ASIAINFO HOLDINGS INC
Form 10-Q
November 09, 2004
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2004

¨ **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 001-15713

ASIAINFO HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

DELAWARE	**752506390**

(State or other jurisdiction	**(I.R.S. Employer**
of incorporation or organization)	**Identification No.)**

4TH FLOOR, ZHONGDIAN INFORMATION TOWER

6 ZHONGGUANCUN SOUTH STREET, HAIDIAN DISTRICT

BEIJING 100086, CHINA

(Address of principal executive office, including zip code)

+8610 6250 1658

(Registrant s telephone number, including area code)

(Former Name, Former Address and Former Fiscal Year,

if Changed Since Last Report)

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 x No ¨

The number of shares outstanding of the Registrant s common stock as of November 5, 2004 was 46,462,100

Table of Contents

ASIAINFO HOLDINGS, INC.

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2004

TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ASIAINFO HOLDINGS, INC.

CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS (unaudited)

(In US Dollars thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2004	2003	2004
Revenues:				
Software products and solutions	$ 8,441	$ 9,614	$ 21,956	$ 28,615
Network service	6,759	4,304	17,028	14,849
Third party hardware	12,784	6,088	46,577	31,031
Total revenues	27,984	20,006	85,561	74,495
Cost of revenues:				
Software products and solutions	4,098	4,536	10,505	12,799
Network service	1,745	1,328	6,106	5,904
Third party hardware	12,145	5,784	44,248	29,480
Total cost of revenues	17,988	11,648	60,859	48,183
Gross profit	9,996	8,358	24,702	26,312
Operating expenses:				
Sales and marketing	2,820	3,092	8,265	8,687
General and administrative	3,116	2,413	8,399	6,396
Research and development	2,037	2,279	7,248	6,593
Impairment of goodwill and acquired intangible assets			30,221	
Amortization of deferred stock compensation			105	
Amortization of acquired intangible assets	41	151	128	480
Total operating expenses	8,014	7,935	54,366	22,156
Income (loss) from operations	1,982	423	(29,664)	4,156
Other income				
Interest income	362	674	1,182	1,589
Interest expense			(2)	

Gain from disposal of investment		4,018		4,018
Other expenses, net	(1)		(32)	(20)
Total other income, net	361	4,692	1,148	5,587
Income (loss) before income taxes, minority interests and equity in loss of affiliates	2,343	5,115	(28,516)	9,743
Income tax expense (benefit)		137	(958)	718
Income (loss) before minority interests	2,343	4,978	(27,558)	9,025
Minority interests			(12)	
Equity in loss of affiliate	(94)		(281)	(42)
Net income (loss)	$ 2,249	$ 4,978	$ (27,851)	$ 8,983
Net income (loss) per share:				
Basic	$ 0.05	$ 0.11	$ (0.63)	$ 0.20
Diluted	$ 0.05	$ 0.11	$ (0.63)	$ 0.19
Shares used in computation:				
Basic	44,521,025	45,426,451	44,329,684	45,377,384
Diluted	46,971,126	46,705,356	44,329,684	46,988,388

See notes to condensed consolidated financial statements.

Table of Contents

ASIAINFO HOLDINGS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)

(In US Dollars thousands, except per share amounts)

	December 31, 2003 (1)	September 30, 2004 (Unaudited)
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 119,395	$ 131,284
Restricted cash	14,827	15,453
Short-term investments	13,218	14,624
Notes receivable	3,832	1,824
Accounts receivable (net of allowances of $3,095 and $2,878 as of December 31, 2003 and September 30, 2004 respectively)	51,923	59,383
Inventories	3,235	3,672
Other receivables	8,528	2,397
Deferred income taxes current	1,842	1,715
Prepaid expenses and other current assets	2,680	3,664
Total current assets	219,480	234,016
Property and equipment-net	2,348	1,987
Goodwill	15,368	14,782
Other acquired intangible assets-net	2,341	1,896
Investment in affiliate	331	
Deferred income taxes	154	394
Total Assets	$ 240,022	$ 253,075
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Short-term bank loans	$ 60	$
Notes payable	2,609	3,807
Accounts payable	13,945	12,777
Accrued expenses	12,822	13,559
Deferred revenue	11,738	12,965
Accrued employee benefits	5,971	7,032
Other payables	2,776	2,152
Other taxes payables	2,212	2,100
Income taxes payables	1,232	1,857
Total current liabilities	53,365	56,249
Commitments and contingencies (Note 13)		
Stockholders Equity:		
Common stock, 100,000,000 shares authorized, $0.01 par value, shares issued and outstanding: 2004: 45,431,424; 2003: 45,112,278	451	454
Additional paid-in capital	205,154	206,340
Accumulated deficit	(19,009)	(10,026)

Accumulated other comprehensive income	61	58
Total stockholders equity	186,657	196,826
Total Liabilities and Stockholders Equity	$ 240,022	$ 253,075

(1) December 31, 2003 balances were obtained from audited financial statements.

See notes to condensed consolidated financial statements.

Table of Contents

ASIAINFO HOLDINGS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

(In US Dollars thousands, except per share amounts)

	Nine Months Ended September 30,	
	2003	**2004**
	(unaudited)	
Cash flows from operating activities:		
Net (loss) income	$ (27,851)	$ 8,983
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation	1,551	1,092
Amortization of other acquired intangible assets	128	480
Impairment of goodwill and acquired intangible assets	30,221	
Amortization of deferred stock compensation	105	
Deferred income taxes	181	(113)
Minority interest in loss of consolidated subsidiaries	12	
Equity in loss of an affiliate	281	42
Loss on disposal of property and equipment	24	18
Bad debt expense	2,155	(217)
Stocks issued for services and others	179	
Gain from disposal of investment		(4,018)
Changes in operating assets and liabilities, net of effects of business acquired:		
Restricted cash	(1,616)	(626)
Notes receivable	(2,712)	2,008
Accounts receivable	(8,722)	(7,278)
Inventories	7,399	(437)
Other receivables	(4,056)	6,131
Prepaid expenses and other current assets	(23)	(984)
Notes payable	1,670	1,198
Accounts payable	4,546	(1,168)
Accrued expenses	(2,121)	737
Deferred revenue	2,492	1,227
Accrued employee benefits	1,635	1,061
Other payables	(1,084)	315
Other taxes payable	(1,400)	(112)
Income taxes payable	(1,796)	625
Net cash provided by operating activities	1,198	8,964
Cash flows from investing activities:		
Decrease (increase) in short-term investments	(59)	1,286
Purchases of property and equipment	(351)	(755)
Purchases of business	(205)	(354)
Proceeds on disposal of property, plant, and equipment	19	7
Proceeds from affiliate		1,615
Net cash (used in) provided by investing activities	(596)	1,799

Table of Contents

ASIAINFO HOLDINGS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited) (CONTINUED)

(In US Dollars thousands, except per share amounts)

	Nine Months Ended September 30, 2003	Nine Months Ended September 30, 2004
	(unaudited)	
Cash flows from financing activities:		
Repayment of short-term bank loans		(60)
Proceeds on exercise of stock options	1,022	1,189
Distribution to minority shareholder of consolidated subsidiaries	(427)	
Net cash provided by financing activities	595	1,129
Net increase in cash and cash equivalents:	1,197	11,892
Cash and cash equivalents at beginning of period	115,153	119,395
Effect of exchange rate changes on cash and cash equivalents	1	(3)
Cash and cash equivalents at end of period	$ 116,351	$ 131,284
Supplemental cash flow information:		
Cash paid during the period:		
Income tax	481	406
Interest		

Non-cash investing activity:

In December 2003, the Company acquired certain assets from Pacific Software (China) Limited (Pacific) for cash of $4,180 (of which $266 represented acquisition costs) and the issuance of 349,315 shares of common stock with a fair market value of approximately $2,550 at the time the acquisition was announced. Of the cash amount, $3,006 and $939 was paid in December 2003 and in the first quarter of 2004, respectively. A refund of contingent payments of $585 was received from Pacific in the third quarter of 2004. In connection with the acquisition, the Company acquired tangible assets and intangible assets with a fair value of $93 and $2,355, respectively.

See notes to condensed consolidated financial statements.

Table of Contents

ASIAINFO HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Three and Nine Months Ended September 30, 2003 and 2004

(In US dollars thousands, except per share amounts)

1. GENERAL AND BASIS OF PREPARATION

AsiaInfo Holdings, Inc. (the Company) is incorporated in the State of Delaware, in the United States of America (the US). The Company principally operates through the following directly owned subsidiaries, or their respective subsidiaries: AsiaInfo Technologies (China), Inc. (AsiaInfo Technologies) (100% owned), incorporated in the People s Republic of China (China or the PRC), and Bonson Information Technology Holdings Limited, (Bonson) (100% owned), incorporated in the Cayman Islands.

The Company and its subsidiaries are leading providers of network and software solutions in China. The software products and network services of the Company enable its customers to build, maintain, operate, manage and continuously improve their communications infrastructure. The main customers of the Company are the major telecommunications carriers in China and their provincial subsidiaries.

The Company acts as a holding company and, through certain subsidiaries, sources network-related equipment in the United States for sale to customers in the PRC.

The consolidated financial statements include the financial statements of the Company and its subsidiaries. All significant inter-company transactions and balances are eliminated in consolidation. Investments in 50% or less owned affiliates over which the Company exercises significant influence, but not control, are accounted for using the equity method. The Company s share of earnings (losses) of these companies is included in the accompanying condensed statement of operations.

All adjustments necessary for a fair presentation of the unaudited results of operations for the nine months ended September 30, 2003 and 2004 are included in the accompanying condensed financial statements. All such adjustments are of a normal and recurring nature. The results of operations for the periods are not necessarily indicative of the results of operations for the full year. The financial statements are unaudited.

The Company s revenues are derived from the procurement of hardware on behalf of customers, software license fees, and professional services for systems design, planning, consulting, and system integration, and is recognized based on the percentage of completion method. Revenues from customer orders requiring significant production, modifications, or customization of the software are recognized over the installation and customization period. Labor costs and direct project expenses are used to determine the stage of completion, except for revenues associated with the procurement of hardware. Such hardware-related revenues are recognized upon delivery. Estimates of hardware warranty costs are included in determining project costs. Revenue from packaged software license fees through reseller arrangements is recorded when the related products are shipped and installed. Costs related to insignificant obligations for a period of up to one year, which include telephone support, are accrued at the time the revenue is recorded.

Revenue from software products and solutions includes the benefit of the rebate of valued added taxes on sales of software received from the Chinese tax authorities as part of the PRC government s policy of encouragement of software development in the PRC. The rebate was $499 and $352 for the three months ended September 30, 2003 and 2004, respectively, and $1,347 and $1,762 for the nine months ended September 30, 2003 and 2004, respectively.

Revisions in estimated contract profits are made in the period in which the circumstances requiring the revision become known. Provisions, if any, are made currently for anticipated losses on uncompleted contracts. Revenue in excess of billings is recorded as unbilled receivables and included in trade accounts receivable, net of allowances, amounted to $31,927 at December 31, 2003 and $21,029 at September 30, 2004. Billings in excess of revenues recognized are recorded as deferred revenue. Billings are rendered based on agreed milestones included in the contracts with customers.

Table of Contents

ASIAINFO HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Three and Nine Months Ended September 30, 2003 and 2004

(In US dollars thousands, except per share amounts)

1. GENERAL AND BASIS OF PREPARATION - CONTINUED

At December 31, 2003 and September 30, 2004, the balance of trade accounts receivable, net of allowances, amounted to $19,996 and $38,354, respectively, represented amounts billed but not yet collected. All billed and unbilled amounts are expected to be collected within 1 year.

These financial statements of the Company and its subsidiaries are prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). This basis of accounting differs from that used in the statutory financial statements of the PRC subsidiaries which are prepared in accordance with the accounting principles and the relevant financial regulations applicable to enterprises with foreign investment as established by China s Ministry of Finance. The principal adjustments made to conform the statutory financial statements of these subsidiaries to U.S. GAAP included an adjustment to record goodwill from business acquisitions and the related impairment provisions, and an adjustment to recognize compensation expense on the issuance of stock options.

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The financial records of the Company s PRC subsidiaries are maintained in Renminbi (RMB), their functional currency and the currency of the PRC. Their balance sheets are translated into United States dollars based on the rates of exchange ruling at the balance sheet date. Their statements of operations are translated using a weighted average rate for the period. Translation adjustments are reflected as cumulative translation adjustments in stockholders equity.

The Renminbi is not fully convertible into United States dollars or other foreign currencies. The rate of exchange quoted by the People s Bank of China on September 30, 2004 was US$1.00=RMB8.2766. No representation is made that the Renminbi amounts could have been, or could be, converted into United States dollars at that rate or at any other rate.

In January 2003, the FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46). FIN 46 clarifies the application of Accounting Research Bulletin No. 51, Consolidated Financial Statements and provides guidance on the identification of entities for which control is achieved through means other than voting rights (variable interest entities or VIEs) and on the determination of when and which business enterprise should consolidate the VIEs. This new model for consolidation applies to an entity in which either: (1) the equity investors (if any) lack one or more characteristics deemed essential to a controlling financial interest or (2) the equity investment at risk is insufficient to finance that entity s activities without receiving additional subordinated financial support from other parties. FIN 46 was applicable for periods ended after December 15, 2003. In December 2003, the FASB issued FIN 46R which defers the implementation date to the end of the first reporting period after March 15, 2004 unless the Company has a variable interest entity in which case the provisions must be applied for fiscal years ended December 31, 2003. The Company has adopted the provisions of FIN 46(R) in June 2004 and consolidated its variable interest entity, Beijing Star VATS Technologies, Inc. since its incorporation.

Table of Contents

ASIAINFO HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Three and Nine Months Ended September 30, 2003 and 2004

(In US dollars thousands, except per share amounts)

1. GENERAL AND BASIS OF PREPARATION - CONTINUED

The variable interest entity was established by the Company for the purpose of engaging in the value-added telecommunications services business in the PRC in June 2004. PRC regulations restrict direct foreign ownership of such businesses in the PRC. In order to comply with these regulations, while allowing foreign indirect participation, the Company entered into various contractual agreements with certain individuals to set-up a domestic company, Beijing Star VATS Technologies, Inc. (Star VATS), with a registered capital of approximately US$2.4 million, to conduct the value-added telecommunications services business in the PRC. The Company owns all the beneficial interests in, and effectively controls, Star VATS through these agreements. As of September 30, 2004, the Company has consolidated the results of Star VATS and Star VATS was inactive during the period ended.

Reclassifications Certain comparative figures have been reclassified to conform with current year s presentation.

2. CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of cash on hand, demand deposits and highly liquid investments, which are unrestricted as to withdrawal or use, and which have maturities of three months or less when purchased.

3. SHORT-TERM INVESTMENTS

Short-term investments are classified as available-for-sale and consist principally of certificates of deposit and marketable securities. Certificates of deposit are issued by major financial institutions which have maturities of between 6 and 12 months.

The marketable securities were received in September 2004 as a result of the liquidation of the Company s affiliate, Intrinsic Technology (Holdings), Ltd. (Intrinsic). Total consideration received from the liquidation of Intrinsic includes $1,615 in cash and 3,262,770 shares of Linktone Ltd. (Linktone) valued at $2,746, which resulted in a gain from disposal of investment in affiliate of $4,018. The Linktone shares are carried at fair market value, and the unrealized gain or loss from the change in market values is included in accumulated other comprehensive income. There was no material change in the market value of Linktone shares held by the Company through September 30, 2004.

4. NOTES RECEIVABLE

At December 31, 2003 and September 30, 2004, the balances of notes receivable of $3,832 and $1,824, respectively, represented bank acceptance drafts of $3,832 and $323, and commercial acceptance notes of nil and $1,501, respectively, that are non-interest bearing and due within six months.

Table of Contents

ASIAINFO HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Three and Nine Months Ended September 30, 2003 and 2004

(In US dollars thousands, except per share amounts)

5. COMPREHENSIVE INCOME (LOSS)

The components of comprehensive income for the periods presented are as follows:

	Three Months Ended September 30,	
	2003,	**2004**
Net income	$ 2,249	$ 4,978
Change in cumulative translation adjustment	2	
Comprehensive income	$ 2,251	$ 4,978

	Nine Months Ended September 30,	
	2003,	**2004**
Net (loss) income	$ (27,851)	$ 8,983
Change in cumulative translation adjustment	(1)	(3)
Comprehensive (loss) income	$ (27,852)	$ 8,980

6. SHORT-TERM BANK LOANS

As of December 31, 2003 and September 30, 2004, the Company had total short-term banking facilities for working capital purposes totaling $40,540 and $38,123, expiring by December 2005. The facilities were secured by bank deposits of $14,000 as of December 31, 2003 and September 30, 2004. At December 31, 2003, unused short-term credit facilities were $28,759 and used facilities totalled $11,781. The used facilities were used for issuing standby letters of credit and notes payable to hardware suppliers and customers. Additional bank deposits of $827 were used for issuing standby letters of credit and bank acceptance drafts as of December 31, 2003. At September 30, 2004, unused short-term credit facilities were $31,615 and used facilities totaled $6,508. The used facilities were used for issuing standby letters of credit and notes payable to hardware suppliers and customers. Additional bank deposits of $1,453 were used for issuing standby letters of credit and back acceptance drafts as of September 30, 2004. Bank deposits pledged as security for these credit facilities totaled $14,827 and $15,453 as of

December 31, 2003 and September 30, 2004, respectively, and are presented as restricted cash in the consolidated balance sheets.

In addition, as of December 31, 2003, the Company had short-term borrowings of $60, bearing an interest rate of 4.8% and secured by certain assets of the Company. As of September 30, 2004, the Company had no short-term borrowings outstanding.

7. NOTES PAYABLE

At December 31, 2003 and September 30, 2004, the balances of notes payable of $2,609 and $3,807, respectively, represented commercial notes of $945 and $1,329, and bank acceptance drafts of $1,664 and $2,478, respectively, that are non-interest bearing and due within six months.

Table of Contents

ASIAINFO HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Three and Nine Months Ended September 30, 2003 and 2004

(In US dollars thousands, except per share amounts)

8. INCOME TAXES

The Company is subject to US federal and state income taxes. The Company s subsidiaries incorporated in the PRC are subject to PRC income taxes.

A reconciliation between the provision for income taxes computed by applying the US federal tax rate to income (loss) before income taxes, minority interests and equity in loss of affiliate and the actual provision for income taxes is as follows:

	Nine Months Ended September 30,	
	2003	**2004**
US federal rate	(35)%	35%
Difference between statutory rate and foreign effective tax rate	24	(35)
Non-deductible goodwill and intangible expenses	8	
Benefit of stock option deduction related to cheap stock expenses	(3)	
Increase in valuation allowance	3	7
	(3)%	7%

9. CAPITAL STOCK

Option activity in the Company s stock option plans is summarized as follows:

	Number of shares	Outstanding options weighted average exercise price per share
Outstanding, January 1, 2004:	9,657,883	$ 7.37
Granted	94,700	8.20
Cancelled	(434,134)	10.94

Exercised	(273,260)		3.69
Outstanding, March 31, 2004	9,045,189	$	7.31
Granted	1,600,950		5.44
Cancelled	(201,044)		9.41
Exercised	(37,900)		3.96
Outstanding, June 30, 2004	10,407,195	$	7.00
Granted	95,000		4.49
Cancelled	(261,742)		7.38
Exercised	(7,986)		3.99
Outstanding, September 30, 2004	10,232,467	$	6.97

The exercise price of all options granted during the three months and the nine months ended September 30, 2004 was equal to the fair market value of the Company s common stock on the dates of grant.

Table of Contents

ASIAINFO HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Three and Nine Months Ended September 30, 2003 and 2004

(In US dollars thousands, except per share amounts)

10. ACCOUNTING FOR STOCK-BASED COMPENSATION

The following table summarizes relevant information as to reported results under the Company s intrinsic value method of accounting for stock awards, with supplemental information as if the fair value recognition provisions of FASB Statement No. 123 had been applied:

	Three Months Ended September 30,	
	2003	**2004**
Net income as reported	$ 2,249	$ 4,978
Add: Stock-based compensation included in reported net income		
Deduct: Total stock-based compensation expense under SFAS 123, net of tax effect	(2,508)	(1,847)
Pro forma net (loss) income	$ (259)	$ 3,131
Net income per share as reported		
Basic	$ 0.05	$ 0.11
Diluted	$ 0.05	$ 0.11
Pro forma net (loss) income per share		
Basic	$ (0.01)	$ 0.07
Diluted	$ (0.01)	$ 0.07

	Nine Months Ended September 30,	
	2003	**2004**
Net (loss) income as reported	$ (27,851)	$ 8,983
Add: Stock-based compensation included in reported net income	105	
Deduct: Total stock-based compensation expense under SFAS 123, net of tax effect	(13,411)	(5,319)
Pro forma net (loss) income	$ (41,157)	$ 3,664

Net (loss) income per share as reported		
Basic	$ (0.63)	$ 0.20
Diluted	$ (0.63)	$ 0.19
Pro forma net (loss) income per share		
Basic	$ (0.93)	$ 0.08
Diluted	$ (0.93)	$ 0.08

Table of Contents

ASIAINFO HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Three and Nine Months Ended September 30, 2003 and 2004

(In US dollars thousands, except per share amounts)

11. NET INCOME (LOSS) PER SHARE

The following is a reconciliation of the numerators and denominators of the basic and diluted net income (loss) per share computations:

	Three Months Ended September 30, 2003	Three Months Ended September 30, 2004
Net income (numerator):		
Net income		
Basic and diluted	$ 2,249	$ 4,978
Shares (denominator):		
Weighted average		
Common Stock Outstanding	44,521,025	45,426,451
Basic	44,521,025	45,426,451
Options (Treasury Method)	2,450,101	1,278,905
Diluted	46,971,126	46,705,356
Net income per share:		
Basic	$ 0.05	$ 0.11
Diluted	$ 0.05	$ 0.11

	Nine Months Ended September 30, 2003	Nine Months Ended September 30, 2004
Net income (numerator):		
Net (loss) income		
Basic and diluted	$ (27,851)	$ 8,983

Shares (denominator):		
Weighted average		
Common Stock Outstanding	44,329,684	45,377,384
Basic	44,329,684	45,377,384
Options (Treasury Method)		1,611,004
Diluted	44,329,684	46,988,388
Net (loss) income per share:		
Basic	$ (0.63)	$ 0.20
Diluted	$ (0.63)	$ 0.19

Table of Contents

ASIAINFO HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Three and Nine Months Ended September 30, 2003 and 2004

(In US dollars thousands, except per share amounts)

11. NET INCOME (LOSS) PER SHARE - CONTINUED

As of September 30, 2003, the Company had 10,175,362 options outstanding that could have potentially diluted earnings per share (EPS) in the future, but which were excluded in the computation of diluted EPS in these periods, as their effect would have been antidilutive due to the net loss reported in these periods.

As of September 30, 2004, the Company had 6,025,973 options outstanding that could have potentially diluted EPS in the future, but which were excluded in the computation of diluted EPS in these periods, as their exercise prices were above the average market values in such periods.

12. ACQUISITION

On October 20, 2003 (the date of acquisition), the Company acquired certain human resources management and business intelligence assets from Pacific Software (China) Limited (Pacific), a software solutions company, in exchange for cash of $4,180 and 349,315 shares of the Company s common stock valued at $2,550. The value of the shares issued was determined based on the average market price of the Company s common shares over the 5-day period before and after the terms of the acquisition were agreed to and announced. There was an additional contingent payment which amount has been indeterminable at date of acquisition and is payable by the Company in the third quarter of 2004 upon Pacific s attaining certain terms and conditions on or before July 31, 2004. During the three-month period ended September 30, 2004, $585 was released by Pacific from the escrow account established for the contingent consideration, which reduced the goodwill recognized by $585 as of September 30, 2004.

This acquisition was treated as a purchase and, accordingly, the acquired assets were recorded at their fair market values at the date of acquisition.

The aggregate purchase price of $6,145, net of refund of contingent payment, has been allocated as follows:

		Economic Life
Current assets	$ 58	
Equipment	35	
Completed technology	1,945	5 years

Contract backlog	326	2 years
Trade mark	60	2 years
Customer list	24	5 years
In-process technology	169	None
Goodwill	3,528	Indefinite
Total	$ 6,145	

The Company recorded a charge of $169 at the date of acquisition in accordance with FASB Interpretation No. 4, Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method, for purchased in-process technology related to a development project that had not reached technological feasibility, had no alternative future use, and for which successful development was uncertain. The conclusion that the in-process development effort, or any material sub-component, had no alternative future use was reached in consultation with the Company s management and Pacific s management.

Table of Contents

ASIAINFO HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Three and Nine Months Ended September 30, 2003 and 2004

(In US dollars thousands, except per share amounts)

12. ACQUISITION - CONTINUED

The following unaudited pro forma information summarizes the results of operations for the three months and nine months ended September 30, 2003 and 2004 of the Company and Pacific. It has been prepared on the assumption that the acquisition occurred on January 1, 2003. The following pro forma financial information is not necessarily indicative of the results that would have occurred had the acquisition been completed on January 1, 2003, nor is it indicative of future operating results:

	Three Months Ended September 30,	
	2003	2004
Total revenue	$ 27,984	$ 20,006
Net income	2,098	4,978
Net income per share		
- Basic	$ 0.05	$ 0.11
- Diluted	$ 0.04	$ 0.11
Shares used in calculation of net income per share		
- Basic	44,870,340	45,426,451
- Diluted	47,320,441	46,705,356

	Nine Months Ended September 30,	
	2003	2004
Total revenue	$ 85,561	$ 74,495
Net (loss) income	(28,306)	8,983
Net (loss) income per share		
- Basic	$ (0.63)	$ 0.20
- Diluted	$ (0.63)	$ 0.19
Shares used in calculation of (loss) net income per share		
- Basic	44,678,999	45,377,384
- Diluted	44,678,999	46,988,388

The pro forma results of operations give effect to certain adjustments, including amortization of purchased intangibles with definite lives, associated with the acquisition. The charge for purchased in-process research and development of $169 has been excluded from the pro forma results, as it is a material non-recurring charge.

Table of Contents

ASIAINFO HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Three and Nine Months Ended September 30, 2003 and 2004

(In US dollars thousands, except per share amounts)

13. COMMITMENTS AND CONTINGENCIES

IPO Litigation

On December 4, 2001, a securities class action case was filed in New York City against the Company, certain of its current officers and directors and the underwriters of the Company s initial public offering, or IPO. The lawsuit alleged violations of the federal securities laws and was docketed in the United States District Court for the Southern District of New York, or the Court, as Hassan v. AsiaInfo Holdings, Inc., et al. The lawsuit alleged, among other things, that the underwriters of the Company s IPO improperly required their customers to pay the underwriters excessive commissions and to agree to buy additional shares of the Company s common stock in the aftermarket as conditions to their purchasing shares in the Company s IPO. The lawsuit further claimed that these supposed practices of the underwriters should have been disclosed in the Company s IPO prospectus and registration statement. The suit seeks rescission of the plaintiffs alleged purchases of the Company s common stock as well as unspecified damages. In addition to the case against the Company, various other plaintiffs have filed approximately 1,000 other, substantially similar class action cases against approximately 300 other publicly traded companies and their IPO underwriters in New York City, which along with the case against the Company have all been transferred to a single federal district judge for purposes of case management.

On July 15, 2002, together with the other issuer defendants, the Company filed a collective motion to dismiss the consolidated, amended complaints against the issuers on various legal grounds common to all or most of the issuer defendants. The underwriters also filed separate motions to dismiss the claims against them. On October 9, 2002, the Court dismissed without prejudice all claims against the individual defendants in the litigation. The dismissals were based on stipulations signed by those defendants and the plaintiffs representatives. On February 19, 2003, the Court issued its ruling on the motions to dismiss filed by the underwriter and issuer defendants. In that ruling the Court granted in part and denied in part those motions. As to the claims brought against the Company under the anti-fraud provisions of the securities laws, the Court dismissed all such claims without prejudice. As to the claims brought under the registration provisions of the securities laws, which do not require that intent to defraud be pleaded, the Court denied the motion to dismiss such claims as to the Company and as to substantially all of the other issuer defendants. The Court also denied the underwriter defendants motion to dismiss in all respects.

In June 2003, the Company elected to participate in a proposed settlement agreement with the plaintiffs in this litigation. If ultimately approved by the Court, this proposed settlement would result in a dismissal, with prejudice, of all claims in the litigation against the Company and against any of the other issuer defendants who elect to participate in the proposed settlement, together with the current or former officers and directors of participating issuers who were named as individual defendants. The proposed settlement does not provide for the resolution of any claims against the underwriter defendants, and the litigation against those defendants is continuing. The proposed settlement provides that the class members in the class action cases brought against the participating issuer defendants will be guaranteed a recovery of $1 billion by insurers of the participating issuer defendants. If recoveries totaling $1 billion or more are obtained by the class members from the underwriter defendants, however, the monetary obligations to the class members under the proposed settlement will be satisfied. In addition, all participating issuer defendants will be required to assign to the class members certain claims that the Company may have against the underwriters.

Table of Contents

ASIAINFO HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Three and Nine Months Ended September 30, 2003 and 2004

(In US dollars thousands, except per share amounts)

13. COMMITMENTS AND CONTINGENCIES - CONTINUED

The proposed settlement contemplates that any amounts necessary to fund the settlement or settlement-related expenses would come from participating issuers directors and officers liability insurance policy proceeds as opposed to funds of the participating issuer defendants themselves. A participating issuer defendant could be required to contribute to the costs of the settlement if that issuer s insurance coverage were insufficient to pay that issuer s allocable share of the settlement costs. The Company expects that its insurance proceeds will be sufficient for these purposes and that it will not otherwise be required to contribute to the proposed settlement. Consummation of the proposed settlement is conditioned upon, among other things, negotiating, executing, and filing with the Court final settlement documents, and final approval by the Court. If the proposed settlement described above is not consummated, the Company intends to continue to defend the litigation vigorously. Moreover, if the proposed settlement is not consummated, the Company believes that the underwriters may have an obligation to indemnify the Company for the legal fees and other costs of defending this suit and that the Company s directors and officers liability insurance policies would also cover the defense and potential exposure in the suit. While the Company cannot guarantee the outcome of these proceedings, the Company believes that the final result of these actions will have no material effect on the Company s consolidated financial condition, results of operations or cash flows.

Warranty Costs

The Company s product warranty accrual reflects management s best estimate of probable liability under its product warranties. Management determines the warranty based on historical experience and other currently available evidence.

Changes in the product warranty accrual for the 9 months ended September 30, 2004 were as follows:

Balance at beginning of period	$ 2,060
Current period provision	389
Payments	(53)
Balance, end of period	$ 2,396

14. SUBSEQUENT EVENTS

On October 19, 2004, the Company closed the acquisition of the Lenovo Group Limited s (Lenovo) non-telecom related IT services business in a transaction valued at US$ 36.3 million (RMB 300 million). A new division of AsiaInfo Holdings, Inc., Lenovo-AsiaInfo Technologies, Inc., has been formed from the combination of the assets acquired and AsiaInfo s enterprise information solutions (EIS) business unit. The consideration for the acquisition is paid in two parts. On October 20, 2004, the Company paid the Lenovo shares of the Company valued at US$ 4.8 million (RMB 40 million). The value of the shares issued was determined based on the average market price of the Company s common shares over the 10-day period before the closing date, October 19, 2004. On October 19, 2004, the Company entered into a forward contract with a subsidiary of Lenovo to deliver shares of the Company with a market value of approximately US$31.5 million (RMB 260 million) at any time during the twelve months after closing, at the Company s option. Lenovo may also be entitled to an earn-out payment following the first anniversary of the closing, depending on the level of operating income achieved by the acquired business during the first year following the closing.

Table of Contents

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

Except for historical information, the statements contained in this Quarterly Report on Form 10-Q are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. The Private Securities Litigation Reform Act of 1995 (the Reform Act) contains certain safe harbors regarding forward-looking statements. Certain of the forward-looking statements include management s expectations, intentions and beliefs with respect to our growth, our operating results, the nature of the industry in which we are engaged, our business strategies and plans for future operations, our needs for capital expenditures, capital resources and liquidity, and similar expressions concerning matters that are not historical facts. Such forward-looking statements are subject to risks and uncertainties that could cause actual results to materially from those expressed in the statements. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. These cautionary statements are being made pursuant to the provisions of the Reform Act with the intention of obtaining the benefits of the safe harbor provisions of the Reform Act. Among the factors that could cause actual results to differ materially are the factors discussed below under the heading Certain Risks That May Affect Our Operating Results and Our Common Stock.

Overview

We are a leading provider of high-quality software and customer solutions in China, helping our customers increase their business value in fast-growing and evolving markets. In the telecommunications market, our software products and services, and our network services enable our customers to build, maintain, operate, manage and continuously improve their communications infrastructure. Our largest customers are the major telecommunications carriers in China and their provincial subsidiaries, such as China Telecommunications Corporation, or China Telecom, China Network Communications Group Corporation, or China Netcom Group, China Mobile Communications Corporation, or China Mobile, and China United Telecommunications Corporation, or China Unicom. In addition to providing software and customer solutions to China s telecom carriers, we also offer a wide range of enterprise solutions, including security products and services, management consulting, e-HR and business intelligence, e-government and financial solutions to small, medium and large sized Chinese enterprises, across multiple vertical industries.

We commenced our operations in the United States in 1993 and moved our major operations from the United States to China in 1995. We began generating significant network solutions revenues in 1996 and significant software revenues in 1998. We conduct the bulk of our business through our operating subsidiaries, including AsiaInfo Technologies (China), Inc., or AsiaInfo Technologies, and AsiaInfo Management Software, Inc., or AsiaInfo Management, which are both Chinese companies.

We believe that there are opportunities for us to expand into new business areas and to continue to grow our business both organically and through acquisitions. On July 27, 2004, we signed a definitive agreement with Lenovo Group Limited to acquire its non-telecommunications related information technology services business in a transaction valued at approximately $36.3 million. On October 19, 2004, we completed the closing of this acquisition and formed a new division, Lenovo-AsiaInfo Technologies, under which we will operate the acquired assets, along with our enterprise information solutions business unit. We believe this acquisition will greatly expand our current enterprise offerings and will allow us to provide security products and services, management consulting, as well as e-HR and business intelligence, e-government and financial solutions to Chinese enterprises in industries beyond our traditional telecommunications customer base. We also anticipate that this acquisition will create significant cross-selling synergies for our products and services across a range of vertical industries, including manufacturing, financial services and the government sector. In the fourth quarter of 2004, the new Lenovo-AsiaInfo division is expected to generate approximately $7 million revenues, representing more than 30% of our total expected net revenues for the quarter.

Reliance on key telecommunications customers. We have derived, and believe that we will continue to derive, a significant portion of our revenues from a limited number of large customers, such as China Telecom, China Unicom, China Mobile and China Netcom Group. Sales to

China Telecom and its subsidiaries amounted to approximately 9%, 21% and 31% of total revenues in 2003, 2002 and 2001, respectively. Sales to China Unicom and its subsidiaries amounted to approximately 38%, 22% and 45% of total revenues in 2003, 2002 and 2001, respectively. Sales to China Netcom Group and its subsidiaries amounted to approximately 13%, 6% and 9% of total revenues in 2003, 2002 and 2001, respectively. Sales to China Mobile and its subsidiaries amounted to approximately 38%, 42% and 10% of total revenues in 2003, 2002 and 2001, respectively. The sum of our top five receivable balances represented 96% and 95% of the total receivable balances for the years ended December 31, 2003 and 2002, respectively. We have expanded our customer base recently through the acquisition of an e-HR and business intelligence software business with customers in sectors such as transportation and energy and expect to continue to expand our customer base with our acquisition of Lenovo s IT Services business. However, our operating results are still dependent on our large customers in the telecommunications sector, and the loss of any of those customers could have a material adverse impact on us.

As a result of our reliance on our key customers in the telecommunications industry, our operating results are influenced by governmental spending policies in that sector. Ongoing uncertainty in the telecommunication industry, combined with the Chinese government s measures to control the over-heating of the Chinese economy, has contributed and will continue to contribute to cautious spending by our telecommunications customers and could lead to the delay of many large telecommunications spending projects.

Impact of goodwill impairments. In connection with our acquisition of Bonson Information Technology Holdings Limited in February 2002, we paid the former shareholders of that company $32.76 million (net of acquisition costs) in cash and 1,031,686 shares of our common stock (which were valued at approximately $18 million at the time the acquisition was announced). During the first quarter of 2003, we completed an annual impairment test as required by Statement of Financial Accounting Standard (SFAS) No.142 and recorded a non-cash impairment charge of $29.84 million relating to the goodwill and acquired intangible assets attributable to our acquisition of Bonson. We do not presently anticipate any further impairment charges in connection with our acquisition of Bonson, however, any future deterioration of market conditions or other changes may require us to record additional impairment charges in the future, which would impact our net income (loss).

In December 2003, we conducted an impairment test in connection with our investment in Intrinsic Technology (Holdings) Limited, in which we hold a minority stake, and recorded a charge of $2.2 million. In this quarter, we received a distribution from Intrinsic consisting of cash and shares of Linktone Ltd. (Nasdaq: LTON). The distribution resulted in an investment gain of $4.0 million for this quarter because the distribution exceeded the carried value of our investment in Intrinsic, which had been written down to zero as of September 30, 2004.

Revenues

To provide a clearer breakdown of our revenues, we have recently begun reporting our revenues on the basis of the three principal types of revenues derived from our business: software products and solutions revenue, network service revenue and third party hardware revenue.

Software products and solutions revenue. We typically sell our software as part of total solutions for our customers, which include proprietary software licenses, professional services related to the design and implementation of the solution (such as consulting, training, technical support and maintenance) and, in cases where the customer requests a turn-key solution, related hardware. We do not sell any software products without these related implementation services. Software products and solutions revenue include two types of revenues: software license revenue and software services revenue. Software license revenue consists of fees received from customers for licenses or sublicenses to use our software products as well as third party software products in perpetuity, typically up to a specified maximum number of users. In most cases where a customer is required to purchase additional licenses from us because the number of users exceeds the number of licensed users, we enter into an extension agreement with the customer to expand and upgrade the customer s system. These extension contracts will usually include a license for the additional users, an updated versions of our software and, if required, additional services and hardware for the customer s network. Our software license revenue also includes the benefit of value added tax rebates on software license sales, which are part of the Chinese government s policy of encouraging China s software industry. Software services revenue consists of revenue from software installation, customization, training and other services.

Table of Contents

Network service revenue. Network service revenue consists of revenue from services for network planning, design, systems integration and training.

Third party hardware revenue. Third party hardware revenue consists of hardware sales for equipment procured by us on behalf of our customers from hardware vendors. We procure for and sell hardware to our customers as part of our total solutions strategy. We minimize our exposure to hardware risks by sourcing equipment from hardware vendors against letters of credit from our customers. We believe that as the telecommunications-related market in China develops our customers will increasingly purchase hardware directly from hardware vendors and hire us for our professional services.

Net revenues. Although we report our revenues on a gross basis, inclusive of hardware acquisition costs that are passed through to our customers, we manage our business internally based on revenues net of hardware costs, or net revenues, which is consistent with our strategy of providing our customers with high value IT professional services and, where efficient, outsourcing lower-end services such as hardware acquisition and installation. This strategy may result in lower growth rates for total revenues as against prior periods, but will not adversely impact revenues net of hardware costs. The following table shows our revenue breakdown on this basis and reconciles our net revenues to our total revenues:

	Nine Months Ended September 30,		Year Ended December 31,	
	2004	2003	2003	2002
	(amounts in thousands of dollars)			
Software products and solutions revenue	$ 28,615	$ 21,956	$ 31,488	$ 33,013
Network service revenue	14,849	17,028	22,892	28,745
Third party hardware revenue (net of hardware costs)	1,551	2,329	3,090	2,975
Total net revenues	$ 45,015	$ 41,313	$ 57,470	$ 64,733
Hardware costs	29,480	44,248	58,704	56,533
Total revenues	$ 74,495	$ 85,561	$ 116,174	$ 121,266

The information on revenues net of hardware costs, or net revenues, in the above table is a non-GAAP financial measure within the meaning of Item 10 of Regulation S-K under the Securities Exchange Act of 1934, as amended. We have provided a reconciliation of this non-GAAP financial measure to the most directly comparable GAAP financial measure, total revenues. We believe that the presentation of this non-GAAP measure provides useful information for investors regarding our regular financial performance because total revenues net of hardware costs more accurately reflect the core of our business, which is the provision of software solutions and services. We believe such measure provides transparency to our investors because it is the measure used by our management to evaluate the competitiveness and development of our business. In addition, third party hardware revenue tends to fluctuate from period to period depending on the requirements of our customers. As a result, a presentation that excludes hardware costs allows investors to better evaluate the performance of our core business. We have evaluated the criteria outlined in EITF No. 99-19, Reporting Revenue Gross as Principal Versus Net as an Agent, in determining whether it is appropriate under GAAP to record the gross amount of revenues and related costs or the net amount earned after deducting hardware costs paid to the supplier. We record the gross amounts billed to our customers because we are the primary obligor in these transactions, bear the inventory risk, have latitude in establishing prices, are involved in the determination of the product specifications, bear credit risk and have the right to select suppliers. The presentation above of additional information on revenues net of hardware costs is not meant to be considered in isolation or as a substitute for our financial results prepared in accordance with GAAP.

Cost of Revenues

Software products and solutions costs. Software products and solutions costs consist primarily of three components:

packaging and written manual expenses for our proprietary software products and solutions;

Table of Contents

compensation and travel expenses for the professionals involved in modifying, customizing or installing our software products and solutions and in providing consultation, training and support services; and

software license fees paid to third-party software providers for the right to sublicense their products to our customers as part of our solutions offerings.

The costs associated with designing and modifying our proprietary software are classified as research and development expenses as incurred.

Network service costs. Network service costs consist primarily of compensation and travel expenses for the professionals involved in designing and implementing projects, as well as hardware warranty costs. We accrue hardware warranty costs upon final acceptance. We typically obtain manufacturers warranties for hardware we sell, which cover a portion of the warranties that we give to our customers. We currently accrue 0.5% of hardware sales to cover potential warranty expenses. This estimate of warranty cost is based on our current experience with contracts for which the warranty period has expired.

Third party hardware costs. Third party hardware costs consist primarily of hardware costs. We recognize hardware costs in full upon delivery of the hardware to our customers. In order to minimize our working capital requirements, we generally obtain from our hardware vendors payment terms that are timed to permit us to receive payment from our customers for the hardware before our payments to hardware vendors are due. However, in large projects we sometimes obtain less favorable payment terms from our customers, thereby increasing our working capital requirements.

Operating Expenses

Operating expenses are comprised of sales and marketing expenses, research and development expenses, general and administrative expenses, and amortization expenses for intangible assets, deferred stock compensation and impairment of goodwill and acquired intangible assets. Compensation expenses consistently comprise a significant portion of our total operating expenses.

Sales and marketing expenses include compensation expenses for employees in our sales and marketing departments, third party advertising expenses, as well as sales commissions and sales agency fees.

Research and development expenses relate to the development of new software and the modification of existing software. We expense such costs as they are incurred.

Taxes

Except for certain hardware procurement and resale transactions, we conduct substantially all of our business through our Chinese subsidiaries, which are generally subject to a 30% state corporate income tax and a 3% local income tax.

Under the income tax laws of China, foreign invested enterprises, or FIEs, satisfying certain criteria can enjoy preferential tax treatment. Our subsidiaries, AsiaInfo Technologies, AsiaInfo Management and AsiaInfo Technologies (Chengdu), Inc., are FIEs and enjoy certain preferential tax treatments in China. Please refer to Note 11 to our consolidated financial statements included in our annual report on Form 10-K filed with the United States Securities and Exchange Commission on March 15, 2004 for details of the respective preferential treatments for each of these subsidiaries.

The unified Chinese corporate income tax laws for domestic enterprises and FIEs will likely take effect in 2005. We anticipate that these unified tax laws will eliminate various preferential tax provisions in China. However, such unified tax laws should not affect the preferential tax treatments granted to FIEs in previous years. We expect our effective income tax rate to be within the range of 13% to 15% for the full year of 2004, absent extraordinary regulatory changes in China.

Sales of hardware procured in China are subject to a 17% value added tax. Most of our sales of hardware procured outside of China are made through our U.S. parent company, AsiaInfo Holdings, Inc., and thus are not subject to the value added tax. We effectively pass value-added taxes on hardware sales through to our customers and do not include them in revenues reported in our financial statements. In addition, companies that develop their own software and register the software with the relevant authorities in China are generally entitled to a value added tax refund. If the net amount of the value added tax payable exceeds 3% of software sales, the excess portion of the value added tax is refundable immediately. This policy is effective until 2010.

We are also subject to U.S. income taxes on revenues generated in the United States, including revenues from our limited hardware procurement activities through our U.S. parent company, AsiaInfo Holdings, Inc., and interest income earned in the United States.

Foreign Exchange

A majority of our revenues and expenses relating to hardware sales are denominated in U.S. dollars, and substantially all of our revenues and expenses relating to the software and service components of our business are denominated in Renminbi. The value of our shares will be affected by the foreign exchange rate between U.S. dollars and Renminbi because the value of our business is effectively denominated in Renminbi, while our shares are traded in U.S. dollars. Furthermore, an increase in the value of the Renminbi may require us to exchange more U.S. dollars into Renminbi to meet the working capital requirements of our subsidiaries in China. Depreciation of the value of the U.S. dollar will also reduce the value of the cash we hold in U.S. dollars, which we may use for purposes of future acquisitions or other business expansion. We actively monitor our exposure to these risks and adjust our cash position in the Renminbi and the U.S. dollar when we believe such adjustments will reduce our foreign exchange risks. For example, in February 2004 we exchanged approximately $28 million cash from U.S. dollars to Renminbi in order to address concerns regarding a possible increase in the relative value of the Renminbi.

Critical Accounting Policies

We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. On an on-going basis, we evaluate our estimates and judgments, including those related to revenues and cost of revenues under customer contracts, warranty obligations, bad debts, income taxes, investment in affiliate, goodwill and other intangible assets, and litigation. We base our estimates and judgments on historical experience and on various other factors that we believe are reasonable. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies affect the more significant judgments and estimates used in the preparation of our consolidated financial statements.

Revenue recognition. We generally charge a fixed price for all of our projects and recognize revenue based on the percentage of completion of the project as required under SOP 81-1. With respect to software products and solutions, revenue from customer orders requiring significant production, modifications, or customizations of the software are recognized over the installation and customization period. Labor costs and direct project expenses are used to determine the stage of completion. Costs related to insignificant obligations for a period of up to one year, which include telephone support, are accrued at the time the revenue is recorded. We do not sell any software products without related implementation services. In cases where the customer requires additional software licenses, we enter into an extension agreement with the customer to expand and upgrade the customer s system. Revenue arising from such extension agreements is also recognized under SOP 81-1. We recognize network service revenue (which is charged on a fixed price basis) based on the percentage of completion of the project as required under SOP 81-1. We use labor costs and direct project expenses to determine the state of completion. We recognize third party hardware revenue upon delivery of the hardware to the customer. Since a large part of the cost of certain projects often relates to hardware, the timing of hardware delivery can cause our quarterly gross revenue and inventory level to fluctuate significantly. However, those fluctuations do not significantly affect our gross profits because third party hardware revenue generally approximates the costs of the hardware.

Recognized revenues and profit are subject to adjustments in current periods as the contract progresses to completion. If we do not have a sufficient basis to measure progress toward completion, revenue will be recognized upon completion. Provisions for estimated losses on contracts are made in the period in which the anticipated losses become known. Actual costs and gross margins on such contracts could differ from management s estimates and those differences could be material to the consolidated financial statements. Historically, our estimates for costs and gross margins have not differed significantly from actual costs and gross margins. However, any material deviation of such costs and gross margins from our estimates would impact our future operating results.

Income taxes. We record a valuation allowance to reduce our deferred tax assets to the amount that we believe is more likely than not to be realized. In the event we were to determine that we would be able to realize our deferred tax assets in the future in excess of their recorded amount, an adjustment to the deferred tax asset would increase income in the period such determination was made. Likewise, should we determine that we would not be able to realize all or part of our net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made.

Impairment of long-lived assets. We review our long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may no longer be recoverable. When these events occur, we measure impairment by comparing the carrying value of the long-lived assets to the estimated future value.

Goodwill. Beginning in 2002, with the adoption of SFAS 142, Goodwill and Other Intangible Assets, goodwill is no longer amortized, but instead tested for impairment upon first adoption and annually thereafter, or more frequently if events or changes in circumstances indicate that it might be impaired. We use a two-step impairment test to identify potential goodwill impairment and recognize a goodwill impairment loss in the statement of operations when the carrying amount of goodwill exceeds its implied fair value. Prior to 2002, goodwill was amortized using a straight-line method over its economic life of five years. Accumulated amortization recorded through December 31, 2001 was $2,971,000. The latest goodwill impairment tests were performed in the first and second quarters of 2003 for our acquisitions of Bonson Information Technology Holdings, Ltd., and Zhejiang AsiaInfo Dekang Telecommunications Technology, Inc., respectively. Subsequently, we decided to change the date of our annual goodwill impairment test and perform all goodwill impairment tests in the fourth quarter of each year. The change did not have a material impact on our financial position, results of operations or cash flows.

Consolidated Results of Operations

Revenues. Total revenues were $20 million and $74.5 million, respectively, in the three-and nine-month periods ended September 30, 2004, representing decreases of 29% and 13%, respectively, against the comparable periods in 2003, and an 11% decrease compared with the previous quarter. These decreases were primarily due to lower network service revenues, as well as lower hardware passthrough revenue, as we continue to focus our business on software and services.

Revenues net of third party hardware costs were $14.2 million and $45 million, respectively, in the three-and nine-month periods ended September 30, 2004, representing a 10% decrease and a 9% increase, respectively, against the comparable periods in 2003 and a 10% decrease against the previous quarter. The decreases in net revenues during the third quarter resulted primarily from lower network service revenue.

Software products and solutions revenues were $9.6 million and $28.6 million, respectively, in the three-and nine-month periods ended September 30, 2004, representing increases of 14% and 30%, respectively, over the comparable periods in 2003 and a 3% increase over the previous quarter. These increases reflect our strategy to focus on our software solutions business.

Network service revenues were $4.3 million and $14.8 million, respectively, in the three-and nine-month periods ended September 30, 2004, representing decreases of 36% and 13%, respectively, against the comparable periods in 2003 and a 29% decrease against the previous quarter. The decreases were due to cautious spending on network construction by our key customers in the telecommunications industry.

Table of Contents

Third party hardware revenues were $6.1 million and $31 million, respectively, in the three-and nine month periods ended September 30, 2004, representing decreases of 52% and 33%, respectively, against the comparable periods in 2003 and a 14% decrease over the previous quarter. These decreases were attributable to our strategy to focus more of our resources on growing our software products and solutions businesses and reduce hardware passthrough.

Net revenue from our e-HR and business intelligence unit, which we acquired in December 2003, accounted for approximately 2% of our net revenue in the quarter ended September 30, 2004. Going forward, our e-HR and business intelligence business unit will be integrated into our new Lenovo-AsiaInfo division,which will include the IT services business we acquired from Lenovo Group Limited.

Cost of Revenues. Our cost of gross revenues decreased 35% to $11.6 million and 21% to $48.2 million, respectively, in the three-and nine-month periods ended September 30, 2004, against the comparable periods in 2003. These decreases in cost of gross revenue were attributable to our strategy to reduce hardware passthrough.

Gross Profit. Our gross profit was $8.4 million and $26.3 million, respectively, in the three-and nine-month periods ended September 30, 2004, representing decreases of 16% and an increase of 7%, respectively, against comparable periods in 2003, and a decrease of 4% against the previous quarter. These decreases were primarily due to lower revenues and the absorption of employees, including software engineers and sales personnel, from our former telecom software competitor, Wholewise. Gross profit as a percentage of gross revenues, or gross margin, increased to 42% and 35%, respectively, in the three-and nine-month periods ended September 30, 2004, as compared to 36% and 29%, respectively, in the comparable periods of 2003 and 39% in the previous quarter. These increases were attributable to our strategy of reducing hardware passthrough, which provides a relatively low gross margin. Gross profit as a percentage of net revenues decreased to 59% and 58%, respectively, in the three-and nine-month periods ended September 30, 2004, as compared to 63% and 60%, respectively, in comparable periods in 2003.

Operating Expenses. Total operating expenses decreased 1% and 59%, respectively, to $7.9 million and $22.2 million, in the three-and nine-month periods ended September 30, 2004, from $8 million and $54.4 million, respectively, against the comparable periods in 2003. The 59% decrease in total operating expenses in the nine-month period ended September 30, 2004 was primarily attributable to the $30 million goodwill impairment charge we recognized during the comparable period in 2003.

Sales and marketing expenses increased 10% and 5%, respectively, to $3.1 million and $8.7 million, in the three-and nine-month periods ended September 30, 2004, against the comparable periods in 2003.

Research and development expenses increased 12% and decreased 9%, respectively, to $2.3 million and $6.6 million, in the three-and nine-month periods ended September 30, 2004, against the comparable periods in 2003.

General and administrative expenses decreased 23% and 24%, respectively, to $2.4 million and $6.4 million, in the three-and nine-month periods ended September 30, 2004, against the comparable periods in 2003. General and administrative expenses increased 59% compared with the previous quarter. General and administrative expenses in the second quarter were lower than normal due to a bad debt collection of approximately US$1 million. The increase in general and administrative expenses in the third quarter also reflects costs associated with the audit of our internal controls as required under Section 404 of the Sarbenes-Oxley Act of 2002.

Income (Loss) from Operations. Our operating income was $0.4 million and $4.2 million, respectively, in the three-and nine-month periods ended September 30, 2004, as compared to operating income of $2 million and an operating loss of $29.7 million in the comparable periods in 2003. The loss in the first nine months of 2003 was due primarily to the one-time, non-cash impairment charge of $30.2 million for goodwill and acquired intangible assets attributable to our acquisition of Bonson and the minority interest in Marsec Holdings, Inc.

Other Income (Expense). Other income and expenses, consisting primarily of net interest income and expense, increased from income of approximately $0.4 million and $1.1 million, respectively, in the three-and nine-month periods ended September 30, 2003 to $4.7 million and $5.6 million, respectively, in the same periods in 2004. In the third quarter, we received a distribution from Intrinsic Technology (Holdings) Limited consisting of cash and shares of Linktone Ltd. (Nasdaq: LTON), which resulted in an investment gain of $4 million for the quarter.

Table of Contents

Net Income (Loss). We recorded net income of $5 million, or $0.11 basic income per share, for the quarter ended September 30, 2004, compared to net income in the comparable period in 2003 of $2.2 million, or $0.05 basic income per share. We expect net revenue for the fourth quarter of 2004 to be approximately $21 million, or approximately $0.01 to $0.02 per basic share.

Liquidity and Capital Resources

Our capital requirements are primarily working capital requirements related to hardware sales and costs associated with the expansion of our business, such as research and development and sales and marketing expenses. We recognize hardware costs in full upon delivery of the hardware to our customers. In order to minimize our working capital requirements, we generally obtain from our hardware vendors payment terms that are timed to permit us to receive payment from our customers for the hardware before our payments to hardware vendors are due. However, we sometimes obtain less favorable payment terms from our customers, thereby increasing our working capital requirements. See Certain Risks That May Affect Our Operating Results and Our Common Stock - Our working capital requirements may increase significantly. We have historically financed our working capital and other financing requirements through careful management of our billing cycle, private placements of equity securities, our initial public offering in March of 2000 and, to a limited extent, bank loans.

Our accounts receivable balance at September 30, 2004 was $59.4 million, consisting of $38.4 million in billed receivables and $21.0 million in unbilled receivables . Our billed receivables are based on revenue we have booked and billed. Our unbilled receivables are based on revenue we have booked through the percentage completion method, but for which we have not yet billed the customer. For example, we recognize revenues for hardware pass-through at the time the hardware is accepted by the customer, based on the cost of the underlying hardware. However, our contracts with our customers will often allow the customers to withhold 10-20% of the total contract payments until final project acceptance, which on average is eight to nine months after hardware delivery. As a result, revenues from hardware pass-through generally represent a significant portion of our unbilled receivables and can cause the aging of these receivables to be relatively long.

At the end of the third quarter, our days sales outstanding were 215 days, as compared to 208 days at the end of the second quarter of 2004. Our billed receivables were 139 days sales outstanding and our unbilled receivables were 76 days sales outstanding. As of the end of the third quarter, our accounts payable balance increased 23% as compared to the previous quarter end.

As of September 30, 2004, we had total short-term credit facilities for working capital purposes totaling $38.1 million, expiring by December 2005, which were secured by bank deposits of $14.0 million. $6.5 million of the short-term credit facilities were used to issue letters of credit a