarter of 2012 or in any prior periods.

**Table of Contents****Lease Obligations**

We have entered into operating leases for facilities, including data center space. In 2010, we executed an operating lease agreement for 267,000 square feet of office space for our headquarters in San Francisco, California, which we expanded to 407,000 square feet in 2011. The lease term was seven years from the defined commencement date. In March 2012, we entered into an agreement to purchase our corporate headquarters building in San Francisco, California for \$233.7 million from 650 Townsend Associates LLC. Because the building purchase was not executed until April 2012, the minimum lease commitments for our corporate headquarters building are included in the table below. Future minimum lease payments that have initial or remaining non-cancelable lease terms as of March 31, 2012, are as follows (in thousands).

|                          |            |
|--------------------------|------------|
| Year ending December 31: |            |
| 2012                     | \$ 24,446  |
| 2013                     | 37,398     |
| 2014                     | 40,115     |
| 2015                     | 38,781     |
| 2016 and thereafter      | 110,092    |
|                          | \$ 250,832 |

Included in the table above are \$2.2 million, \$7.4 million, \$10.2 million and \$10.6 million and \$26.4 million of lease payments associated with the lease of our corporate headquarters building in the years ending December 31, 2012, 2013, 2014, 2015 and 2016 and thereafter, respectively. These lease commitments were cancelled in April 2012 after the building purchase agreement was executed.

We do not have any debt or material capital lease obligations, and all of our property, equipment and software has been purchased with cash.

**Critical Accounting Policies and Estimates**

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts in our consolidated financial statements and related notes. Our significant accounting policies are described in Note 1 to our consolidated financial statements included in our previously filed Annual Report on Form 10-K. We have identified below our critical accounting policies and estimates that we believe require the greatest amount of judgment. These estimates and judgments have a significant impact on our consolidated financial statements. Actual results could differ materially from those estimates. The accounting policies that reflect our more significant estimates and judgments and that we believe are the most critical to fully understand and evaluate our reported financial results include the following:

Revenue Recognition

Income Taxes

Business Combinations

Stock-Based Expense

During the first quarter of 2012, there were no significant changes to our critical accounting policies and estimates. Please refer to Management's Discussion and Analysis of Financial Condition and Results of Operations contained in Part II, Item 7 of our Annual Report on Form 10-K for our fiscal year ended December 31, 2011 for a more complete discussion of our critical accounting policies and estimates.



## **Table of Contents**

### **Recent Accounting Pronouncements**

For information with respect to recent accounting pronouncements and the impact of these pronouncements on our consolidated financial statements, see Note 1 – Overview and Summary of Significant Accounting Policies in the notes to the consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

During the first quarter of 2012, there were no material changes to our quantitative and qualitative disclosures about market risk. Please refer to Part II, Item 7A. Quantitative and Qualitative Disclosure About Market Risk included in our Annual Report on Form 10-K for our fiscal year ended December 31, 2011 for a more complete discussion on the market risks we encounter.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### **Evaluation of Disclosure Controls and Procedures**

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission (the SEC) rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Based on the evaluation of our disclosure controls and procedures as of March 31, 2012, our chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

#### **Changes in Internal Control over Financial Reporting**

There were no changes in our internal control over financial reporting identified in management's evaluation pursuant to Rules 13a-15(d) or 15d-15(d) of the Exchange Act during the quarter ended March 31, 2012 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

#### **Limitations on Effectiveness of Controls and Procedures**

In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply judgment in evaluating the benefits of possible controls and procedures relative to their costs.

## **PART II. OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

For a description of our material legal proceedings, see Note 11 – Commitments and Contingencies in the Notes to the consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q.



---

**Table of Contents**

**ITEM 1A. RISK FACTORS**

*We have identified the following risks and uncertainties that may have a material adverse effect on our business, financial condition or results of operations. The risks described below are not the only ones we face. Additional risks not presently known to us or that we currently believe are not material may also significantly impair our business operations. Our business could be harmed by any of these risks. The trading price of our common stock could decline due to any of these risks, and you may lose all or part of your investment. In assessing these risks, you should also refer to the other information contained in this Quarterly Report on Form 10-Q, including our condensed consolidated financial statements and related notes.*

*We have marked with an asterisk (\*) those risks described below that reflect substantive changes from, or additions to, the risks described in our Annual Report on Form 10-K for the year ended December 31, 2011.*

**Risks Related to Our Business and Industry**

*If we are unable to maintain a good relationship with Facebook, our business will suffer. \**

Facebook is the primary distribution, marketing, promotion and payment platform for our games. We generate substantially all of our revenue and players through the Facebook platform and expect to continue to do so for the foreseeable future. Any deterioration in our relationship with Facebook would harm our business and adversely affect the value of our Class A common stock.

We are subject to Facebook's standard terms and conditions for application developers, which govern the promotion, distribution and operation of games and other applications on the Facebook platform. We have entered into an addendum to these terms and conditions pursuant to which we have agreed to use Facebook Credits, Facebook's proprietary payment method, as the primary means of payment within our games played through Facebook. This addendum expires in May 2015.

Our business would be harmed if:

Facebook discontinues or limits access to its platform by us and other game developers;

Facebook terminates or does not renew our addendum;

Facebook modifies its terms of service or other policies, including fees charged to, or other restrictions on, us or other application developers, or Facebook changes how the personal information of its users is made available to application developers on the Facebook platform or shared by users;

Facebook establishes more favorable relationships with one or more of our competitors; or

Facebook develops its own competitive offerings.

We have benefited from Facebook's strong brand recognition and large user base. If Facebook loses its market position or otherwise falls out of favor with Internet users, we would need to identify alternative channels for marketing, promoting and distributing our games, which would consume substantial resources and may not be effective. In addition, Facebook has broad discretion to change its terms of service and other policies with respect to us and other developers, and those changes may be unfavorable to us. For example, in 2010 Facebook adopted a policy requiring applications on Facebook to accept only its virtual currency, Facebook Credits, as payment from users. As a result of this change, which we completed in April 2011, Facebook receives a greater share of payments made by our players than it did when other payment options were allowed. Facebook may also change its fee structure, add fees associated with access to and use of the Facebook platform, change how the personal information of its users is made available to application developers on the Facebook platform or restrict how Facebook users can share information with friends on their platform. Beginning in early 2010, Facebook changed its policies for application developers regarding use of its communication channels. These changes limited the level of communication among users about applications on the Facebook platform. As a

## Edgar Filing: ZYNGA INC - Form 10-Q

result, the number of our players on Facebook declined. Our agreement with Facebook allows our users to use Zynga-branded game cards for the redemption of Facebook Credits and allows us to continue to distribute our game cards for a limited time. We are working with Facebook to transition retailers from our gift card program to Facebook's gift cards. We expect this transition to occur over time and to be completed in the fourth quarter of 2012. Our future bookings and revenue may be negatively impacted during this transition period and upon the expiration of our game card program. Any such changes in the future could significantly alter how players experience our games or interact within our games, which may harm our business.

---

## **Table of Contents**

***We operate in a new and rapidly changing industry, which makes it difficult to evaluate our business and prospects.***

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

continued worldwide growth in the adoption and use of Facebook and other social networks;

changes in consumer demographics and public tastes and preferences;

the availability and popularity of other forms of entertainment;

the worldwide growth of personal computer, broadband Internet and mobile device users, and the rate of any such growth; and

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

Our ability to plan for game development, distribution and promotional activities will be significantly affected by our ability to anticipate and adapt to relatively rapid changes in the tastes and preferences of our current and potential players. New and different types of entertainment may increase in popularity at the expense of social games. A decline in the popularity of social games in general, or our games in particular would harm our business and prospects.

***We have a new business model and a short operating history, which makes it difficult to evaluate our prospects and future financial results and may increase the risk that we will not be successful.***

We began operations in April 2007, and we have a short operating history and a new business model, which makes it difficult to effectively assess our future prospects. Our business model is based on offering games that are free to play. To date, only a small portion of our players pay for virtual goods. You should consider our business and prospects in light of the various challenges we face, including the ones discussed in these Risk Factors.

***We rely on a small portion of our total players for nearly all of our revenue.\****

Compared to all players who play our games in any period, only a small portion are paying players. During the three months ended March 31, 2012, we had approximately 3.5 million MUPs (excluding payers who use certain payment methods for which unique payer data is not available). We lose players in the ordinary course of business. In order to sustain our revenue levels, we must attract, retain and increase the number of players or more effectively monetize our players. To retain players, we must devote significant resources so that the games they play retain their interest and attract them to our other games. If we fail to grow or sustain the number of our players, or if the rates at which we attract and retain players declines or if the average amount our players pay declines, our business may not grow and our financial results will suffer.

***Our growth prospects may suffer if the Zynga Platform is unsuccessful.\****

We launched the Zynga Platform in March 2012. Our ability to increase our player base and revenue will depend, in part, on the successful operation of the Zynga Platform. If the Zynga Platform fails to engage players, interest third-party game developers or attract advertisers, we may fail to generate sufficient revenue, operating margin or other value to justify our investment in the development and operation of the Zynga Platform. We have very limited experience launching third-party developed games on the Zynga Platform, and supporting games developed by third parties. We may encounter technical and operational challenges operating a platform. In addition, although the Zynga Platform is integrated with Facebook and uses Facebook Credits as the only payment method for purchasing virtual goods, our launch and promotion of the Zynga Platform could harm our relationship with Facebook. If we are not successful with the overall monetization of the Zynga Platform, we may not be able to maintain or grow our revenue as anticipated and our financial results could be adversely affected.

*We expect our bookings and revenue growth rate to decline over time and anticipate operating margins may decline in the future.*

From 2010 to 2011, our revenue grew from \$597.5 million to \$1.14 billion, which represents an annual growth rate of approximately 91%. We expect that as our bookings and revenue increase the growth rate in bookings and revenue will decline over time. We believe our operating margin will also experience downward pressure as a result of increasing competition and the need for increased operating expenditures for many aspects of our business in addition to increased stock-based expense associated with vested restricted stock units, or ZSUs, which we had not recognized prior to the initial public offering. We also expect to continue to expend substantial financial and other resources on game development, international expansion and our network infrastructure.

## **Table of Contents**

***A small number of games have generated a majority of our revenue, and we must continue to launch and enhance games that attract and retain a significant number of players in order to grow our revenue and sustain our competitive position.***

Historically we have depended on a small number of games for a majority of our revenue and we expect that this dependency will continue for the foreseeable future. Our growth depends on our ability to consistently launch new games that achieve significant popularity. Each of our games requires significant engineering, marketing and other resources to develop, launch and sustain via regular upgrades and expansions, and such costs on average have increased. Our ability to successfully launch, sustain and expand games and attract and retain players largely will depend on our ability to:

anticipate and effectively respond to changing game player interests and preferences;

anticipate or respond to changes in the competitive landscape;

attract, retain and motivate talented game designers, product managers and engineers;

develop, sustain and expand games that are fun, interesting and compelling to play;

effectively market new games and enhancements to our existing players and new players;

minimize launch delays and cost overruns on new games and game expansions;

minimize downtime and other technical difficulties; and

acquire high quality assets, personnel and companies.

It is difficult to consistently anticipate player demand on a large scale, particularly as we develop games in new genres or new markets, including international markets and mobile platforms. If we do not successfully launch games that attract and retain a significant number of players and extend the life of our existing games, our market share, reputation and financial results will be harmed.

***If our top games do not maintain their popularity, our results of operations could be harmed.***

In addition to creating new games that are attractive to a significant number of players, we must extend the life of our existing games, in particular our most successful games. For a game to remain popular, we must constantly enhance, expand or upgrade the game with new features that players find attractive. Such constant enhancement requires the investment of significant resources, particularly with older games, and such costs on average have increased. We may not be able to successfully enhance, expand or upgrade our current games. Any reduction in the number of players of our most popular games, any decrease in the popularity of our games or social games in general, any breach of game-related security or prolonged server interruption, any loss of rights to any intellectual property underlying such games, or any other adverse developments relating to our most popular games, could harm our results of operations.

***Any failure or significant interruption in our network could impact our operations and harm our business.\****

Our technology infrastructure is critical to the performance of our games and to player satisfaction. Our games run on a complex distributed system, or what is commonly known as cloud computing. We own, operate and maintain the primary elements of this system, but some elements of this system are operated by third parties that we do not control and which would require significant time to replace. We have experienced, and may in the future experience, website disruptions, outages and other performance problems due to a variety of factors, including infrastructure changes, human or software errors and capacity constraints. For example, the operation of a few of our significant games, including *FarmVille*

## Edgar Filing: ZYNGA INC - Form 10-Q

and *CityVille*, was interrupted for several hours in April 2011 due to a network outage. If a particular game is unavailable when players attempt to access it or navigation through a game is slower than they expect, players may stop playing the game and may be less likely to return to the game as often, if at all. A failure or significant interruption in our game service would harm our reputation and operations. We expect to continue to make significant investments in our technology infrastructure to maintain and improve all aspects of player experience and game performance. To the extent that our disaster recovery systems are not adequate, or we do not effectively address capacity constraints, upgrade our systems as needed and continually develop our technology and network architecture to accommodate increasing traffic, our business and operating results may suffer. We do not maintain insurance policies covering losses relating to our systems and we do not have business interruption insurance.

---

**Table of Contents**

***Security breaches, computer viruses and computer hacking attacks could harm our business and results of operations.***

Security breaches, computer malware and computer hacking attacks have become more prevalent in our industry, have occurred on our systems in the past and may occur on our systems in the future. Any security breach caused by hacking, which involves 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 harm our business, financial condition and operating results. We have experienced and will continue to experience hacking attacks. Because of our prominence in the social game industry, we believe we are a particularly attractive target for hackers. Though it is difficult to determine what harm may directly result from any specific interruption or breach, any failure to maintain performance, reliability, security and availability of our network infrastructure to the satisfaction of our players may harm our reputation and our ability to retain existing players and attract new players.

***If we fail to effectively manage our growth, our business and operating results could be harmed.***

We continue to experience rapid growth in our headcount and operations, which will continue to place significant demands on our management and our operational, financial and technological infrastructure. As of March 31, 2012, approximately 52% of our employees had been with us for less than one year and approximately 81% for less than two years. As we continue to grow, we must expend significant resources to identify, hire, integrate, develop and motivate a large number of qualified employees. If we fail to effectively manage our hiring needs and successfully integrate our new hires, our ability to continue launching new games and enhance existing games could suffer.

To effectively manage the growth of our business and operations, we will need to continue spending significant resources to improve our technology infrastructure, our operational, financial and management controls, and our reporting systems and procedures by, among other things:

monitoring and updating our technology infrastructure to maintain high performance and minimize down time;

enhancing information and communication systems to ensure that our employees and offices around the world are well-coordinated and can effectively communicate with each other;

enhancing our internal controls to ensure timely and accurate reporting of all of our operations; and

appropriately documenting our information technology systems and our business processes.

These enhancements and improvements will require significant capital expenditures and allocation of valuable management and employee resources. If we fail to implement these enhancements and improvements effectively, our ability to manage our expected growth and comply with the rules and regulations that are applicable to public reporting companies will be impaired. In addition, if our operating costs are higher than we expect or if we do not maintain adequate control of our costs and expenses, our operating results will suffer.

***Our growth prospects will suffer if we are unable to continue to develop successful games for mobile platforms or successfully monetize mobile games we develop or acquire.\****

Developing games for mobile platforms is an important component of our strategy. We have devoted, and we expect to continue to devote, substantial resources to the development of additional mobile games, and we cannot guarantee that we will continue to develop games that appeal to our players or advertisers. In addition, we may encounter difficulty in integrating features on games developed for mobile platforms that a sufficient number of players will pay for or otherwise sufficiently monetize mobile games. Our mobile games currently monetize at a lower rate than our web-based games and we may not be successful in our efforts to increase our monetization from mobile games. If we are unable to implement successful monetization strategies for our mobile games, our ability to grow revenue and our financial performance will be negatively affected.

Our ability to successfully develop games for mobile platforms will depend on our ability to:

anticipate and effectively respond to the changing mobile landscape and the interests of players on mobile platforms;

attract, retain and motivate talented game designers, product managers and engineers who have experience developing games for mobile platforms;

expand on our current mobile games;

effectively market new mobile games to our existing web-based players and players of our current mobile games;

minimize launch delays and cost overruns on the development of new games; and

acquire and successfully integrate high quality mobile game assets, personnel or companies.

These and other uncertainties make it difficult to know whether we will succeed in continuing to develop successful mobile games. If we do not succeed in doing so, our growth prospects and our business will suffer.



---

## **Table of Contents**

***Our core values of focusing on our players first and acting for the long term may conflict with the short-term interests of our business.***

One of our core values is to focus on surprising and delighting our players, which we believe is essential to our success and serves the best, long-term interests of Zynga and our stakeholders. Therefore, we have made in the past and we may make in the future, significant investments or changes in strategy that we think will benefit our players, even if our decision negatively impacts our operating results in the short term. For example, in late 2009 and in 2010 we reduced in-game advertising offers in order to improve player experience. This decrease in in-game offers led to a reduction of advertising revenue in 2010 as compared to 2009. Our decisions may not result in the long-term benefits that we expect, in which case the success of our games, business and operating results could be harmed.

***If we lose the services of our founder and Chief Executive Officer or other members of our senior management team, we may not be able to execute our business strategy.***

Our success depends in a large part upon the continued service of our senior management team. In particular, our founder and Chief Executive Officer, Mark Pincus, is critical to our vision, strategic direction, culture, products and technology. We do not maintain key-man insurance for Mr. Pincus or any other member of our senior management team. The loss of our founder and Chief Executive Officer, even temporarily, or any other member of senior management would harm our business.

***If we are unable to attract and retain highly qualified employees, we may not be able to grow effectively.***

Our ability to compete and grow depends in large part on the efforts and talents of our employees. Such employees, particularly game designers, product managers and engineers, are in high demand, and we devote significant resources to identifying, hiring, training, successfully integrating and retaining these employees. We have historically hired a number of key personnel through acquisitions, and as competition with several other game companies increases, we may incur significant expenses in continuing this practice. The loss of employees or the inability to hire additional skilled employees as necessary could result in significant disruptions to our business, and the integration of replacement personnel could be time-consuming and expensive and cause additional disruptions to our business.

We believe that two critical components of our success and our ability to retain our best people are our culture and our competitive compensation practices. As we continue to grow rapidly and develop the infrastructure of a public company, we may find it difficult to maintain our entrepreneurial, execution-focused culture. In addition, many of our employees may be able to receive significant proceeds from sales of our equity in the public markets, which may reduce their motivation to continue to work for us. Moreover, there may also be disparities of wealth between those of our employees whom we hired prior to our initial public offering in December 2011 and those who joined us after we became a public company, which may harm our culture and relations among employees.

***An increasing number of individuals are utilizing devices other than personal computers to access the Internet, and versions of our games developed for these devices might not gain widespread adoption, or may not function as intended.***

The number of individuals who access the Internet through devices other than a personal computer, such as smartphones, tablets, televisions and set-top box devices, has increased dramatically, and we believe this trend is likely to continue. The generally lower processing speed, power, functionality and memory associated with these devices make playing our games through such devices more difficult; and the versions of our games developed for these devices may not be compelling to players. In addition, each device manufacturer or platform provider may establish unique or restrictive terms and conditions for developers on such devices or platforms, and our games may not work well or be viewable on these devices as a result. To expand our business, we will need to continue to support a number of alternative devices and technologies. Once developed, we may choose to port or convert a game into separate versions for alternative devices with different technological requirements. As new devices and new mobile platforms or updates to platforms are continually being released, we may encounter problems in developing versions of our games for use on these alternative devices and we may need to devote significant resources to the creation, support, and maintenance of such devices and platforms. If we are unable to successfully expand the platforms and devices on which our games are available, or if the versions of our games that we create for alternative platforms and devices are not compelling to our players, our business will suffer.

***Expansion into international markets is important for our growth, and as we expand internationally, we will face additional business, political, regulatory, operational, financial and economic risks, any of which could increase our costs and hinder such growth.***

Continuing to expand our business to attract players in countries other than the United States is a critical element of our business strategy. An important part of targeting international markets is developing offerings that are localized and customized for the players in those markets. We have a limited operating history as a company outside of the United States. We expect to continue to devote



**Table of Contents**

significant resources to international expansion through acquisitions, the establishment of additional offices and development studios, and increasing our foreign language offerings. Our ability to expand our business and to attract talented employees and players in an increasing number of international markets will require considerable management attention and resources and is subject to the particular challenges of supporting a rapidly growing business in an environment of multiple languages, cultures, customs, legal systems, alternative dispute systems, regulatory systems and commercial infrastructures. We have experienced difficulties in the past and have not been successful in all the countries we have entered. Expanding our international focus may subject us to risks that we have not faced before or increase risks that we currently face, including risks associated with:

recruiting and retaining talented and capable management and employees in foreign countries;

challenges caused by distance, language and cultural differences;

developing and customizing games and other offerings that appeal to the tastes and preferences of players in international markets;

competition from local game makers with significant market share in those markets and with a better understanding of player preferences;

protecting and enforcing our intellectual property rights;

negotiating agreements with local distribution platforms that are sufficiently economically beneficial to us and protective of our rights;

the inability to extend proprietary rights in our brand, content or technology into new jurisdictions;

implementing alternative payment methods for virtual goods in a manner that complies with local laws and practices and protects us from fraud;

compliance with applicable foreign laws and regulations, including privacy laws and laws relating to content;

compliance with anti-bribery laws including without limitation, compliance with the Foreign Corrupt Practices Act;

credit risk and higher levels of payment fraud;

currency exchange rate fluctuations;

protectionist laws and business practices that favor local businesses in some countries;

foreign tax consequences;

foreign exchange controls or U.S. tax restrictions that might restrict or prevent us from repatriating income earned in countries outside the United States;

political, economic and social instability;

higher costs associated with doing business internationally;

export or import regulations; and

trade and tariff restrictions.

Entering new international markets will be expensive, our ability to successfully gain market acceptance in any particular market is uncertain, and the distraction of our senior management team could harm our business.

***Competition within the broader entertainment industry is intense and our existing and potential players may be attracted to competing forms of entertainment such as offline and traditional online games, television, movies and sports, as well as other entertainment options on the Internet.\****

Our players face a vast array of entertainment choices. Other forms of entertainment, such as offline, traditional online, personal computer and console games, television, movies, sports, online gambling and the Internet, are much larger and more well-established markets and may be perceived by our players to offer greater variety, affordability, interactivity and enjoyment. These other forms of entertainment compete for the discretionary time and income of our players. If we are unable to sustain sufficient interest in our games in comparison to other forms of entertainment, including new forms of entertainment, our business model may no longer be viable.

---

## **Table of Contents**

*There are low barriers to entry in the social game industry, and competition is intense.\**

The social game industry is highly competitive, with low barriers to entry, and we expect more companies to enter the sector and a wider range of social games to be introduced. Our competitors that develop social games for social networks vary in size and include publicly-traded companies such as Electronic Arts Inc. and The Walt Disney Company and privately held companies such as Crowdstar, Inc., Vostu, Ltd., DeNA Co. Ltd., King.com and wooga GmbH. In addition, online game developers and distributors who are primarily focused on specific international markets, such as Tencent Holdings Limited in Asia, and high-profile companies with significant online presences that to date have not developed social games, such as Amazon.com, Facebook, Google Inc., and Microsoft Corporation, may decide to develop social games. Some of these current and potential competitors have significant resources for developing or acquiring additional games, may be able to incorporate their own strong brands and assets into their games, have a more diversified set of revenue sources than we do and may be less severely affected by changes in consumer preferences, regulations or other developments that may impact the online social game industry. In addition, we have limited experience in developing games for mobile and other platforms and our ability to succeed on those platforms is uncertain. As we continue to devote significant resources to developing games for those platforms, we will face significant competition from established companies, including Electronic Arts, GREE International, Inc., DeNA, Gameloft SA, Glu Mobile Inc., Disney and Rovio Mobile Ltd. We expect new mobile-game competitors to enter the market and existing competitors to allocate more resources to develop and market competing games and applications.

*The value of our virtual goods is highly dependent on how we manage the economies in our games. If we fail to manage our game economies properly, our business may suffer.*

Paying players purchase virtual goods in our games because of the perceived value of these goods which is dependent on the relative ease of securing an equivalent good via non-paid means within the game. The perceived value of these virtual goods can be impacted by an increase in the availability of free or discounted Facebook Credits or by various actions that we take in the games including offering discounts for virtual goods, giving away virtual goods in promotions or providing easier non-paid means to secure these goods. If we fail to manage our virtual economies properly, players may be less likely to purchase virtual goods and our business may suffer.

*Some of our players may make sales and/or purchases of virtual goods used in our games through unauthorized third-party websites, which may impede our revenue growth.*

Some of our players may make sales and/or purchases of our virtual goods, such as Zynga Poker virtual poker chips, through unauthorized third-party sellers in exchange for real currency. These unauthorized transactions are usually arranged on third-party websites. We do not generate any revenue from these transactions. Accordingly, these unauthorized purchases and sales from third-party sellers could impede our revenue and profit growth by, among other things:

decreasing revenue from authorized transactions;

creating downward pressure on the prices we charge players for our virtual currency and virtual goods;

causing us to lose revenue from paying players who stop playing a particular game;

increasing costs we incur to develop technological measures to curtail unauthorized transactions;

generating legal claims relating to the diminution of value of our virtual goods; and

increasing customer support costs to respond to dissatisfied players.

To discourage unauthorized purchases and sales of our virtual goods, we have stated in our terms of service that the buying or selling of virtual currency and virtual goods from unauthorized third-party sellers may result in bans from our games and/or legal action. We have banned players

as a result of such activities. We have also developed technological measures to help detect unauthorized transactions. If we decide to implement further restrictions on players' ability to transfer virtual goods, we may lose players, which could harm our financial condition and results of operations.

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

Unrelated third parties have developed, and may continue to develop, cheating programs that enable players to exploit our games, play them in an automated way or obtain unfair advantages over other players who do play fairly. These programs harm the experience of players who play fairly and may disrupt the virtual economy of our games. In addition, unrelated third parties attempt to scam our players with fake offers for virtual goods. We devote significant resources to discover and disable these programs and activities, and if we are unable to do so quickly our operations may be disrupted, our reputation damaged and players may stop playing our games. This may lead to lost revenue from paying players, increased cost of developing technological measures to combat these programs and activities, legal claims relating to the diminution in value of our virtual currency and goods, and increased customer service costs needed to respond to dissatisfied players.

**Table of Contents**

***Our quarterly operating results are volatile and difficult to predict, and our stock price may decline if we fail to meet the expectations of securities analysts or investors.\****

Our bookings, revenue, traffic and operating results could vary significantly from quarter-to-quarter and year-to-year and may fail to match our past performance or the expectations of securities analysts or investors because of a variety of factors, some of which are outside of our control. Any of these events could cause the market price of our Class A common stock to fluctuate. Factors that may contribute to the variability of our operating results include the risk factors listed in these Risk Factors and the factors discussed in the section titled Management's Discussion and Analysis of Financial Condition and Results of Operations Factors Affecting Our Performance.

In particular, we recognize revenue from sale of our virtual goods in accordance with GAAP, which is complex and based on our assumptions and historical data with respect to the sale and use of various types of virtual goods. In the event that such assumptions are revised based on new data or there are changes in the historical mix of virtual goods sold due to new game introductions, reduced virtual good sales in existing games or other factors or there are changes in our estimates of average playing periods, the amount of revenue that we recognize in any particular period may fluctuate significantly. For further information regarding our revenue recognition policy, see the section titled Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Revenue Recognition.

Given our short operating history and the rapidly evolving social game industry, our historical operating results may not be useful in predicting our future operating results. In addition, metrics we have developed or those available from third parties regarding our industry and the performance of our games, including DAUs, MAUs, MUUs, MUPs and ABPU may not be indicative of our financial performance.

***Failure to protect or enforce our intellectual property rights or the costs involved in such enforcement could harm our business and operating results.***

We regard the protection of our trade secrets, copyrights, trademarks, trade dress, domain names and other product rights as critical to our success. We strive to protect our intellectual property rights by relying on federal, state and common law rights, as well as contractual restrictions. We enter into confidentiality and invention assignment agreements with our employees and contractors and confidentiality agreements with parties with whom we conduct business in order to limit access to, and disclosure and use of, our proprietary information. However, these contractual arrangements and the other steps we have taken to protect our intellectual property may not prevent the misappropriation of our proprietary information or deter independent development of similar technologies by others.

We pursue the registration of our domain names, trademarks, and service marks in the United States and in certain locations outside the United States. We are seeking to protect our trademarks, patents and domain names in an increasing number of jurisdictions, a process that is expensive and time-consuming and may not be successful or which we may not pursue in every location. We may, over time, increase our investment in protecting our innovations through increased patent filings that are expensive and time-consuming and may not result in issued patents that can be effectively enforced. The Leahy-Smith America Invents Act ( the Leahy-Smith Act ) was adopted in September 2011.

The Leahy-Smith Act includes a number of significant changes to United States patent law, including provisions that affect the way patent applications will be prosecuted and may also affect patent litigation. The United States Patent and Trademark Office is currently developing regulations and procedures to govern administration of the Leahy-Smith Act, and many of the substantive changes to patent law associated with the Leahy-Smith Act will not become effective until up to 18 months after its enactment. Accordingly, it is not clear what, if any, impact the Leahy-Smith Act will have on the operation of our business. However, the Leahy-Smith Act and its implementation could increase the uncertainties and costs surrounding the prosecution of our patent applications and the enforcement or defense of our issued patents, all of which could harm our business.

Litigation may be necessary to enforce our intellectual property rights, protect our trade secrets or determine the validity and scope of proprietary rights claimed by others. Any litigation of this nature, regardless of outcome or merit, could result in substantial costs, adverse publicity or diversion of management and technical resources, any of which could adversely affect our business and operating results. If we fail to maintain, protect and enhance our intellectual property rights, our business and operating results may be harmed.

***We are, and may in the future be, subject to intellectual property disputes, which are costly to defend and could require us to pay significant damages and could limit our ability to use certain technologies in the future.***

From time to time, we have faced, and we expect to face in the future, allegations that we have infringed the trademarks, copyrights, patents and other intellectual property rights of third parties, including our competitors, non-practicing entities and former employers of our personnel. Patent and other intellectual property litigation may be protracted and expensive, and the results are difficult to predict. As the result of any court judgment or settlement we may be obligated to cancel the launch of a new game, stop offering a game or certain features of a game, pay

royalties or significant settlement costs, purchase licenses or modify our games and features while we develop substitutes.



---

## **Table of Contents**

In addition, we use open source software in our games and expect to continue to use open source software in the future. From time to time, we may face claims from companies that incorporate open source software into their products, claiming ownership of, or demanding release of, the source code, the open source software and/or derivative works that were developed using such software, or otherwise seeking to enforce the terms of the applicable open source license. These claims could also result in litigation, require us to purchase a costly license or require us to devote additional research and development resources to change our games, any of which would have a negative effect on our business and operating results.

Although we do not believe that the final outcome of litigation and claims that we currently face will have a material adverse effect on our business, our expectations may not prove to be correct. Even if these matters do not result in litigation or are resolved in our favor or without significant cash settlements, these matters, and the time and resources necessary to litigate or resolve them, could harm our business, operating results, financial condition, reputation or the market price of our Class A common stock.

***Programming errors or flaws in our games could harm our reputation or decrease market acceptance of our games, which would harm our operating results.***

Our games may contain errors, bugs, flaws or corrupted data, and these defects may only become apparent after their launch, particularly as we launch new games and rapidly release new features to existing games under tight time constraints. We believe that if our players have a negative experience with our games, they may be less inclined to continue or resume playing our games or recommend our games to other potential players. Undetected programming errors, game defects and data corruption can disrupt our operations, adversely affect the game experience of our players by allowing players to gain unfair advantage, harm our reputation, cause our players to stop playing our games, divert our resources and delay market acceptance of our games, any of which could result in legal liability to us or harm our operating results.

***Evolving regulations, industry standards and practices by platform providers concerning data privacy could prevent us from providing our current games to our players, or require us to modify our games, thereby harming our business.\****

The regulatory framework for privacy issues worldwide is currently in flux and is likely to remain so for the foreseeable future. Practices regarding the collection, use, storage, transmission and security of personal information by companies operating over the Internet and on mobile platforms have recently come under increased public scrutiny, and civil claims alleging liability for the breach of data privacy have been asserted against us. The U.S. government, including the Federal Trade Commission and the Department of Commerce, has announced that it is reviewing the need for greater regulation for the collection of information concerning consumer behavior on the Internet, including regulation aimed at restricting certain targeted advertising practices. In addition, the European Union is in the process of proposing reforms to its existing data protection legal framework, which may result in a greater compliance burden for companies with users in Europe. Various government and consumer agencies have also called for new regulation and changes in industry practices.

We began operations in 2007 and have grown rapidly. While our administrative systems have developed rapidly, during our earlier history our practices relating to intellectual property, data privacy and security, and legal compliance may not have been as robust as they are now, and there may be unasserted claims arising from this period that we are not able to anticipate. In addition, our business, including our ability to operate and expand internationally, could be adversely affected if laws or regulations are adopted, interpreted, or implemented in a manner that is inconsistent with our current business practices and that requires changes to these practices, the design of our website, games, features or our privacy policy. In particular, the success of our business has been, and we expect will continue to be, driven by our ability to responsibly use the data that our players share with us. Therefore, our business could be harmed by any significant change to applicable laws, regulations or industry practices or the requirements of platform providers regarding the use or disclosure of data our players choose to share with us, or regarding the manner in which the express or implied consent of consumers for such use and disclosure is obtained. Such changes may require us to modify our games, features and advertising practices, possibly in a material manner, and may limit our ability to use of the data that our players share with us.

***We process, store and use personal information and other data, which subjects us to governmental regulation and other legal obligations related to privacy, and our actual or perceived failure to comply with such obligations could harm our business.***

We receive, store and process personal information and other player data, and we enable our players to share their personal information with each other and with third parties, including on the Internet and mobile platforms. There are numerous federal, state and local laws around the world regarding privacy and the storing, sharing, use, processing, disclosure and protection of personal information and other player data on the Internet and mobile platforms, the scope of which are changing, subject to differing interpretations, and may be inconsistent between countries or conflict with other rules. We generally comply with industry standards and are subject to the terms of our own privacy policies and privacy-related obligations to third parties (including voluntary third-party certification bodies such as TRUSTe). We strive to comply with all applicable laws, policies, legal obligations and certain industry codes of conduct relating to privacy and data protection, to the extent reasonably attainable. However, it is possible that these obligations may be interpreted and applied in a manner that is inconsistent from one jurisdiction to

another and may conflict with other rules or our practices. Any failure or perceived failure by us to comply with our privacy policies, our privacy-related obligations

**Table of Contents**

to players or other third parties, or our privacy-related legal obligations, or any compromise of security that results in the unauthorized release or transfer of personally identifiable information or other player data, may result in governmental enforcement actions, litigation or public statements against us by consumer advocacy groups or others and could cause our players to lose trust in us, which could have an adverse effect on our business. Additionally, if third parties we work with, such as players, vendors or developers, violate applicable laws or our policies, such violations may also put our players' information at risk and could in turn have an adverse effect on our business.

In the area of information security and data protection, many states have passed laws requiring notification to players when there is a security breach for personal data, such as the 2002 amendment to California's Information Practices Act, or requiring the adoption of minimum information security standards that are often vaguely defined and difficult to practically implement. The costs of compliance with these laws may increase in the future as a result of changes in interpretation. Furthermore, any failure on our part to comply with these laws may subject us to significant liabilities.

***Our business is subject to a variety of other U.S. and foreign laws, many of which are unsettled and still developing and which could subject us to claims or otherwise harm our business.***

We are subject to a variety of laws in the United States and abroad, including laws regarding consumer protection, intellectual property, export and national security, that are continuously evolving and developing. The scope and interpretation of the laws that are or may be applicable to us are often uncertain and may be conflicting, particularly laws outside the United States. For example, laws relating to the liability of providers of online services for activities of their users and other third parties are currently being tested by a number of claims, including actions based on invasion of privacy and other torts, unfair competition, copyright and trademark infringement, and other theories based on the nature and content of the materials searched, the ads posted or the content provided by users. It is also likely that as our business grows and evolves and our games are played in a greater number of countries, we will become subject to laws and regulations in additional jurisdictions. We are potentially subject to a number of foreign and domestic laws and regulations that affect the offering of certain types of content, such as that which depicts violence, many of which are ambiguous, still evolving and could be interpreted in ways that could harm our business or expose us to liability. In addition, certain of our games, including *Zynga Poker*, may become subject to gambling-related rules and regulations and expose us to civil and criminal penalties if we do not comply. It is difficult to predict how existing laws will be applied to our business and the new laws to which we may become subject.

If we are not able to comply with these laws or regulations or if we become liable under these laws or regulations, we could be directly harmed, and we may be forced to implement new measures to reduce our exposure to this liability. This may require us to expend substantial resources or to modify our games, which would harm our business, financial condition and results of operations. In addition, the increased attention focused upon liability issues as a result of lawsuits and legislative proposals could harm our reputation or otherwise impact the growth of our business. Any costs incurred as a result of this potential liability could harm our business and operating results.

It is possible that a number of laws and regulations may be adopted or construed to apply to us in the United States and elsewhere that could restrict the online and mobile industries, including player privacy, advertising, taxation, content suitability, copyright, distribution and antitrust. Furthermore, the growth and development of electronic commerce and virtual goods may prompt calls for more stringent consumer protection laws that may impose additional burdens on companies such as ours conducting business through the Internet and mobile devices. We anticipate that scrutiny and regulation of our industry will increase and we will be required to devote legal and other resources to addressing such regulation. For example, existing laws or new laws regarding the regulation of currency and banking institutions may be interpreted to cover virtual currency or goods. If that were to occur we may be required to seek licenses, authorizations or approvals from relevant regulators, the granting of which may be dependent on us meeting certain capital and other requirements and we may be subject to additional regulation and oversight, all of which could significantly increase our operating costs. Changes in current laws or regulations or the imposition of new laws and regulations in the United States or elsewhere regarding these activities may lessen the growth of social game services and impair our business.

***Companies and governmental agencies may restrict access to Facebook, our website or the Internet generally, which could lead to the loss or slower growth of our player base.***

Our players need to access the Internet and in particular Facebook and our website to play our games. Companies and governmental agencies, could block access to Facebook, our website or the Internet generally for a number of reasons such as security or confidentiality concerns or regulatory reasons, or they may adopt policies that prohibit employees from accessing Facebook, our website or other social platforms. For example, the government of the People's Republic of China has blocked access to Facebook in China. If companies or governmental entities block or limit access to Facebook or our website or otherwise adopt policies restricting players from playing our games our business could be negatively impacted and could lead to the loss or slower growth of our player base.



---

**Table of Contents**

***Our business will suffer if we are unable to successfully integrate acquired companies into our business or otherwise manage the growth associated with multiple acquisitions.***

We have acquired businesses, personnel and technologies in the past and we intend to continue to pursue acquisitions that are complementary to our existing business and expand our employee base and the breadth of our offerings. Our ability to grow through future acquisitions will depend on the availability of suitable acquisition and investment candidates at an acceptable cost, our ability to compete effectively to attract these candidates and the availability of financing to complete larger acquisitions. Since we expect the social game industry to consolidate in the future, we may face significant competition in executing our growth strategy. Future acquisitions or investments could result in potential dilutive issuances of equity securities, use of significant cash balances or incurrence of debt, contingent liabilities or amortization expenses related to goodwill and other intangible assets, any of which could adversely affect our financial condition and results of operations. The benefits of an acquisition or investment may also take considerable time to develop, and we cannot be certain that any particular acquisition or investment will produce the intended benefits.

Integration of a new company's operations, assets and personnel into ours will require significant attention from our management. The diversion of our management's attention away from our business and any difficulties encountered in the integration process could harm our ability to manage our business. Future acquisitions will also expose us to potential risks, including risks associated with any acquired liabilities, the integration of new operations, technologies and personnel, unforeseen or hidden liabilities and unanticipated information security vulnerabilities, the diversion of resources from our existing businesses, sites and technologies, the inability to generate sufficient revenue to offset the costs and expenses of acquisitions, and potential loss of, or harm to, our relationships with employees, players, and other suppliers as a result of integration of new businesses.

***Failure in pursuing or executing new business initiatives could have a material adverse impact on our business and future growth.\****

Our growth strategy includes evaluating, considering and effectively executing new business initiatives, which can be difficult. Management may not properly ascertain or assess the risks of new initiatives, and subsequent events may alter the risks that were evaluated at the time we decided to execute any new initiative. Entering into any new initiatives can also divert our management's attention from other business issues and opportunities. Failure to effectively identify, pursue and execute new business initiatives, including online gambling as discussed below, may adversely affect our reputation, business, financial condition and results of operations.

We have stated publicly that we are evaluating the opportunity of expanding our business to include online gambling. Although we may not ultimately pursue this opportunity, we believe it could have risks that are different than those associated with other new initiatives. In particular, online gambling is subject to stringent, complicated and rapidly changing licensing and regulatory requirements, both federally and in each state, as well as internationally. Regulatory and legislative developments may prevent or significantly limit our ability to enter into or succeed in online gambling. Becoming familiar with and complying with these requirements will increase our costs and subject our business to greater scrutiny by regulators in many different jurisdictions. If our brand becomes associated with online gambling we may lose current players, advertisers or partners or have difficulty attracting new players, advertisers or partners, which could adversely impact our business.

***Fluctuations in foreign currency exchange rates will affect our financial results, which we report in U.S. dollars.***

As we continue to expand our international operations, we become more exposed to the effects of fluctuations in currency exchange rates. We incur expenses for employee compensation and other operating expenses at our non-U.S. locations in the local currency, and an increasing percentage of our international revenue is from players who pay us in currencies other than the U.S. dollar. Fluctuations in the exchange rates between the U.S. dollar and those other currencies could result in the dollar equivalent of such expenses being higher and/or the dollar equivalent of such foreign-denominated revenue being lower than would be the case if exchange rates were stable. This could have a negative impact on our reported operating results.

***The enactment of legislation implementing changes in the U.S. taxation of international business activities or the adoption of other tax reform policies could materially impact our financial position and results of operations.***

The current administration has made public statements indicating that it has made international tax reform a priority, and key members of the U.S. Congress have conducted hearings and proposed new legislation. Recent changes to U.S. tax laws, including limitations on the ability of taxpayers to claim and utilize foreign tax credits and the deferral of certain tax deductions until earnings outside of the United States are repatriated to the United States, as well as changes to U.S. tax laws that may be enacted in the future, could impact the tax treatment of our foreign earnings. Due to the large and expanding scale of our international business activities, any changes in the U.S. taxation of such activities may increase our worldwide effective tax rate and harm our financial position and results of operations.



**Table of Contents**

***A change in the application of the tax laws of various jurisdictions could result in an increase to our worldwide effective tax rate and a change in how we operate our business.***

Our corporate structure and intercompany arrangements, including the manner in which we develop and use our intellectual property and the transfer pricing of our intercompany transactions, are intended to provide us worldwide tax efficiencies. The application of the tax laws of various jurisdictions, including the United States, to our international business activities is subject to interpretation and depends on our ability to operate our business in a manner consistent with our corporate structure and intercompany arrangements. The taxing authorities of the jurisdictions in which we operate may challenge our methodologies for valuing developed technology or intercompany arrangements, including our transfer pricing, or determine that the manner in which we operate our business is not consistent with the manner in which we report our income to the jurisdictions, which could increase our worldwide effective tax rate and harm our financial position and results of operations.

***Our facilities are located near known earthquake fault zones, and the occurrence of an earthquake or other natural disaster could cause damage to our facilities and equipment, which could require us to curtail or cease operations.***

Our principal offices and network operations centers are located in the San Francisco Bay Area, an area known for earthquakes, and are thus vulnerable to damage. We are also vulnerable to damage from other types of disasters, including power loss, fire, explosions, floods, communications failures, terrorist attacks and similar events. If any disaster were to occur, our ability to operate our business at our facilities could be impaired.

***We may require additional capital to meet our financial obligations and support business growth, and this capital might not be available on acceptable terms or at all.***

We intend to continue to make significant investments to support our business growth and may require additional funds to respond to business challenges, including the need to develop new games and features or enhance our existing games, improve our operating infrastructure or acquire complementary businesses, personnel and technologies. Accordingly, we may need to engage in equity or debt financings to secure additional funds. If we raise additional funds through future issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution, and any new equity securities we issue could have rights, preferences and privileges superior to those of holders of our Class A common stock. Any debt financing that we secure in the future could involve restrictive covenants relating to our capital raising activities and other financial and operational matters, which may make it more difficult for us to obtain additional capital and to pursue business opportunities, including potential acquisitions. We may not be able to obtain additional financing on terms favorable to us, if at all. If we are unable to obtain adequate financing or financing on terms satisfactory to us when we require it, our ability to continue to support our business growth and to respond to business challenges could be significantly impaired, and our business may be harmed.

**Risks Related to Our Class A Common Stock**

***The three class structure of our common stock has the effect of concentrating voting control with those stockholders who held our stock prior to our initial public offering, including our founder and Chief Executive Officer and our other executive officers, employees and directors and their affiliates; this limits our other stockholders' ability to influence corporate matters.\****

Our Class C common stock has 70 votes per share, our Class B common stock has seven votes per share and our Class A common stock has one vote per share. Mark Pincus, our Chief Executive Officer, beneficially owned approximately 37.6% of the total voting power of our outstanding capital stock as of April 3, 2012, following our secondary offering. As a result, Mr. Pincus has significant influence over the management and affairs of the company and control over matters requiring stockholder approval, including the election of directors and significant corporate transactions, such as a merger or other sale of our company or our assets. This concentrated voting control will limit the ability of our stockholders to influence corporate matters and could adversely affect the market price of our Class A common stock.

Future transfers or sales by holders of Class B common stock or Class C common stock will result in those shares converting to Class A common stock, which will have the effect, over time, of increasing the relative voting power of those stockholders who retain their existing shares of Class B or Class C common stock. In addition, as shares of Class B common stock are transferred or sold and converted to Class A common stock, the sole holder of Class C common stock, Mark Pincus, will have greater relative voting control to the extent he retains his existing shares of Class C common stock, and as a result he could in the future control a majority of our total voting power. Mr. Pincus is entitled to vote his shares in his own interests and may do so.

## **Table of Contents**

***Certain provisions in our charter documents and under Delaware law could limit attempts by our stockholders to replace or remove our board of directors or current management and limit the market price of our Class A common stock.***

Provisions in our certificate of incorporation and bylaws may have the effect of delaying or preventing changes in our board of directors or management. Our certificate of incorporation and bylaws include provisions that:

establish an advance notice procedure for stockholder proposals to be brought before an annual meeting, including proposed nominations of persons for election to our board of directors;

prohibit cumulative voting in the election of directors; and

reflect three classes of common stock, as discussed above.

These provisions may frustrate or prevent any attempts by our stockholders to replace or remove our current management by making it more difficult for stockholders to replace members of our board of directors, which is responsible for appointing the members of our management. In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which generally prohibits a Delaware corporation from engaging in any of a broad range of business combinations with any interested stockholder for a period of three years following the date on which the stockholder became an interested stockholder.

### ***Our share price has been and will likely continue to be volatile.\****

The trading price of our Class A common stock has been, and is likely to continue to be, highly volatile and could be subject to wide fluctuations in response to various factors, some of which are beyond our control. Since shares of our Class A common stock were sold in our initial public offering in December 2011 at a price of \$10.00 per share, our stock price has ranged from \$7.97 to \$15.91, through March 31, 2012. In addition to the factors discussed in these Risk Factors and elsewhere in this Quarterly Report on Form 10-Q, factors that may cause volatility in our share price include:

changes in projected operational and financial results;

issuance of new or updated research or reports by securities analysts;

market rumors or press reports;

the use by investors or analysts of third-party data regarding our business that may not reflect our actual performance;

the expiration of contractual lock-up agreements;

fluctuations in the valuation of companies perceived by investors to be comparable to us;

the activities, public announcements and financial performance of our commercial partners, such as Facebook;



## Edgar Filing: ZYNGA INC - Form 10-Q

fluctuations in the trading volume of our shares, or the size of our public float relative to the total number of shares of our Class A, Class B and Class C common stock that are issued and outstanding;

share price and volume fluctuations attributable to inconsistent trading volume levels of our shares; and

general economic and market conditions.

Furthermore, the stock markets have experienced extreme price and volume fluctuations that have affected and continue to affect the market prices of equity securities of many companies. These fluctuations often have been unrelated or disproportionate to the operating performance of those companies. These broad market and industry fluctuations, as well as general economic, political and market conditions such as recessions, interest rate changes or international currency fluctuations, may negatively impact the market price of our Class A common stock. In the past, companies that have experienced volatility in the market price of their stock have been subject to securities class action litigation. We may be the target of this type of litigation in the future. Securities litigation against us could result in substantial costs and divert our management's attention from other business concerns, which could harm our business.

---

## **Table of Contents**

### ***Our Class A common stock price may be volatile due to third-party data regarding our games.***

Third parties, such as AppData, publish daily data about us and other social game companies with respect to DAUs and MAUs and other information concerning social game usage, in particular on Facebook. These metrics can be volatile, particularly for specific games, and in many cases do not accurately reflect the actual levels of usage of our games across all platforms and may not correlate to our bookings or revenue from the sale of virtual goods. There is a possibility that third parties could change their methodologies for calculating these metrics in the future. To the extent that securities analysts or investors base their views of our business or prospects on such third-party data, the price of our Class A common stock may be volatile and may not reflect the performance of our business.

### ***If securities or industry analysts do not publish research about our business, or publish negative reports about our business, our share price and trading volume could decline.***

The trading market for our Class A common stock, to some extent, depends on the research and reports that securities or industry analysts publish about our business. We do not have any control over these analysts. If one or more of the analysts who cover us downgrade our shares or lower their opinion of our shares, our share price would likely decline. If one or more of these analysts cease coverage of our company or fail to regularly publish reports on us, we could lose visibility in the financial markets, which could cause our share price or trading volume to decline.

### ***Future sales or potential sales of our common stock in the public market could cause our share price to decline.\****

We have a small public float relative to the total number of shares of our Class A, Class B and Class C common stock that are issued and outstanding and a substantial majority of our issued and outstanding shares are currently restricted as a result of securities laws, lock-up agreements or other contractual restrictions that restrict transfers.

Upon completion of the release of the underwriters' lockup from our public offerings, currently scheduled to expire at various dates through August 15, 2012, subject to extension in certain circumstances, approximately 550 million shares will be eligible for sale in the future upon the expiration of lock-up agreements, subject in some cases to volume and other restrictions of Rule 144 and Rule 701 under the Securities Act of 1933, as amended. In addition, the holders of 364.6 million shares of Class B common stock, or 50% of our total outstanding common stock, based on shares outstanding as of March 31, 2012, will be entitled to rights with respect to registration of these shares under the Securities Act pursuant to an investors' rights agreement. If these holders of our Class B common stock, by exercising their registration rights, sell a large number of shares, they could adversely affect the market price for our Class A common stock. If we file a registration statement for the purposes of selling additional shares to raise capital and are required to include shares held by these holders pursuant to the exercise of their registration rights, our ability to raise capital may be impaired. Sales of substantial amounts of our Class A common stock in the public market following the release of the lock-ups or otherwise, or the perception that these sales could occur, could cause the market price of our Class A common stock to decline.

### ***If we are unable to implement and maintain effective internal control over financial reporting in the future, the accuracy and timeliness of our financial reporting may be adversely affected.***

If we are unable to maintain adequate internal controls for financial reporting in the future, or if our auditors are unable to express an opinion as to the effectiveness of our internal controls as required pursuant to the Sarbanes-Oxley Act, investor confidence in the accuracy of our financial reports may be impacted or the market price of our Class A common stock could be negatively impacted.

### ***The requirements of being a public company may strain our resources, divert management's attention and affect our ability to attract and retain qualified board members.***

We are subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (the Exchange Act), the Sarbanes-Oxley Act, the Dodd-Frank Act, the listing requirements of the NASDAQ Global Select Market and other applicable securities rules and regulations. Compliance with these rules and regulations has increased and will continue to increase our legal and financial compliance costs, make some activities more difficult, time-consuming or costly and increase demand on our systems and resources. The Exchange Act requires, among other things, that we file annual, quarterly and current reports with respect to our business and operating results.

We also expect that being a public company, subject to these rules and regulations, will make it more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. These factors could also make it more difficult for us to attract and retain qualified members of our board of directors, particularly to serve on our audit committee and compensation committee, and qualified executive officers.



---

## **Table of Contents**

As a result of disclosure of information in this Quarterly Report on Form 10-Q and our other public filings with the SEC as required of a public company, our business and financial condition have become more visible, which we believe may result in threatened or actual litigation, including by competitors and other third parties. If such claims are successful, our business and operating results could be harmed, and even if the claims do not result in litigation or are resolved in our favor, these claims, and the time and resources necessary to resolve them, could divert the resources of our management and harm our business and operating results.

*We do not intend to pay dividends for the foreseeable future.*

We have never declared or paid any cash dividends on our common stock and do not intend to pay any cash dividends in the foreseeable future. We anticipate that we will retain all of our future earnings for use in the development of our business and for general corporate purposes. Any determination to pay dividends in the future will be at the discretion of our board of directors. Accordingly, investors must rely on sales of their Class A common stock after price appreciation, which may never occur, as the only way to realize any future gains on their investments.

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

### **Recent Sale of Unregistered Securities**

On January 20, 2012 we issued 290,697 shares of Class A Common Stock to an accredited investor pursuant to certain commercial agreements. The offer, sale and issuance of these shares were deemed to be exempt from registration under the Securities Act in reliance on Section 4(2) of the Securities Act on Regulation D promulgated thereunder as transactions not involving a public offering. The recipient of these securities acquired the securities for investment only and not with a view to or for sale in connection with any distribution thereof and the recipient of these securities was an accredited investor and had adequate access, through employment, business or other relationships, to information about us.

### **Use of Proceeds**

On December 15, 2011, our registration statement on Form S-1 (File No. 333-175298) was declared effective for our initial public offering pursuant to which we sold 100,000,000 shares of Class A common stock at a public offering price of \$10.00 per share for an aggregate offering price of \$1.0 billion. Morgan Stanley & Co. LLC and Goldman, Sachs & Co. acted as joint book running managers and representatives of the underwriters for the offering, BofA Merrill Lynch, Barclays Capital Inc. and J.P. Morgan Securities LLC acted as additional joint book running managers, and Allen & Company LLC acted as senior co-manager for the offering.

As a result of our initial public offering, we received net proceeds of \$961.4 million, after deducting underwriting discounts and commissions and other offering expenses. None of the expenses associated with the initial public offering were paid to directors, officers or persons owning ten percent or more of our common stock or to their associates, or to our affiliates.

We intend to use the net proceeds to us from the initial public offering for general corporate purposes, including working capital, game development, marketing activities and capital expenditures. In addition, we may use a portion of the proceeds from the initial public offering for acquisitions of or investments in complementary businesses, technologies or other assets. As of March 31, 2012, the net offering proceeds have been invested in money market funds, debt instruments of the U.S. government and its agencies and high credit quality corporate issuers. There has been no material change in the planned use of proceeds from our initial public offering as described in our final prospectus filed with the SEC pursuant to Rule 424(b) on December 15, 2011.

### **Issuer Purchases of Equity Securities**

None.

**Table of Contents****ITEM 6. EXHIBITS**

| Exhibit Number          | Description of Document   |
|-------------------------|---|
| 2.1 <sup>(1)</sup>      | Purchase and Sale Agreement and Escrow Instructions, by and between 650 Townsend Associates LLC and Zynga Inc., dated February 29, 2012.  |
| 3.1 <sup>(2)</sup>      | Sixteenth Amended and Restated Certificate of Incorporation of Zynga Inc.   |
| 3.2 <sup>(3)</sup>      | Amended and Restated Bylaws of the Zynga Inc.   |
| 4.1 <sup>(4)</sup>      | Form of Zynga Inc. Class A Common Stock Certificate.  |
| 10.1 <sup>(5)</sup>     | Lease Termination Agreement, dated April 2, 2012, by and between Zynga Inc. and Big Dog Holdings LLC.   |
| 10.2 <sup>(6)</sup>     | 2012 Compensation Information for Registrant's Executive Officers   |
| 10.3*                   | Restricted Stock Unit Grant Notice under the 2011 Equity Incentive Plan.  |
| 10.4* <sup>(7)</sup>    | Offer Letter between Zynga Inc. and Barry Cottle, dated January 5, 2012.  |
| 10.5*                   | Zynga Inc. Non-Employee Director Compensation Policy.   |
| 31.1*                   | Certification of Chief Executive Officer pursuant to Rules 13a-14(a) and 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.                           |
| 31.2*                   | Certification of Chief Financial Officer pursuant to Rules 13a-14(a) and 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.                           |
| 32.1* <sup>(8)</sup>    | Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS* <sup>(9)</sup> | XBRL Instance Document  |
| 101.SCH* <sup>(9)</sup> | XBRL Taxonomy Extension Schema Document   |
| 101.CAL* <sup>(9)</sup> | XBRL Taxonomy Extension Calculation Linkbase Document   |
| 101.DEF* <sup>(9)</sup> | XBRL Taxonomy Extension Definition Linkbase Document  |
| 101.LAB* <sup>(9)</sup> | XBRL Taxonomy Extension Labels Linkbase Document  |
| 101.PRE* <sup>(9)</sup> | XBRL Taxonomy Extension Presentation Linkbase Document  |

\* Filed herewith.

- (1) Previously filed as Exhibit 2.1 to Registrant's Current Report on Form 8-K (File No. 001-35375), filed with the Securities and Exchange Commission on March 5, 2012, and incorporated by reference herein.
- (2) Previously filed as Exhibit 3.1 to the Registrant's Current Report on Form 8-K (File No. 001-35375), filed with the Securities and Exchange Commission on December 21, 2011, and incorporated by reference herein.
- (3) Previously filed as Exhibit 3.4 to the Registrant's Registration Statement on Form S-1/A (File No. 333-175298), filed with the Securities and Exchange Commission on November 17, 2011, and incorporated by reference herein.
- (4) Previously filed as Exhibit 4.1 to Registrant's Registration Statement on Form S-1/A (File No. 333-175298), filed with the Securities and Exchange Commission on November 4, 2011, and incorporated by reference herein.
- (5) Previously filed as Exhibit 10.1 to Registrant's Current Report on Form 8-K filed on April 6, 2012 and incorporated by reference herein.
- (6) Previously filed with Registrant's Current Report on Form 8-K filed on March 15, 2012 and incorporated by reference herein.
- (7) Previously filed as Exhibit 10.28 to Registrant's Amendment No. 1 to Form S-1 (File No. 333-180078), filed with the Securities and Exchange Commission on March 23, 2012, and incorporated by reference herein.
- (8) The certifications attached as Exhibit 32.1 accompany this Quarterly Report on Form 10-Q pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, and shall not be deemed filed by the Registrant for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.
- (9) Pursuant to applicable securities laws and regulations, the Registrant is deemed to have complied with the reporting obligation relating to the submission of interactive data files in such exhibits and is not subject to liability under any anti-fraud provisions of the federal securities laws as long as the Registrant has made a good faith attempt to comply with the submission requirements and promptly amends

## Edgar Filing: ZYNGA INC - Form 10-Q

the interactive data files after becoming aware that the interactive data files fails to comply with the submission requirements. These interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under these sections.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of San Francisco, State of California, on May 8, 2012.

**ZYNGA INC.**

By: /s/ David M. Wehner  
David M. Wehner

*Chief Financial Officer*

*(On behalf of Registrant)*

By: /s/ Mark Vranesh  
Mark Vranesh

*Chief Accounting Officer*

*(Principal Accounting Officer)*

**Table of Contents****EXHIBIT INDEX**

| <b>Exhibit Number</b>  | <b>Description of Document</b>  |
|------------------------|---|
| 2.1 <sup>(1)</sup>     | Purchase and Sale Agreement and Escrow Instructions, by and between 650 Townsend Associates LLC and Zynga Inc., dated February 29, 2012.  |
| 3.1 <sup>(2)</sup>     | Sixteenth Amended and Restated Certificate of Incorporation of Zynga Inc.   |
| 3.2 <sup>(3)</sup>     | Amended and Restated Bylaws of the Zynga Inc.   |
| 4.1 <sup>(4)</sup>     | Form of Zynga Inc. Class A Common Stock Certificate.  |
| 10.1 <sup>(5)</sup>    | Lease Termination Agreement, dated April 2, 2012, by and between Zynga Inc. and Big Dog Holdings LLC.   |
| 10.2 <sup>(6)</sup>    | 2012 Compensation Information for Registrant's Executive Officers   |
| 10.3*                  | Restricted Stock Unit Grant Notice under the 2011 Equity Incentive Plan.  |
| 10.4 <sup>(7)</sup>    | Offer Letter between Zynga Inc. and Barry Cottle, dated January 5, 2012.  |
| 10.5*                  | Zynga Inc. Non-Employee Director Compensation Policy.   |
| 31.1*                  | Certification of Chief Executive Officer pursuant to Rules 13a-14(a) and 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.                           |
| 31.2*                  | Certification of Chief Financial Officer pursuant to Rules 13a-14(a) and 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.                           |
| 32.1 <sup>(8)</sup>    | Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS <sup>(9)</sup> | XBRL Instance Document  |
| 101.SCH <sup>(9)</sup> | XBRL Taxonomy Extension Schema Document   |
| 101.CAL <sup>(9)</sup> | XBRL Taxonomy Extension Calculation Linkbase Document   |
| 101.DEF <sup>(9)</sup> | XBRL Taxonomy Extension Definition Linkbase Document  |
| 101.LAB <sup>(9)</sup> | XBRL Taxonomy Extension Labels Linkbase Document  |
| 101.PRE <sup>(9)</sup> | XBRL Taxonomy Extension Presentation Linkbase Document  |

\* Filed herewith.

- (1) Previously filed as Exhibit 2.1 to Registrant's Current Report on Form 8-K (File No. 001-35375), filed with the Securities and Exchange Commission on March 5, 2012, and incorporated by reference herein.
- (2) Previously filed as Exhibit 3.1 to the Registrant's Current Report on Form 8-K (File No. 001-35375), filed with the Securities and Exchange Commission on December 21, 2011, and incorporated by reference herein.
- (3) Previously filed as Exhibit 3.4 to the Registrant's Registration Statement on Form S-1/A (File No. 333-175298), filed with the Securities and Exchange Commission on November 17, 2011, and incorporated by reference herein.
- (4) Previously filed as Exhibit 4.1 to Registrant's Registration Statement on Form S-1/A (File No. 333-175298), filed with the Securities and Exchange Commission on November 4, 2011, and incorporated by reference herein.
- (5) Previously filed as Exhibit 10.1 to Registrant's Current Report on Form 8-K filed on April 6, 2012 and incorporated by reference herein.
- (6) Previously filed with Registrant's Current Report on Form 8-K filed on March 15, 2012 and incorporated by reference herein.
- (7) Previously filed as Exhibit 10.28 to Registrant's Amendment No. 1 to Form S-1 (File No. 333-180078), filed with the Securities and Exchange Commission on March 23, 2012, and incorporated by reference herein.
- (8) The certifications attached as Exhibit 32.1 accompany this Quarterly Report on Form 10-Q pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, and shall not be deemed filed by the Registrant for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.
- (9)



## Edgar Filing: ZYNGA INC - Form 10-Q

Pursuant to applicable securities laws and regulations, the Registrant is deemed to have complied with the reporting obligation relating to the submission of interactive data files in such exhibits and is not subject to liability under any anti-fraud provisions of the federal securities laws as long as the Registrant has made a good faith attempt to comply with the submission requirements and promptly amends the interactive data files after becoming aware that the interactive data files fails to comply with the submission requirements. These interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under these sections.