

ASIAINFO HOLDINGS INC  
Form 10-Q  
August 09, 2007  
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 June 30, 2007

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 001-15713

---

**ASIAINFO HOLDINGS, INC.**

(Exact name of registrant as specified in its charter)

---

**DELAWARE**  
(State or other jurisdiction of

incorporation or organization)

**4TH FLOOR, ZHONGDIAN INFORMATION TOWER**

**6 ZHONGGUANCUN SOUTH STREET, HAIDIAN DISTRICT**

**752506390**  
(I.R.S. Employer

Identification No.)

Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

**BEIJING 100086, CHINA**

(Address of principal executive offices, including zip code)

**+8610 8216 6688**

(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  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The number of shares outstanding of the Registrant's common stock as of August 7, 2007 was 43,598,615.

---

**Table of Contents**

ASIAINFO HOLDINGS, INC.  
FORM 10-Q  
FOR THE QUARTER ENDED June 30, 2007  
TABLE OF CONTENTS

	<b>Page</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	<b>3</b>
<b>Item 1. <u>Financial Statements (unaudited)</u></b>	<b>3</b>
a) <u>Condensed Consolidated Statements of Operations for the three months and six months ended June 30, 2007 and 2006</u>	3
b) <u>Condensed Consolidated Balance Sheets as of June 30, 2007 and December 31, 2006</u>	5
c) <u>Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2007 and 2006</u>	7
d) <u>Notes to Condensed Consolidated Financial Statements for the six months ended June 30, 2007 and 2006</u>	9
<b>Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	<b>20</b>
<b>Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u></b>	<b>27</b>
<b>Item 4. <u>Controls and Procedures</u></b>	<b>27</b>
<b><u>PART II. OTHER INFORMATION</u></b>	<b>28</b>
<b>Item 1. <u>Legal Proceedings</u></b>	<b>28</b>
<b>Item 1A. <u>Risk Factors</u></b>	<b>28</b>
<b>Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u></b>	<b>35</b>
<b>Item 3. <u>Defaults Upon Senior Securities</u></b>	<b>35</b>
<b>Item 4. <u>Submission of Matters to a Vote of Security Holders</u></b>	<b>35</b>
<b>Item 5. <u>Other Information</u></b>	<b>35</b>
<b>Item 6. <u>Exhibits</u></b>	<b>36</b>
<b><u>SIGNATURES</u></b>	<b>37</b>
<b><u>Exhibit Index</u></b>	<b>38</b>

**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****ASIAINFO HOLDINGS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)**

(In US dollars thousands, except share and per share amounts)

	Three Months Ended		Six Months Ended	
	2007	June 30, 2006	2007	June 30, 2006
<b>Revenues:</b>				
Software products and solutions				
Sales to non-related parties	\$ 22,406	\$ 14,603	\$ 42,006	\$ 28,666
Sales to related parties		1,544		2,702
<b>Total software products and solutions</b>	<b>22,406</b>	<b>16,147</b>	<b>42,006</b>	<b>31,368</b>
<b>Service</b>				
Sales to non-related parties	4,011	2,011	7,580	4,487
Sales to related parties		669		1,348
<b>Total Service</b>	<b>4,011</b>	<b>2,680</b>	<b>7,580</b>	<b>5,835</b>
<b>Third party hardware</b>				
Sales to non-related parties	3,153	3,750	10,039	9,809
Sales to related parties		557		2,686
<b>Total third party hardware</b>	<b>3,153</b>	<b>4,307</b>	<b>10,039</b>	<b>12,495</b>
<b>Total revenues</b>	<b>29,570</b>	<b>23,134</b>	<b>59,625</b>	<b>49,698</b>
<b>Cost of revenues:</b>				
Software products and solutions (including cost of purchases from related parties of nil and \$11, amortization of other acquired intangible assets of \$163 and \$88 for the three months ended June 30, 2007 and 2006, respectively; cost of purchases from related parties of \$1 and \$31, amortization of other acquired intangible assets of \$358 and \$140 for the six months ended June 30, 2007 and 2006, respectively)	10,116	7,941	19,089	15,216
Service (including cost of purchases from related parties of nil and \$3 for the three months ended June 30, 2007 and 2006, respectively; including cost of purchases from related parties of nil and \$9 for the six months ended June 30, 2007 and 2006, respectively)	1,980	2,011	3,676	3,923
Third party hardware (including cost of purchases from related parties of \$583 and nil for the three months ended June 30, 2007 and 2006, respectively; including cost of purchases from related parties of \$583 and nil for the six months ended June 30, 2007 and 2006, respectively)	2,995	4,092	9,537	11,871
<b>Total cost of revenues</b>	<b>15,091</b>	<b>14,044</b>	<b>32,302</b>	<b>31,010</b>

Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Gross profit	14,479	9,090	27,323	18,688
Sales and marketing (including sales and marketing expenses incurred from transactions with related parties of \$18 and \$18, amortization of other acquired intangible assets of \$360 and \$129 for the three months ended June 30, 2007 and 2006, respectively; sales and marketing expenses incurred from transactions with related parties of \$43 and \$47, amortization of other acquired intangible assets of \$717 and \$230 for the six months ended June 30, 2007 and 2006, respectively)	6,653	4,140	12,723	8,090

**Table of Contents**

General and administrative (including general and administrative expenses incurred from transactions with related parties of nil and \$3 for the three months ended June 30, 2007 and 2006, respectively; general and administrative expenses incurred from transactions with related parties of nil and \$7 for the six months ended June 30, 2007 and 2006, respectively)	2,470	1,275	4,418	4,431
Research and development (including research and development expenses incurred from transactions with related parties of \$1 and \$11 for the three months ended June 30, 2007 and 2006, respectively; research and development expenses incurred from transactions with related parties of \$2 and \$23 for the six months ended June 30, 2007 and 2006, respectively)	4,161	3,498	8,247	6,702
Total operating expenses	13,284	8,913	25,388	19,223
Other operating income			2,734	
Income (loss) from operations	1,195	177	4,669	(535)
Other income				
Interest income	1,249	1,127	2,806	2,095
Gain on investments	556		581	
Other income (expenses), net	52	3	(20)	(55)
Total other income, net	1,857	1,130	3,367	2,040
Income from continuing operations before income taxes	3,052	1,307	8,036	1,505
Income tax expense	554	205	587	266
Income from continuing operations	2,498	1,102	7,449	1,239
Income from discontinued operations, net of taxes		246	1,445	469
Net income	\$ 2,498	\$ 1,348	\$ 8,894	\$ 1,708
Net income from continuing operations per share:				
Basic	\$ 0.06	\$ 0.02	\$ 0.17	\$ 0.03
Diluted	\$ 0.06	\$ 0.02	\$ 0.17	\$ 0.03
Net income from discontinued operations per share:				
Basic	\$	\$ 0.01	\$ 0.04	\$ 0.01
Diluted	\$	\$ 0.01	\$ 0.03	\$ 0.01
Net income per share				
Basic	\$ 0.06	\$ 0.03	\$ 0.21	\$ 0.04
Diluted	\$ 0.06	\$ 0.03	\$ 0.20	\$ 0.04
Shares used in computation:				
Basic	43,231,164	43,941,763	43,191,216	44,693,342
Diluted	45,050,920	44,916,700	44,869,741	45,634,975

See accompanying notes to condensed consolidated financial statements.



**Table of Contents****ASIAINFO HOLDINGS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)**

(In US dollars thousands, except share and per share amounts)

	June 30, 2007	December 31, 2006(1)
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 87,668	\$ 104,575
Restricted cash	13,435	12,645
Short-term investments	63,381	45,882
Trade notes receivable	152	848
Accounts receivable:		
Accounts receivable due from non-related parties (net of allowances of \$2,473 and \$2,874 as of June 30, 2007 and December 31, 2006, respectively)	41,150	35,231
Accounts receivable due from related parties (net of allowances of \$446 and \$437 as of June 30, 2007 and December 31, 2006, respectively)	4	3
Total accounts receivable	41,154	35,234
Inventories		
Other receivables (including other receivables of \$207 and \$296 due from related parties as of June 30, 2007 and December 31, 2006, respectively)	2,641	4,288
Deferred income tax assets - current		124
Prepaid expenses and other current assets (including prepaid expenses and other current assets of nil and \$241 due from related parties as of June 30, 2007 and December 31, 2006, respectively)	6,063	5,614
Assets held for sale		857
Total current assets	220,396	216,585
Long-term investment		
Property and equipment - net	1,833	1,787
Goodwill	1,891	1,857
Other acquired intangible assets - net	18,114	17,993
Deferred income tax assets - non-current	3,770	4,765
	1,175	1,175
Total Assets	\$ 247,179	\$ 244,162
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Trade notes payable	\$ 4,309	\$ 4,045
Accounts payable	10,387	15,537
Accrued expenses	11,720	11,738
Deferred revenue (including deferred revenue of \$348 and \$339 from related parties as of June 30, 2007 and December 31, 2006, respectively)	17,486	23,169
Accrued employee benefits	13,688	18,376
Other payables (including other payables of \$702 and \$685 due to related parties as of June 30, 2007 and December 31, 2006, respectively)	4,553	4,450
Income taxes payable	71	927
Other taxes payable	2,938	3,232
Deferred income tax liabilities - current	2,135	



Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Liabilities held for sale		227
<b>Total current liabilities</b>	<b>67,287</b>	<b>81,701</b>
Unrecognized tax benefits	689	

**Table of Contents**

Total liabilities	67,976	81,701
Commitments and contingencies (Note 18)		
Stockholders' Equity:		
Common stock (100,000,000 shares authorized; 43,572,340 and 43,076,034 shares issued and outstanding as of June 30, 2007 and December 31, 2006, respectively)	436	431
Additional paid-in capital	198,235	195,881
Accumulated deficit	(31,878)	(40,556)
Accumulated other comprehensive income	12,410	6,705
Total stockholders' equity	179,203	162,461
Total Liabilities and Stockholders' Equity	\$ 247,179	\$ 244,162

(1) December 31, 2006 balances were extracted from audited financial statements  
See accompanying notes to condensed consolidated financial statements.

**Table of Contents****ASIAINFO HOLDINGS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)**

(In US dollars thousands, except share and per share amounts)

	<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 8,894	\$ 1,708
<b>Adjustments to reconcile net income to net cash (used in) provided by operating activities:</b>		
Depreciation	410	728
Stock-based compensation expense	1,851	272
Amortization of other acquired intangible assets	1,075	370
Loss on disposal of property and equipment	2	42
Gain from sale of investments	(581)	
Gain on settlement of escrow	(2,734)	
Provision for bad debt	(182)	(112)
Provision for inventory	(146)	(104)
Gain on sale of discontinued components	(1,536)	(140)
Proceeds from sales of trading securities	171	
Purchases of trading securities	(105)	
<b>Changes in operating assets and liabilities:</b>		
Trade notes receivable	696	3,186
Accounts receivable	(5,257)	213
Inventories	762	1,532
Other receivables	1,391	(787)
Prepaid expenses and other current assets	(488)	207
Trade notes payable	264	3,515
Accounts payable	(5,716)	960
Accrued expenses	(54)	(167)
Deferred revenue	(5,735)	(4,209)
Accrued employee benefits	(4,759)	386
Other payables	661	(220)
Other taxes payable	(303)	123
Income tax liabilities	(381)	(102)
<b>Net cash (used in) provided by operating activities</b>	<b>(11,800)</b>	<b>7,401</b>
<b>Cash flows from investing activities:</b>		
(Increase) decrease in restricted cash	(412)	943
Purchases of short-term investments	(25,231)	(3,801)
Proceeds from sales of short-term investments	14,588	4,750
Purchases of property and equipment	(273)	(316)
Proceeds from disposal of property and equipment	3	21
Purchase of business, net of cash acquired	(706)	(4,496)

**Table of Contents**

Proceeds from disposal of business components	1,477	161
Net cash used in investing activities	(10,554)	(2,738)
Cash flows from financing activities:		
Proceeds on exercise of stock options	4,130	312
Repurchase of common stock		(14,035)
Net cash provided by (used in) financing activities	4,130	(13,723)
Net decrease in cash and cash equivalents	(18,224)	(9,060)
Cash and cash equivalents at beginning of period	104,575	92,176
Effect of exchange rate changes on cash and cash equivalents	1,317	498
Cash and cash equivalents at end of period	\$ 87,668	\$ 83,614
Supplemental cash flow information:		
Income taxes paid	\$ 975	\$ 344
Supplemental disclosure of non-cash investing activities:		
Obligations incurred for purchase of equipment	\$ 127	\$ 179

## Supplemental disclosure of non-cash financing activities:

On January 24, 2007, the Company entered into a Settlement and Release Agreement with Lenovo Group Limited to resolve certain matters arising out of the Acquisition Agreement dated July 27, 2004 and an Escrow Agreement dated October 19, 2004 between the Company and Lenovo Group Limited. Under the Settlement and Release Agreement, 648,769 shares of the Company's common stock, valued at \$3,633, which had been held in escrow since the closing of the acquisition, were returned to the Company. See Note 10 to the Condensed Consolidated Financial Statements for further discussion on this activity.

See accompanying notes to condensed consolidated financial statements.

---

**Table of Contents**

**ASIAINFO HOLDINGS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)**

(In US dollars thousands, except share and per share amounts)

**1. BASIS OF PREPARATION**

The accompanying unaudited condensed consolidated financial statements include the accounts of AsiaInfo Holdings, Inc., its subsidiaries, and consolidated variable interest entities (collectively, the Company). All significant intercompany balances and transactions have been eliminated in consolidation.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X, as promulgated by the Securities and Exchange Commission (the SEC). Accordingly, they do not include all of the information and notes required by U.S. GAAP for complete financial statements. However, management believes that the disclosures are adequate to ensure the information presented is not misleading. U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, contingencies and results of operations. While management has based their assumptions and estimates on the facts and circumstances existing at June 30, 2007, final amounts may differ from these estimates.

In the opinion of the management of the Company, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, which are necessary for a fair presentation of the results for the interim period presented. These financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company's audited financial statements on Form 10-K for the fiscal year ended December 31, 2006. The results of operations for the interim periods presented are not indicative of the operating results to be expected for any subsequent interim period or for the Company's fiscal year ending December 31, 2007.

Revenue from software products and solutions includes the benefit of the rebate of valued-added taxes on sales of software and services received from the Chinese tax authorities as part of the People's Republic of China (PRC) government's policy of encouraging software development in the PRC. The rebate totaled \$1,636 and \$1,039 for the three months ended June 30, 2007 and 2006, respectively. The rebate totaled \$2,775 and \$2,105 for the six months ended June 30, 2007 and 2006, respectively.

Revenue in excess of billings is recorded as unbilled receivables and included in accounts receivable. Billings in excess of revenues recognized are recorded as deferred revenue. Billings are rendered based on agreed milestones included in customer contracts. Amounts billed but not yet collected are recorded as billed receivables and included in accounts receivable. All billed and unbilled amounts are expected to be collected within one year.

AsiaInfo Holdings, Inc. uses the United States (U.S.) dollar as its reporting currency and functional currency. 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 U.S. dollars based on the rates of exchange quoted by the People's Bank of China as of the balance sheet date. Their statements of operations are translated using a weighted average rate for the period. Translation adjustments are reflected in accumulated other comprehensive income in stockholders' equity.

The RMB is not fully convertible into U.S. dollars or other foreign currencies. On July 21, 2005, the PRC government changed its decade-old policy of pegging the value of RMB to U.S. dollar. Under the new policy, RMB is permitted to fluctuate within a narrow and managed band against a basket of certain foreign currencies, including U.S. dollar. The rate of exchange quoted by the People's Bank of China on June 30, 2007 was US\$1.00=RMB7.6155. No representation is made that the RMB amounts could have been, or could be, converted into U.S. dollars at that rate or at any other rate.

**Reclassifications**

Certain prior period balances have been reclassified due to discontinued operations.

**Recently Issued Accounting Pronouncements**

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115 ( SFAS 159 ). SFAS 159 provides companies with an option to report selected financial assets and liabilities at fair value. The standard requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company's choice to use fair value on its earnings. It also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. This Statement is effective as of the beginning of an entity's first fiscal year beginning after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year provided that the entity makes that choice in the first 120 days of that fiscal year and also elects to apply the provisions of Statement 157. The Company is currently evaluating whether the adoption of SFAS 159 will have a material effect on its consolidated results of operations and financial condition.

**Table of Contents**

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157), which provides enhanced guidance for using fair value to measure assets and liabilities. This standard also responds to investors' requests for expanded information about the extent to which Company's measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 12, 2007, and interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating whether the adoption of SFAS 157 will have a material effect on its consolidated results of operations and financial condition.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Unrecognized Tax Benefits** Effective on January 1, 2007, the Company adopted the provisions of Interpretation No. 48, Accounting for Uncertainty in Income Taxes (An Interpretation of FASB Statement No. 109 (FIN 48)). Under FIN 48, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant taxing authority based solely on the technical merits of the associated tax position. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. The Company also elected the accounting policy that interest recognized in accordance with Paragraph 15 of FIN48 and penalties recognized in accordance with Paragraph 16 of FIN48 are classified as part of its income taxes. The Company classifies the liability for unrecognized tax benefits as current to the extent that it anticipates payment (or receipt) of cash within one year, otherwise, the liability will be classified as non-current. Additionally, FIN 48 provides guidance on de-recognition, accounting in interim periods, disclosure and transition. See Note 13 for additional information.

**3. 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.

**4. SHORT-TERM INVESTMENTS**

Short-term investments are classified as available-for-sale securities, held-to-maturity securities and trading securities. Available-for-sale securities consist principally of corporate stocks, bond funds, balanced funds, stock funds and variable rate preferred securities issued by major financial institutions. Available-for-sale investments are carried at fair market value and unrealized holding gains or losses resulting from changes in market value associated with such investments are recorded in accumulated other comprehensive income in stockholders' equity. Held-to-maturity securities consist of corporate bonds and are accounted for at amortized cost with effective interest rate method. Trading securities consist of corporate stocks and are reported at fair value, with unrealized holding gains and losses, if any, reported as part of net income. As of June 30, 2007 and December 31, 2006, all short-term investments, except corporate stocks, of the Company had maturities of less than one year.

The following table provides additional information concerning the Company's available-for-sale short-term investments:

	June 30, 2007		December 31, 2006	
	Cost	Fair value	Cost	Fair value
Bond funds	\$ 19,812	\$ 19,874	\$ 12,877	\$ 12,900
Balanced funds	3,417	6,674	3,844	5,295
Stock funds	7,880	12,572	3,843	4,423
Variable rate preferred securities	22,525	22,525	22,925	22,925
Corporate stocks	339	204	339	339
Total	\$ 53,973	\$ 61,849	\$ 43,828	\$ 45,882

As of June 30, 2007, the held-to-maturity securities consist of the corporate bonds that have amortized cost of \$1,532 and fair value of \$1,529. No held-to-maturity securities were held as of December 31, 2006. As of June 30, 2007 and December 31, 2006, no trading securities were held.

The Company incurred a gain of \$556 (proceeds from sale of available-for-sale securities of \$11,598 with cost of \$11,087, and proceeds from sale of trading securities of \$98 with cost of \$53) and \$581 (proceeds from sale of available-for-sale securities of \$14,588 with cost of \$14,073,

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

and proceeds from sale of trading securities of \$171 with cost of \$105) during the three months and six months ended June 30, 2007, respectively.

### **5. TRADE NOTES RECEIVABLE**

As of June 30, 2007 and December 31, 2006, the balances of trade notes receivable of \$152 and \$848, respectively, included bank acceptance drafts of \$106 and nil, and commercial acceptance notes of \$46 and \$848, respectively, all of which are non-interest bearing and due within six months of issuance.



**Table of Contents****6. ACCOUNTS RECEIVABLE**

Revenue in excess of billings is recorded as unbilled receivables and included in accounts receivable, and amounted to \$21,804 at June 30, 2007 and \$17,452 at December 31, 2006, net of allowances. Billings are rendered based on agreed milestones included in the contracts with customers. At June 30, 2007 and December 31, 2006, the balance of accounts receivable net of allowances was \$19,350 and \$17,782, respectively, and represents amounts billed but not yet collected. All billed and unbilled amounts are expected to be collected within one year.

**7. INVENTORIES**

Inventories are stated at the lower of cost or market. The cost of inventories under the AsiaInfo Technologies segment is determined principally by the specific identification method. The cost of inventories under the Lenovo-AsiaInfo segment is computed using standard cost, which approximates actual cost, on a first-in, first-out basis. Provision for diminution in value on inventories is made for any inventories with an aging over 360 days. Additional write-downs to market value are made using the specific identification method. The components of inventories as of June 30, 2007 and December 31, 2006 are as follows:

	June 30, 2007	December 31, 2006
Raw materials	\$ 660	\$ 843
Finished goods	5,242	5,675
<b>Total inventories</b>	<b>\$ 5,902</b>	<b>\$ 6,518</b>

**8. COMPREHENSIVE INCOME**

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

	Three Months Ended		Six Months Ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
Net income	\$ 2,498	\$ 1,348	\$ 8,894	\$ 1,708
Unrealized gain (loss) on available-for-sale investments net of tax effect	2,360	42	3,480	(112)
Change in cumulative foreign currency translation adjustment	1,429	216	2,226	742
<b>Comprehensive income</b>	<b>\$ 6,287</b>	<b>\$ 1,606</b>	<b>\$ 14,600</b>	<b>\$ 2,338</b>

**9. CREDIT FACILITIES**

At June 30, 2007 and December 31, 2006, the Company had total short-term credit facilities for working capital purposes totaling \$41,010 and \$32,806, respectively. The credit facilities as of June 30, 2007 expire between December 2007 and March 2008. The facilities were secured by bank deposits of \$11,795 and \$11,732 as of June 30, 2007 and December 31, 2006, respectively. At June 30, 2007 and December 31, 2006, unused short-term credit facilities were \$36,588 and \$28,506, respectively. The used facilities are pledged as security for standby letters of credit and trade notes payable issued to hardware suppliers and customers. Additional bank deposits of \$1,254 and \$867 were used for issuing standby letters of credit and bank acceptance drafts at June 30, 2007 and December 31, 2006, respectively. Bank deposits pledged as security for these credit facilities (which are presented as restricted cash in the condensed consolidated balance sheets) totaled \$13,049 and \$12,599 at June 30, 2007 and December 31, 2006, respectively.

**10. OTHER OPERATING INCOME**

On July 27, 2004, the Company entered into an Acquisition Agreement (the "Acquisition Agreement") with Lenovo Group Limited ("Lenovo") to acquire Lenovo's non-telecommunications IT service business. Pursuant to the Acquisition Agreement, AsiaInfo acquired the assets comprising Lenovo's non-telecommunications related IT services business on October 1, 2004 (the "Acquisition Date"). The acquisition included the business

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

now comprising the Company's Lenovo-AsiaInfo reportable segment. The Company allocated the purchase price of \$36,784 to the tangible net assets and liabilities and intangible assets acquired, based on their estimated fair values. Goodwill of \$22,921 (\$18,855 of which was impaired in 2005) and other intangible assets of \$5,924 (\$2,342 of which was impaired in 2005) were recognized as a result of the allocation.

An escrow agreement dated October 19, 2004 (the Escrow Agreement) was entered into among the Company, Lenovo and JPMorgan Chase Bank (the Escrow Agent) in order to satisfy the seller's indemnification obligations (if any) under the Acquisition Agreement. On July 1, 2005 (the Settlement Date), the Company instructed its transfer agent to deliver two certificates collectively representing 2,162,562 shares (one representing 1,081,281 shares General Escrow, and the other one representing 1,081,281 shares Security Business Escrow) to the Escrow Agent.

On March 24, 2006, the Company delivered an Indemnity Notice to Lenovo seeking indemnification under the Acquisition Agreement. On January 24, 2007, the Company entered into a Settlement and Release Agreement (the Agreement) with Lenovo to resolve certain matters arising out of the Acquisition Agreement and the Escrow Agreement. Under the Agreement, 648,769 General Escrow Shares were returned to the Company's treasury account on February 9, and the remaining 432,512 General Escrow Shares were released to Lenovo. The Agreement also provides for the mutual release of certain claims that the Company or Lenovo may have had against each other relating to the acquisition.

On March 26, 2007, the Company's Board of Directors authorized the retirement of the 648,769 shares of treasury stock. The retired shares resumed the status of authorized and unissued shares of the Company.

**Table of Contents**

The returned escrow shares were accounted at the historical value of \$3,633 as determined at the date shares were issued to the Escrow Agent. Part of this amount off-sets the released claims against Lenovo, and the remaining \$2,734 gain on settlement of escrow was recorded as other operating income.

**11. DISCONTINUED OPERATIONS**

In January 2007, the Company sold certain assets and liabilities constituting its financial services IT solutions business ( FIS ), which is grouped under the Company's Lenovo-AsiaInfo reportable segment, to Fidelity National Information Services, Inc. ( Fidelity ), a major U.S.-based provider of IT services and information products to financial institutions, for a maximum cash consideration valued at \$3,287 which was structured as follows: (1) \$1,517 was received from Fidelity upon closing; (2) \$379 escrow amount was transferred to an escrow agent by Fidelity upon closing; (3) \$379 will be contingent on the assignment of certain contracts; (4) \$1,012 will be contingent on an earn-out calculation. The management believes that there are uncertainties regarding the resolution of the \$379 contract assignment contingency and the \$1,012 earn-out contingency, and accordingly, deferred the recognition of the sale proceeds and certain directly related transaction costs based on those contingencies until they are resolved. The sale of the business is part of the Company's on-going strategy to divest operations that are not part of its core telecommunications software and information technology ( IT ) security products and services business.

The accompanying condensed consolidated statements of operations reflect FIS as discontinued operation. Please also refer to Note 4 to the Company's consolidated financial statements included in its annual report on Form 10-K for the fiscal year ended on December 31, 2006 for details of other discontinued operations. Results of discontinued operations are summarized as follows:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Revenue of discontinued component	\$	\$ 879	\$ 167	\$ 1,814
Income (loss) from operations of discontinued component		106	(91)	329
Gain on sales of discontinued component		140	1,536	140
Income tax				
Gain on discontinued operations	\$	\$ 246	\$ 1,445	\$ 469

**12. TRADE NOTES PAYABLE**

As of June 30, 2007 and December 31, 2006, the balances of trade notes payable of \$4,309 and \$4,045, respectively, represented commercial notes of \$197 and \$336, and bank acceptance drafts of \$4,112 and \$3,709, respectively, which are non-interest bearing and due within six months of issuance.

**13. INCOME TAXES**

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

Reconciliation between the provision for income taxes computed by applying the U.S. federal tax rate to income from continuing operations before income taxes and equity in loss of affiliate and the actual provision for income taxes is as follows:

	Six Months Ended	
	June 30,	
	2007	2006
US Federal Rate	35%	35%

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Difference between statutory rate and foreign effective tax rate	(30)	(25)
(Decrease) increase in valuation allowance	(4)	11
Subpart F income inclusion	7	
Stock-based compensation	6	
Nontaxable income on settlement of escrow	(5)	
Other permanent differences	(2)	(3)
	7%	18%

During the three months ended March 31, 2007, the Company recorded a one-time tax benefit of \$219 due to a retroactive change of enacted tax rate from 15% to 10% for AsiaInfo Technologies (China), Inc. ( AIBJ ) for taxable year 2006. The reduction in tax rate for AIBJ is a result of AIBJ being qualified as a Key Software Enterprise in China for fiscal year 2006, and therefore enjoying a 10% tax rate for income earned during 2006 according to government regulations.

---

## **Table of Contents**

Effective on January 1, 2007, the company adopted the provisions of FIN 48. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in any entity's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes* and prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Under FIN 48, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, FIN 48 provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006.

The total amount of unrecognized tax benefits as of the date of adoption was \$687. As a result of the implementation of FIN 48, the Company recognized a \$214 increase in the liability for unrecognized tax benefits which was accounted for as a reduction to the January 1, 2007 balance of retained earnings. In addition, consistent with the provisions of FIN 48, the Company reclassified \$473 unrecognized tax benefits from current to non-current because payment of cash is not anticipated within one year of the balance sheet date.

Included in the balance of unrecognized tax benefits at January 1, 2007, are \$687 of tax benefits that, if recognized, would affect the effective tax rate. None of the unrecognized benefit would affect deferred taxes or other tax accounts.

The Company has adopted the accounting policy that interest recognized in accordance with Paragraph 15 of FIN48 and penalties recognized in accordance with Paragraph 16 of FIN48 are classified as part of its income taxes. No interest and penalties were recognized in the statement of operations and statement of financial position as of December 31, 2006. The Company increased its accrual for interest and penalties to \$20 as of January 1, 2007.

The Company does not anticipate any significant change within 12 months of this reporting date of its uncertain tax positions.

The Company's operations are subject to income and transaction taxes in the United States and in certain foreign jurisdictions. Significant estimates and judgments are required in determining the Company's worldwide provision for income taxes. Some of these estimates are based on interpretations of existing tax laws or regulations. The ultimate amount of tax liability may be uncertain as a result.

Tax authorities challenge the allocation of profits between the Company's subsidiaries and may challenge certain tax benefits claimed on its tax returns, and the Company subject to higher tax rates or lose certain tax benefit that could result in higher tax rate.

The Company does not anticipate any events which could cause change to these uncertainties.

The Company is subject to taxation in the U.S. and various states and foreign jurisdictions. There are no ongoing examinations by taxing authorities at this time. The Company's various tax years starting from 2000 to 2006 are remaining open in various taxing jurisdictions.

On March 16, 2007, the Enterprise Income Tax Law of the People's Republic of China (the *New EIT Law*) was passed. It will become effective on January 1, 2008. Under the *New EIT Law*, a single set of laws shall apply to all enterprises, including domestic enterprises, FIEs and foreign enterprises, for tax purposes. The *New EIT Law* unifies the enterprise income tax rate at 25%. This rate is higher than the 15% to 24% rate currently enjoyed by some FIEs located in special zones or operating in certain industry sectors, but lower than the 33% rate currently applicable to other enterprises, including domestic enterprises. The *New EIT Law* contains grandfathering provisions for enterprises that have been established or approved to be established prior to its promulgation date. The *New EIT Law* also provides special tax incentives for certain industries and certain geographic locations, effective post January 1, 2008. No detailed rules have been published as of the date of this report regarding the various tax incentives provided by the *New EIT Law*. The Company anticipates that its subsidiaries in China will qualify for the tax incentives available for *High and New Technology Enterprises*, *Software Enterprises*, or *Advanced Technology Enterprises*, under the *New EIT Law*. If those subsidiaries do not qualify for these incentives, the tax rates will begin to increase in 2008, and will continue to increase until they reach 25% by 2012. Currently, the tax rates applicable to most of the income of the China subsidiaries are 13% to 15%.

## **14. STOCK-BASED COMPENSATION**

### *2002 Stock Option Plan and the prior plans*

Under the Company's 2002 Stock Option Plan, the Company was authorized to grant options for the purchase of up to 4,500,000 shares of common stock to employees, directors and consultants at prices not less than the fair market value on the date of grant for incentive stock options and nonqualified options. Shares as to which an option is granted under the 2002 Stock Option Plan but remains unexercised at the expiration, forfeiture or other termination of such option may be the subject of the grant of further options. Prior to adopting the 2002 Stock Option Plan, the Company adopted annual stock option plans for each of 1995, 1996, 1997, 1998, 1999 and 2000 (such plans, together with the

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

2002 Stock Option Plan, are referred to hereinafter as the Option Plans ).

The vesting periods of the options under the Option Plans are determined based on individual stock option agreements. Options granted prior to 1998 generally vest and become exercisable over three one-year cliffs at an equal annual rate. Exercise terms of options granted in 1998, 1999, 2000 and 2002 are substantially similar to those of options granted prior to 1998 except that the vesting and exercise periods are generally over four one-year cliffs at an annual rate of 20%, 20%, 30% and 30% for the 1999 plan and are generally over four one-year cliffs at an annual rate of 25%, 25%, 25% and 25% for the 2000 plan, and are generally no more than five years from the date of grant for 2002 Plan.

Option activity for the Option Plans is summarized as follows:

	Number of shares	Weighted average exercise price per share
Outstanding, January 1, 2007	6,167,157	\$ 7.26
Granted		
Cancelled or expired	(23,718)	8.10
Exercised	(702,875)	4.39
Outstanding, March 31, 2007	5,440,564	7.62
Granted		
Cancelled or expired	(22,814)	6.22
Exercised	(238,775)	4.42
Outstanding, June 30, 2007	5,178,975	7.78

**Table of Contents***2005 Stock Incentive Plan*

Under 2005 Stock Incentive Plan (the 2005 Plan ), the Company may grant participants restricted stock awards, stock options, or other types of equity incentives. The number of shares authorized for issuance is (a) 600,000 shares plus (b) any authorized shares of Common Stock that, as of April 21, 2005, were available for issuance under the Company's 2002 Stock Option Plan, or that thereafter become available for issuance under the 2002 Stock Option Plan in accordance with its terms.

A restricted stock unit ( RSU ) is an agreement to issue stock at the time the award vests. These units vest on an annual basis equally over four years, 25% on each anniversary of the grant date. RSUs as of June 30, 2007 and changes during the six months ended June 30, 2007 were as follows:

	Number of shares	Weighted average grant date fair value
RSUs unvested at January 1, 2007	394,773	\$ 4.21
Granted		
Vested		
Forfeited	(1,050)	4.05
RSUs unvested at March 31, 2007	393,723	4.21
Granted	5,000	7.87
Vested	(1,425)	4.35
Forfeited	(7,025)	4.05
RSUs unvested at June 30, 2007	390,273	4.26

In November 2006, the Compensation Committee of the Board of Directors of the Company approved another stock unit awards program under the 2005 Plan. Under this program, the Company was approved to grant no more than 2,213,068 shares of performance-based restricted stock units ( PSU ) and 1,995,000 PSUs were granted in November 2006. Unlike the previous RSUs, these awards will vest based on certain performance-based criteria, including annual earnings before interest and tax, annual net revenue growth, average stock closing price and new business revenue percentage, provided the award holder continues to be an employee of the Company at the time the performance goals are met. Each PSU represents the contingent right of the participant to receive a payment in respect of a share of common stock. PSUs as of June 30, 2007 and changes during the six months ended June 30, 2007 were as follows:

	Number of shares	Weighted average grant date fair value
PSUs unvested at January 1, 2007	1,995,000	\$ 4.22
Granted	30,000	5.96
Forfeited or expired		
Vested		
PSUs unvested at March 31, 2007	2,025,000	4.24
Granted	10,000	7.61
Forfeited or expired	(5,000)	4.22
Vested	(202,000)	5.03
PSUs unvested at June 30, 2007	1,828,000	4.17

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

### *Accounting for share-based compensation*

In December 2004, FASB issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)). Under the new standard, companies are no longer able to account for stock-based compensation transactions using the intrinsic value method in accordance with APB 25. Instead, companies are required to account for such transactions using a fair-value method and recognize the compensation expense.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123(R), using the modified prospective transition method and therefore has not restated the results from prior periods. Under this transition method, stock-based compensation expense recognized beginning January 1, 2006 includes: (a) compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006 based on the fair market value as of the grant date, measured in accordance with SFAS 123, and (b) compensation expense for all stock-based compensation awards granted on or subsequent to January 1, 2006, based on grant-date fair value estimated in accordance with the provisions of SFAS 123(R).

Fair values of RSUs and PSUs with performance conditions generally equal their intrinsic value on the date of grant. Fair values of PSUs with market conditions are calculated by an independent third-party appraiser which adopted a Monte-Carlo simulation model using assumptions underlying the Black-Scholes methodology.



**Table of Contents**

The Company recognizes the compensation costs net of a forfeiture rate and recognizes the compensation costs for those shares expected to vest on a straight-line basis over the requisite service period of the award, which is generally the vesting period. The estimate of forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized through a cumulative catch-up adjustment in the period of change and will also impact the amount of stock compensation expense to be recognized in future periods.

The amount of stock-based compensation attributable to cost of revenues, sales and marketing, general and administrative expenses, and research and development is included in those line items on the face of the statement of operations. Stock-based compensation expense related to the stock options, RSUs and PSUs under SFAS 123(R) was allocated as follows:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Cost of revenues	\$ 175	\$ 33	\$ 367	\$ 66
Sales and marketing	335	29	665	58
General and administrative	251	55	504	108
Research and development	151	20	315	40
<b>Total stock-based compensation expense</b>	<b>\$ 912</b>	<b>\$ 137</b>	<b>\$ 1,851</b>	<b>\$ 272</b>

**15. NET INCOME PER SHARE**

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

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
<b>Net income (numerator) basic and diluted</b>				
Income from continuing operations, net of taxes	\$ 2,498	\$ 1,102	\$ 7,449	\$ 1,239
Income from discontinued operations, net of taxes		246	1,445	469
<b>Net income</b>	<b>\$ 2,498</b>	<b>\$ 1,348</b>	<b>\$ 8,894</b>	<b>\$ 1,708</b>
<b>Shares (denominator)</b>				
Weighted average common stock outstanding				
Basic	43,231,164	43,941,763	43,191,216	44,693,342
Dilutive effect of stock-based compensation	1,819,756	974,937	1,678,525	941,633
<b>Diluted</b>	<b>45,050,920</b>	<b>44,916,700</b>	<b>44,869,741</b>	<b>45,634,975</b>
<b>Net income from continuing operations per share</b>				
Basic	\$ 0.06	\$ 0.02	\$ 0.17	\$ 0.03
Diluted	\$ 0.06	\$ 0.02	\$ 0.17	\$ 0.03
<b>Net income from discontinued operations, net of tax, per share</b>				
Basic	\$	\$ 0.01	\$ 0.04	\$ 0.01
Diluted	\$	\$ 0.01	\$ 0.03	\$ 0.01

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Net income per share						
Basic	\$	0.06	\$	0.03	\$ 0.21	\$ 0.04
Diluted	\$	0.06	\$	0.03	\$ 0.20	\$ 0.04

As of June 30, 2007 and 2006, 1,257,251 and 4,693,044 weighted-average dilutive potential shares of common stock have been excluded from the diluted earnings per share ( EPS ) calculation, respectively, as they are anti-dilutive. These shares could potentially have a dilutive effect on EPS in the future.

### 16. SEGMENT INFORMATION

Since the acquisition of the non-telecom IT services business of Lenovo in October 2004, the Company has been organized as two business units, AsiaInfo Technologies, encompassing the Company's traditional telecom business, and Lenovo-AsiaInfo, providing IT services, including IT security products and services, IT consulting, software customization, and business process outsourcing services, to the enterprise market in China. After disposing of certain non-core business lines during 2005, 2006, and 2007, Lenovo-AsiaInfo now focuses on IT security solutions for the small and medium enterprise market in China. Each business unit is further organized into three operating segments by product type: (1) software products and solutions, (2) service and (3) third party hardware. The Company follows the provisions of SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, which establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise about which discrete financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance.

**Table of Contents**

The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies included in the Company's audited financial statements on Form 10-K for the fiscal year ended December 31, 2006. The Company's chief operating decision making group is the Company's Business Committee, comprising the Company's Chief Executive Officer, Chief Financial Officer and its senior management team, who allocate resources and evaluate performance of segments based on the following table of condensed income statement and total assets. Accordingly, other items such as inter-segment sales, interest income (expense), income tax expense (benefit), depreciation and amortization are not disclosed by segment, since this information is not used by the Company's chief operating decision making group to assess the operating performance of individual segments.

The following is a condensed statement of operations and total assets for the Company's reportable segments:

	Three Months Ended June 30,					
	2007			2006		
	AsiaInfo Technologies	Lenovo- AsiaInfo	Total	AsiaInfo Technologies	Lenovo- AsiaInfo	Total
<b>Revenue:</b>						
Software products and solutions	\$ 19,000	\$ 3,406	\$ 22,406	\$ 14,943	\$ 1,204	\$ 16,147
Service	3,950	61	4,011	2,541	139	2,680
Third party hardware	2,306	847	3,153	3,925	382	4,307
<b>Total revenue:</b>	<b>25,256</b>	<b>4,314</b>	<b>29,570</b>	<b>21,409</b>	<b>1,725</b>	<b>23,134</b>
<b>Cost of revenues:</b>						
Software products and solutions	8,861	1,255	10,116	6,976	965	7,941
Service	1,842	138	1,980	1,786	225	2,011
Third party hardware	2,190	805	2,995	3,729	363	4,092
<b>Total cost of revenues</b>	<b>12,893</b>	<b>2,198</b>	<b>15,091</b>	<b>12,491</b>	<b>1,553</b>	<b>14,044</b>
<b>Gross Profit</b>	<b>12,363</b>	<b>2,116</b>	<b>14,479</b>	<b>8,918</b>	<b>172</b>	<b>9,090</b>
<b>Business unit expenses:</b>						
Sales and marketing	4,857	1,796	6,653	2,736	1,404	4,140
General and administrative <sup>(1)</sup>	343	4	347	105	(826)	(721)
Research and development	3,809	352	4,161	3,042	456	3,498
<b>Total business unit expenses</b>	<b>9,009</b>	<b>2,152</b>	<b>11,161</b>	<b>5,883</b>	<b>1,034</b>	<b>6,917</b>
<b>Contribution profit (loss)</b>	<b>\$ 3,354</b>	<b>\$ (36)</b>	<b>\$ 3,318</b>	<b>\$ 3,035</b>	<b>\$ (862)</b>	<b>\$ 2,173</b>

	Six Months Ended June 30,					
	2007			2006		
	AsiaInfo Technologies	Lenovo- AsiaInfo	Total	AsiaInfo Technologies	Lenovo- AsiaInfo	Total
<b>Revenue:</b>						
Software products and solutions	\$ 36,513	\$ 5,493	\$ 42,006	\$ 29,398	\$ 1,970	\$ 31,368
Service	7,415	165	7,580	5,564	271	5,835
Third party hardware	9,190	849	10,039	12,101	394	12,495
<b>Total revenue:</b>	<b>53,118</b>	<b>6,507</b>	<b>59,625</b>	<b>47,063</b>	<b>2,635</b>	<b>49,698</b>
<b>Cost of revenues:</b>						
Software products and solutions	17,117	1,972	19,089	13,773	1,443	15,216

Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Service	3,404	272	3,676	3,452	471	3,923
Third party hardware	8,730	807	9,537	11,497	374	11,871
Total cost of revenues	29,251	3,051	32,302	28,722	2,288	31,010
Gross Profit	23,867	3,456	27,323	18,341	347	18,688
Business unit expenses:						
Sales and marketing	9,243	3,480	12,723	5,368	2,722	8,090
General and administrative <sup>(1)</sup>	252	14	266	455	(335)	120
Research and development	7,482	765	8,247	5,784	918	6,702
Total business unit expenses	16,977	4,259	21,236	11,607	3,305	14,912
Other operating income		2,734	2,734			
Contribution profit (loss)	\$ 6,890	\$ 1,931	\$ 8,821	\$ 6,734	\$ (2,958)	\$ 3,776

**Table of Contents**

	As of June 30, 2007			As of December 31, 2006		
	AsiaInfo	Lenovo-		AsiaInfo	Lenovo-	
	Technologies	AsiaInfo	Total	Technologies	AsiaInfo	Total
Total assets <sup>(2)</sup>	\$ 179,951	\$ 67,228	\$ 247,179	\$ 215,775	\$ 28,387	\$ 244,162

(1) General and administrative expenses reported reflect only the direct controllable expenses of each business unit and do not include allocation of corporate general and administrative expenses. The 2006 balances in Lenovo-AsiaInfo segment primarily reflect the results of certain bad debt provision reversals recorded in the three months and six months ended June 30, 2006.

(2) Included in total assets are net accounts receivable of \$38,918 and \$2,236 for AsiaInfo Technologies and Lenovo-AsiaInfo at June 30, 2007, respectively, and \$33,284 and \$1,950 for AsiaInfo Technologies and Lenovo-AsiaInfo at December 31, 2006, respectively.

The following is a reconciliation of operating segment contribution profit to income before provision for income taxes:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Total contribution profit for reportable segments	\$ 3,318	\$ 2,173	\$ 8,821	\$ 3,776
Corporate general and administrative expenses	(2,123)	(1,996)	(4,152)	(4,311)
Net interest income	1,249	1,127	2,806	2,095
Gain on investments	556		581	
Other income (expense), net	52	3	(20)	(55)
Income before income taxes	\$ 3,052	\$ 1,307	\$ 8,036	\$ 1,505

For the three months and six months ended June 30, 2007 and 2006, almost all of the Company's revenues were derived from sales to customers in the PRC. Revenues are attributed to a country based on the country of installation of hardware, software and performance of system integration work and software related services. As of June 30, 2007 and December 31, 2006, 100% of the Company's long-lived assets were located in the PRC.

**17. RELATED PARTIES TRANSACTIONS**

The Company entered into a series of contractual agreements with Lenovo Group Limited and its affiliates (collectively "Lenovo") in connection with the acquisition of Lenovo's non-telecommunications IT services business in October 2004. In conjunction with that acquisition, the Company delivered 5,472,414 shares of its common stock to Lenovo. Among them, 648,769 shares were returned to the Company from the escrow account in February 2007. As of June 30, 2007, Lenovo owned approximately 9 percent of the Company's outstanding common stock.

Edward Tian, a Director and major shareholder of the Company, was, until May 2006, the Vice President of China Network Communications Group Corporation (together with its affiliates, referred to as "China Netcom Group"), and an executive officer of both China Netcom Group Corporation (Hong Kong) Limited ("China Netcom Hong Kong") and China Netcom (Group) Company Limited ("China Netcom Limited"), each of which is a subsidiary of the China Network Communications Group Corporation. Effective May 17, 2006, Mr. Tian resigned as the Vice President of China Network Communications Group Corporation, as well as from his position as an executive officer of China Netcom Hong Kong and China Netcom Limited, but would serve as a non-executive Director as well as the Vice Chairman of the Board of Directors of China Netcom Hong Kong. Effective July 12, 2007, Mr. Tian resigned as a non-executive Director and Vice Chairman of the Board of Directors of China Netcom Hong Kong. In the three months and six months ended June 30, 2006, the Company entered into network solutions and software revenue contracts with China Netcom Group with aggregate contract value of approximately \$4,659 and \$8,214, respectively.

The following table provides a summary of the Company's transactions with Lenovo and China Netcom Group:

Three Months Ended June 30,

Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

	2007		2006	
			China	
			Netcom	
	Lenovo	Lenovo	Group	Total
<b>Revenues:</b>				
Software products and solutions	\$	\$	\$ 1,526	\$ 1,526
Service			669	669
Third party hardware			557	557
<b>Total revenues</b>			<b>2,752</b>	<b>2,752</b>
<b>Purchases:</b>				
Software products and solutions			11	11
Service			3	3
Third party hardware		583		
<b>Total purchases</b>		<b>583</b>	<b>14</b>	<b>14</b>
<b>Operating expenses:</b>				
Sales and marketing	18	12	6	18
General and administrative			3	3
Research and development	1	1	10	11
<b>Total operating expenses</b>	<b>\$ 19</b>	<b>\$ 13</b>	<b>\$ 19</b>	<b>\$ 32</b>

**Table of Contents**

	Six Months Ended June 30,			
	2007		2006	
	China			
	Netcom			
	Lenovo	Lenovo	Group	Total
<b>Revenues:</b>				
Software products and solutions	\$	\$	\$ 2,643	\$ 2,643
Service			1,348	1,348
Third party hardware			2,686	2,686
<b>Total revenues</b>			<b>6,677</b>	<b>6,677</b>
<b>Purchases:</b>				
Software products and solutions	1	9	22	31
Service			9	9
Third party hardware	583			
<b>Total purchases</b>	<b>584</b>	<b>9</b>	<b>31</b>	<b>40</b>
<b>Operating expenses:</b>				
Sales and marketing	43	35	12	47
General and administrative			7	7
Research and development	2	3	20	23
<b>Total operating expenses</b>	<b>\$ 45</b>	<b>\$ 38</b>	<b>\$ 39</b>	<b>\$ 77</b>

	As of June 30, 2007	As of December 31, 2006
	Lenovo	Lenovo
<b>Balances with related parties:</b>		
Prepaid expenses and other current assets	\$	\$ 241
Net accounts receivable	4	3
Other receivables	207	296
Deferred revenue	348	339
Other payables	702	685

James Ding, a major shareholder of the Company and Chairman of its Board of Directors, is also the Chairman of the Board of Directors of Beijing UITV Culture Development Ltd. ( Beijing UITV ). During the three months and six months ended June 30, 2007, the Company did not enter into any software solution contracts with Beijing UITV. During the three months and six months ended June 30, 2006, the Company entered into software solution contracts with Beijing UITV valued at approximately \$18 and \$62, respectively. The Company did not record any software products and solutions revenue in the three months and six months ended June 30, 2007. The Company recorded \$18 and \$59 of software products and solutions revenue in the three months and six months ended June 30, 2006, respectively. As of June 30, 2007 and December 31, 2006, the Company had no account receivable from Beijing UITV.

The Company believes that all transactions with related parties were arm's length negotiated transactions on terms that are no less favorable than terms that would have been received from an unrelated party.

**18. COMMITMENTS AND CONTINGENCIES**

On December 4, 2001, a securities class action case was filed in New York City against the Company, certain of its officers and directors and the underwriters of the Company's initial public offering ( IPO ). The lawsuit alleged violations of the U.S. federal securities laws and was docketed in the United States District Court for the Southern District of New York 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 of their purchasing shares in the Company's

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

IPO. The lawsuit further claimed that the alleged 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.



## **Table of Contents**

In June 2003, based on a decision made by a special independent committee of its Board, the Company elected to participate in a proposed settlement agreement with the plaintiffs in this litigation. The proposed settlement contemplated 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. The proposed settlement also contemplated that the Company would assign any claims it may have against the underwriters of its IPO for excess commissions to the plaintiffs.

On October 13, 2004, the District Court certified six representative cases (out of hundreds of IPO cases that have been filed) as class actions. These cases were designated "focus cases" and the Court's rulings in those cases going forward were intended to be templates for the remaining hundreds of cases. After objection from the underwriter defendants to the appropriateness of treating these cases as class actions, the Second Circuit Court of Appeals heard the underwriter defendants' appeal of the District Court's class certification decision, and on April 6, 2007 ruled that none of the six focus cases can be certified as a class action.

Based on the rulings from the Second Circuit Court of Appeals regarding class certification, the District Court entered an order formally removing the proposed settlement from the Court's docket. The plaintiffs asked the Court to certify new proposed classes of IPO investors and the Court set dates by when the parties must file briefs addressing the viability of the plaintiffs' new proposed classes, with the plaintiffs' opening briefs due on September 27, 2007, the defendants' opposition briefs due on December 21, 2007, and plaintiffs' briefs responding to the defendants' arguments due on February 15, 2008. If the litigation proceeds, The Company intends to continue to defend the litigation vigorously. Moreover, if the litigation proceeds, the Company believes that the underwriters may have an obligation to indemnify us for the legal fees and other costs of defending this suit and that our 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, it believes that the final result of these actions will have no material effect on our consolidated financial condition, results of operations or cash flows.

## **19. SUBSEQUENT EVENT**

On July 19, 2007, the Company entered into an Acquisition Agreement (the "Agreement") with Shenzhen Modern Computer Manufacturer Co., Ltd. ("Shenzhen Modern"), a China-based provider of information technology services and software products. Under the Agreement, the Company will acquire certain assets constituting Shenzhen Modern's telecom support systems business, including its business support systems business (the "Business").

According to the terms of the Agreement, the Company has agreed to purchase the Business in exchange for a cash payment that will be based on the contract revenues from certain customer contracts to be acquired in the acquisition. Payments will be made in installments, subject to the fulfillment of certain milestones. Closing of the transaction contemplated by the Agreement also is subject to customary closing terms and conditions. The Company believes that the transaction furthers its on-going strategy of expanding its market-leading telecommunications software solutions business in China.

**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, as amended, the Exchange Act, the Private Securities Litigation Reform Act of 1995, or 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 differ materially from those expressed in the statements. All forward-looking statements included in this report 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. The factors that could cause actual results to differ materially include, but are not limited to, the factors discussed below under Item 1A. Risk Factors in Part II Other Information.

In this report, AsiaInfo, the Company, we, us and our refer to AsiaInfo Holdings Inc., its subsidiaries and consolidated variable interest entities.

**Overview**

We are a leading provider of high-quality telecom software solutions and IT security products and services in China. As an established leader in the Chinese telecommunications industry, we became a leading provider of IT security products and services in China with the acquisition of the non-telecommunications related IT services business of Lenovo Group Limited ( Lenovo ) in 2004. In the telecommunications market, our software products and services enable our customers to build, maintain, operate, manage and continuously improve their communications infrastructure and services. Our largest customers are the major telecommunications carriers in China and their provincial subsidiaries, such as China Mobile Communications Corporation ( China Mobile ), China United Telecommunications Corporation ( China Unicom ), China Network Communications Group Corporation ( China Netcom ), and China Telecommunications Corporation ( China Telecom ). In addition to providing customized software solutions to China's telecom carriers, we also offer sophisticated IT security products and services to many small and medium sized companies in China.

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, most of which are Chinese companies.

We have derived, and believe that we will continue to derive, a significant portion of our revenues from a limited number of large telecommunications customers, such as China Mobile, China Unicom, China Netcom and China Telecom. Sales to China Mobile and its subsidiaries amounted to approximately 61%, 51% and 50% of our total revenues in 2006, 2005 and 2004, respectively. Sales to China Unicom and its subsidiaries amounted to approximately 14%, 20% and 24% of our total revenues in 2006, 2005 and 2004, respectively. Sales to China Netcom and its subsidiaries amounted to approximately 12%, 12% and 9% of our total revenues in 2006, 2005 and 2004, respectively. Sales to China Telecom and its subsidiaries amounted to approximately 5%, 3% and 3% of our total revenues in 2006, 2005 and 2004, respectively. The sum of our top five receivable balances represented 95% and 93% of our total receivable balances as at December 31, 2006 and 2005, respectively.

As a result of our reliance on key customers in the telecommunications industry, our operating results are influenced by governmental spending policies in that sector. Historically, a number of state-mandated restructurings in China's telecommunications sector have led to cancellation or delays in telecommunications-related capital expenditure, and have negatively impacted our operating results in certain periods. Ongoing uncertainty in the telecommunications industry, combined with the Chinese government's measures to control over-heating of the Chinese economy, has contributed and may continue to contribute to cautious spending by our telecommunications customers. In addition, any future restructurings affecting our major telecommunications customers may result in delays or cancellation of telecommunications-related spending, which would likely have an adverse impact on our business.

In the fourth quarter of 2004, we acquired the non-telecommunications-related IT services division of Lenovo Group Limited ( Lenovo ), in a transaction valued at approximately \$36.8 million. As of June 30, 2007, Lenovo owned approximately 9% of our outstanding common stock. In connection with the acquisition, we have been organized as two business divisions, AsiaInfo Technologies, encompassing our traditional telecommunications business, and Lenovo-AsiaInfo, providing IT security products and services to China's enterprise market. Each business division is further organized into three operating segments by product types: (1) software products and solutions, (2) service, and (3) third party hardware. In 2006, the Lenovo-AsiaInfo division generated approximately \$9.1 million in revenue, representing more than 8% of our total revenues for the year.

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

We remain on the look-out for attractively-priced acquisitions that can be easily integrated into our existing operations and that will contribute to our expansion of market share. In May 2006, we signed two agreements to acquire certain telecom businesses of Shanghai Emice Information Technology Co., Ltd and Beijing GCTech Company Limited, respectively. These acquisitions are consistent with our strategy of expanding our high-margin telecom software solutions business and enhancing our telecommunication software solutions offerings.

**Table of Contents**

In line with our on-going strategy to divest operations that are not part of our core telecommunications software and IT security products and services business, in December 2006, we signed an agreement with Fidelity to sell certain assets comprising our financial services IT solutions business.

For details regarding these acquisitions, please refer to Note 3 of the accompanying notes included in our audited financial statements in our report on Form 10-K for the fiscal year ended December 31, 2006.

**Recent Developments**

In the quarter ended June 30, 2007, we experienced healthy demand for our market leading telecom software solutions as telecom operators develop systems tailored to specific end-user needs and market segments. We signed contracts to upgrade China Mobile's business intelligence system in Chongqing, to expand China Netcom's broadband billing system in Zhejiang province, and to upgrade China Unicom's billing and customer relationship management system in Jiangsu province to help support their new GPRS services.

In early July, we also signed a contract with China Mobile to service the deployment of their next generation Internet Protocol (IP) infrastructure.

**Revenues**

We report our revenues on the basis of the three principal types of revenues derived from our business: software products and solutions revenue, service revenue and third party hardware revenue. Please refer to Note 16 to the Condensed Consolidated Financial Statements included in this report for detailed financial information regarding segment reporting.

**Software products and solutions revenue.** We typically sell our software as part of a total solution package for our customers, which includes 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. Software products and solutions revenue includes 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 or 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, 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 reflect 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. We also record reductions from revenue for our estimates of expected software sales returns from distributors based on current sales and historical sales returns.

**Service revenue.** Service revenue consists of revenue from professional services, including IT services, management consulting, and revenues for network planning, design, systems integration and training services.

**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 typically minimize our exposure to hardware inventory risks by sourcing equipment from hardware vendors against letters of credit from our customers. As the telecommunications-related IT services market in China develops, our customers are increasingly purchasing hardware directly from hardware vendors and retaining us for our software and professional services.

**Net revenue.** Although we report our revenue on a gross basis, inclusive of hardware acquisition costs, 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 revenue as against prior periods, but will not adversely impact revenue net of hardware costs. The following table shows our revenue breakdown on this basis and reconciles our net revenues to total revenues:

		Three Months Ended June 30,	
2007		2006	
	Total		Total

Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

	AsiaInfo Technologies	Lenovo- AsiaInfo		AsiaInfo Technologies	Lenovo- AsiaInfo	
<b>Revenues net of hardware costs:</b>						
Software products and solutions revenue	\$ 19,000	\$ 3,406	\$ 22,406	\$ 14,943	\$ 1,204	\$ 16,147
Service revenue	3,950	61	4,011	2,541	139	2,680
Third party hardware revenue net of hardware costs	116	42	158	196	19	215
<b>Total revenues net of hardware costs</b>	<b>23,066</b>	<b>3,509</b>	<b>26,575</b>	<b>17,680</b>	<b>1,362</b>	<b>19,042</b>
Total hardware costs	2,190	805	2,995	3,729	363	4,092
<b>Total revenues</b>	<b>\$ 25,256</b>	<b>\$ 4,314</b>	<b>\$ 29,570</b>	<b>\$ 21,409</b>	<b>\$ 1,725</b>	<b>\$ 23,134</b>

**Table of Contents**

	Six Months Ended June 30,					
	2007			2006		
	AsiaInfo Technologies	Lenovo- AsiaInfo	Total	AsiaInfo Technologies	Lenovo- AsiaInfo	Total
Revenues net of hardware costs:						
Software products and solutions revenue	\$ 36,513	\$ 5,493	\$ 42,006	\$ 29,398	\$ 1,970	\$ 31,368
Service revenue	7,415	165	7,580	5,564	271	5,835
Third party hardware revenue net of hardware costs	460	42	502	604	20	624
<b>Total revenues net of hardware costs</b>	<b>44,388</b>	<b>5,700</b>	<b>50,088</b>	<b>35,566</b>	<b>2,261</b>	<b>37,827</b>
Total hardware costs	8,730	807	9,537	11,497	374	11,871
<b>Total revenues</b>	<b>\$ 53,118</b>	<b>\$ 6,507</b>	<b>\$ 59,625</b>	<b>\$ 47,063</b>	<b>\$ 2,635</b>	<b>\$ 49,698</b>

Total revenues net of hardware cost, or net revenue, is a Non-GAAP financial measure as defined by applicable federal securities regulations. We believe total revenues net of hardware costs in each of the segments of our business more accurately reflects our core business, which is the provision of software solutions and services, and provides transparency to our investors. We believe this measure provides transparency to our investors because it is the measure used by our management to evaluate the competitiveness and performance of our business in each of the segments. 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 third party hardware costs allows investors to better evaluate the performance of our core business and we have provided a reconciliation of this measure to the most directly comparable US GAAP financial measure, total revenues, above.

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 US 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 or have the right to select suppliers.

**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;

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 as well as the amortization expenses of acquired intangible assets.

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

**Service costs.** Service costs consist primarily of compensation and travel expenses for the professionals involved in designing and implementing IT services, management consulting and network solutions projects. Service costs also include 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. Our estimates of warranty cost are based on our current experience with contracts for which the warranty period has expired.

**Third party 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 impairment of goodwill and intangible assets. Stock-based compensation expenses attributable to cost of revenues, sales and marketing, general and administrative, and research and development expenses are included in those line items on the face of the statement of operations.

Sales and marketing expenses include compensation expenses for employees in our sales and marketing departments, third party advertising expenses, amortization expense of acquired intangible assets, as well as sales commissions and sales agency fees.

---

## **Table of Contents**

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 old enterprise income tax laws of China, foreign invested enterprises, or FIEs, satisfying certain criteria can enjoy preferential tax treatment. Several of our operating subsidiaries are FIEs and enjoy certain preferential tax treatments in China. Please refer to Note 15 to our consolidated financial statements included in our annual report on Form 10-K for the fiscal year ended on December 31, 2006 for details of the preferential tax treatment for these subsidiaries.

On March 16 2007, the Enterprise Income Tax Law of the People's Republic of China (the New EIT Law) was passed. It will become effective on January 1, 2008. Under the New EIT Law, a single set of laws shall apply to all enterprises, including domestic enterprises, FIEs and foreign enterprises, for tax purposes. The New EIT Law unifies the enterprise income tax rate at 25%. This rate is higher than the 15% to 24% rate currently enjoyed by some FIEs located in special zones or operating in certain industry sectors, but lower than the 33% rate currently applicable to other enterprises, including domestic enterprises. The New EIT Law contains grandfathering provisions for enterprises that have been established or approved to be established prior to its promulgation date. The New EIT Law also provides special tax incentives for certain industries and certain geographic locations, effective post January 1, 2008. No detailed rules have been published as of the date of this report regarding the various tax incentives provided by the New EIT Law.

We anticipate that our subsidiaries in China will qualify for the tax incentives available for High and New Technology Enterprises, Software Enterprises, or Advanced Technology Enterprises, under the New EIT Law. If they do not qualify for these incentives, the tax rates will begin to increase in 2008, and will continue to increase until they reach 25% by 2012. Currently, the tax rates applicable to most of the income of the China subsidiaries are 13% to 15%.

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. 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 and software-related services, the excess portion of the value-added tax is refundable immediately. This policy is effective until 2010. The benefit of the rebate of value added taxes is included in software revenue.

Our PRC subsidiaries are subject to business tax at the rate of 5% on certain types of service revenues and the revenues are presented net of business tax incurred.

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. In addition, certain passive investment income earned by some of our subsidiaries is subject to U.S. income taxes currently at the U.S. statutory rate and offset by allowable foreign tax credits.

### **Foreign Exchange**

A majority of our revenues and expenses relating to hardware sales 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. We did not engage in any significant foreign exchange transactions in the three-month period ended June 30, 2007.

Pursuant to the rate of exchange quoted by China's central bank, as of June 30, 2007 the exchange rate between the U.S. dollar and the Renminbi was US\$1.00 = RMB 7.6155.



**Critical Accounting Policies**

We prepare our consolidated financial statements in accordance with US GAAP. 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, as well as 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, inventory allowance provisions, income taxes, 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.

---

**Table of Contents**

**Revenue recognition.** Our revenue is derived from three primary sources: (i) the procurement of hardware on behalf of customers, (ii) software license and related services, including assistance in implementation, customization and integration, post-contract customer support, training and consulting; and (iii) professional services for systems design, planning, consulting, and system integration. Revenues from customer orders requiring significant production, modifications, or customization of the software are recognized over the installation and customization period based on the percentage of completion method as prescribed by Statement of Position No. 81-1, Accounting for Performance of Construction-Type and Certain Product-Type Contracts ( SOP 81-1 ). 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. 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. On contracts that do not involve significant implementation or customization essential to the functionality of our product, license fees through both direct or reseller arrangements are recorded when there is persuasive evidence of an arrangement for a fixed or determinable fee that is probable of collection and when the related products are shipped and/or installed as prescribed by SOP No. 97-2, Software Revenue Recognition. ( SOP 97-2 ) . For consulting and other professional services, we recognize our service revenue as such services are performed or ratably over the contractual period and recognizes the costs associated with these contracts as incurred.

We record software sales of information security products, net of estimated sales returns, upon shipment to the distributors. For arrangements with multiple elements, we allocate revenue to each element of a transaction based upon its relative fair value as determined by vendor specific objective evidence ( VSOE ). We defer revenue for the fair value of its undelivered elements and recognize revenue for the remainder of the contractual arrangement fee attributable to the delivered elements when the basic criteria of SOP 97-2 have been met. If the only undelivered element is post contract support ( PCS ) for which we have established VSOE, we recognize the difference between the total arrangement fee and the amount deferred for PCS as revenue upon delivery. The PCS revenue is recognized ratably over the PCS term. If the costs related to PCS are insignificant and for a period of up to one year, which include telephone support, we accrue the costs at the time the revenue is recorded.

Revenue in excess of billings is recorded as unbilled receivables and amounts billed but not yet collected are recorded as billed receivables. Billings in excess of revenues recognized are recorded as deferred revenue. 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 assets in the future, an adjustment to the valuation allowance would be charged to the Statement of Operations in the period such determination was made.

**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. We perform all goodwill impairment tests in the fourth quarter of each year. The latest goodwill impairment tests were performed in the fourth quarter of 2006 and no impairment losses were recognized.

**Stock-based compensation.** Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS 123R, using the modified prospective transition method and therefore we have not restated prior periods' results. Under this transition method, stock-based compensation expense for the first three quarters of fiscal year 2006 included compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006 based on the fair market value as of the grant date, measured in accordance with SFAS 123. We recognize the compensation costs net of a forfeiture rate and recognize the compensation costs for those shares expected to vest on a straight-line basis over the requisite service period of the award, which is generally the restricted stock unit and option vesting term of four years. We estimated the forfeiture rate of restricted stock units based on our historical experience for the options during the preceding four fiscal years. The amount of stock-based compensation attributable to cost of revenues, sales and marketing, general and administrative expenses, and research and development are included in those line items on the face of the statement of operations. We did not expect any tax benefits resulting from tax deductions in excess of the compensation cost recognized and therefore no deferred tax assets were recorded upon the adoption of SFAS 123R. For the three-month and six month periods ended June 30, 2007, we recorded \$0.9 million and \$1.9 million of stock-based compensation expense, respectively, and the adoption of FAS 123R has had no material effect on our results of operations and financial condition.



---

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

**Revenues.** Gross revenues were \$ 29.6 million for the three-month period ended June 30, 2007, 28% higher than the year ago period and down 2% sequentially. Gross revenues were \$59.6 million for the six-month period ended June 30, 2007, representing an increase of 20% over the comparable period in 2006. The overall year-over-year increases in gross revenues are largely the result of increases in software products and solutions revenues and serviced revenues described below. The sequential decreases in gross revenue were due to the decrease of third-party hardware revenue, which tends to fluctuate from period to period depending on the requirements of our customers.

Software products and solutions revenue was \$22.4 million and \$42.0 million, respectively, for the three-month and six-month periods ended June 30, 2007, representing increases of 39% and 34% over the comparable periods in 2006 and a 14% sequential increase. The increases in software products and solutions revenue were mainly due to the continuous growth in our telecommunications software business. During the second quarter, we deployed software solutions for telecommunications customers in areas including billing, customer relationship management, and business intelligence. Second quarter telecom software products and solutions revenue rose 27% year-over-year as telecom customers upgraded and expanded their BOSS systems and invested in more sophisticated technologies. Sequentially, telecom software products and solutions revenue rose 8% from the previous quarter.

Service revenue was \$4.0 million and \$7.6 million in the three-month and six-month periods ended June 30, 2007, representing increases of 50% and 30% against the comparable periods in 2006 and a 12% increase over the previous quarter. The increase in service revenue was primarily due to continuous growth in our telecommunication software business, which generates more need for service from our customers.

Third party hardware revenue for the three-month and six-month periods ended June 30, 2007 was \$3.2 million and \$10.0 million, 27% and 20% decreases over the comparable periods in 2006 and a 54% decrease sequentially. Third party hardware revenue has been generally decreasing in the past several years as we have increasingly focused on our high-margin software product and solutions business; however, from time to time we offer third party hardware for certain projects in response to customer requests.

Our Lenovo-AsiaInfo division contributed 15% to our gross revenues in the three-month period ended June 30, 2007, including a 15% contribution to software products and solutions revenue and a 2% contribution to service revenue. Lenovo-AsiaInfo contributed 7% to our gross revenue in the year-ago period and 7% in the preceding quarter.

During the second quarter, sales to our top four customers (China Mobile, China Unicom, China Netcom and China Telecom) accounted for approximately 85% of our total revenue.

**Cost of revenues.** Our cost of revenues increased 7% to \$15.1 million and increased 4% to \$32.3 million, respectively, in the three-month and six-month periods ended June 30, 2007, compared to \$14.0 million and \$31.0 million in the comparable periods of 2006. The year-over-year increase in cost of revenues is slower than the revenue growth, reflecting the declining proportion of low margin third party hardware revenue in our total revenues. Our cost of revenue declined 12% over the previous quarter, due to the decrease in third party hardware sales.

**Gross profit.** Our gross profit margin increased from 39% in the same period last year to 49% in the three-month period ended June 30 2007. Sequentially, our gross profit margin increased from 43% to 49%. The improvement in gross margin reflects execution of our long-term strategy to focus on high margin software solutions, as well as the improving operating results of our Lenovo-AsiaInfo division.

During the second quarter, our telecommunications business posted a contribution profit, before corporate general and administrative expenses, of \$3.4 million, increasing by 11% over the same period last year and decreasing 5% sequentially. The year-over-year increase was largely due to the increases in revenues from telecommunication software solutions and services, while the sequential decrease was largely due to the increase in general and administrative expenses and sales and marketing expenses discussed below. Lenovo-AsiaInfo posted a contribution loss, before corporate general and administrative expenses, of \$0.03 million, compared to a loss of \$0.86 million in the comparable period of 2006, and a profit of \$2.0 million in the previous quarter, which included \$2.7 million in one-off other operating income.

**Operating expenses.** Our operating expenses in the second quarter of 2007 were \$13.3 million, representing an increase of 49% over the comparable period in 2006 and a 10% sequential increase. The increase was due to increased sales and marketing, research and development, and general and administrative expenses discussed below.

Sales and marketing expenses were \$6.7 million for the second quarter of 2007, representing increases of 61% over the comparable periods in 2006 and a 10% sequential increase. The increases were primarily due to our greater marketing efforts, which are intended to expand our customer base and help us take advantage of new market opportunities.

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

General and administrative expenses were \$2.5 million for the second quarter of 2007, representing an increase of 94% over the comparable period in 2006 and 27% sequentially. The increases in general and administrative expenses were primarily due to recovery of bad debt expense in the comparable period of 2006 and the preceding quarter.

Research and development expenses were \$4.2 million for second quarter of 2007, representing an increase of 19% over the comparable period in 2006 and a 2% sequential increase. The increases were in line with our strategy of continuing to invest in our research and development capabilities and position AsiaInfo for future market opportunities.

**Total other income.** Total other income including interest income, gain on investment, and other income in the second quarter of 2007 was \$1.9 million, representing an increase of 64% over the comparable period in 2006 and a 23% sequential increase. The increase was primarily due to gain incurred from sales of short-term investments during the second quarter of 2007.

**Net income from continuing operations.** Net income from continuing operations for the second quarter of 2007 was \$2.5 million, or \$0.06 per basic share. Net income in the year-ago period was \$1.1 million or \$0.02 per basic share, and \$5.0 million or \$0.12 per basic share in the previous quarter.

## **Table of Contents**

**Net income.** Net income for the second quarter of 2007 was \$2.5 million, or \$0.06 per basic share, compared to \$1.3 million, or \$0.03 per basic share, for the year-ago period, and \$6.4 million, or \$0.15 per basic share, for the previous quarter.

## **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. With respect to our billing cycle, we generally require our customers to pay 80% to 90% of the invoice value of the hardware upon delivery. We typically place orders for hardware against back-to-back orders from customers and seek favorable payment terms from hardware vendors. However, we sometimes obtain less favorable payment terms from our customers, thereby increasing our working capital requirements. In addition to this careful management of our billing cycle, we have also historically financed working capital and other financing requirements through private placements of equity securities, our initial public offering in March of 2000 and, to a limited extent, bank loans.

Our net cash used in operating activities for the six-month period ended June 30, 2007 was \$11.8 million. This was primarily attributable to our net income of \$8.9 million, adjusted by a net non-cash related gain of \$1.8 million, and a net increase in the components of our working capital of \$18.9 million.

Our accounts receivable balance at June 30, 2007 was \$41.2 million, consisting of \$19.4 million in billed receivables and \$21.8 million in unbilled receivables. Our billed receivables are recorded based on agreed milestones included in customer contracts. 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. Our day's sales outstanding at June 30, 2007 were 116 days, as compared to last quarter's 117 days.

Our inventory position at the end of the second quarter of 2007 was approximately \$5.9 million, a decrease of \$0.6 million as compared to December 31, 2006. The sequential decrease was mainly due to decreased third-party hardware and software procurement.

Our net cash used in investing activities for the six-month period ended June 30, 2007 was \$10.6 million. This was primarily due to purchase of short-term investments of \$25.2 million, which was partially offset by proceeds from sale of short-term investment of \$14.6 million.

Our net cash provided by financing activities for the six-month period ended June 30, 2007 was \$4.1 million. This was primarily due to proceeds generated by the exercise of stock options.

As of June 30, 2007, we had total short-term credit facilities for working capital purposes totaling \$41.0 million, expiring by March 2008, which were secured by bank deposits of \$11.8 million. At June 30, 2007, unused short-term credit facilities were \$36.6 million and used facilities totaled \$4.4 million. The used facilities were pledged as security for issuing standby letters of credit and trade notes payable to hardware suppliers and customers. Additional bank deposits of \$1.3 million were used for issuing standby letters of credit and bank acceptance drafts as of June 30, 2007. Bank deposits pledged as security for these credit facilities totaled \$13.1 million as of June 30, 2007 and are presented as restricted cash in our consolidated balance sheets.

We anticipate that our available funds and cash flows generated from operations will be sufficient to meet our anticipated needs for working capital, capital expenditures and business expansion through 2007. We may need to raise additional funds in the future, however, in order to fund acquisitions, develop new or enhanced services or products, respond to competitive pressures to compete successfully for larger projects involving higher levels of hardware purchases, or if our business otherwise grows more rapidly than we currently predict. We anticipate that we would raise additional funds, if necessary, through new issuances of shares of our equity securities in one or more public offerings or private placements, or through credit facilities extended by lending institutions.

In the event that we decide to pay dividends to our stockholders, our ability to pay dividends will depend in part on our ability to receive dividends from our operating subsidiaries in China. Foreign exchange and other regulations in China may restrict our ability to distribute retained earnings from our operating subsidiaries in China or convert those payments from Renminbi into foreign currencies.

## **Off-Balance Sheet Arrangements**

As of June 30, 2007, we have not entered into any material off-balance sheet arrangements with any individuals or entities.

## **Accounting Pronouncements**

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115 (SFAS 159). SFAS159 provides companies with an option to report selected financial assets and liabilities at fair value. The standard requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company's choice to use fair value on its earnings. It also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. This Statement is effective as of the beginning of an entity's first fiscal year beginning after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year provided that the entity makes that choice in the first 120 days of that fiscal year and also elects to apply the provisions of Statement 157. We are currently evaluating whether the adoption of SFAS 159 will have a material effect on our consolidated results of operations and financial condition.

---

**Table of Contents**

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157), which provides enhanced guidance for using fair value to measure assets and liabilities. This standard also responds to investors' requests for expanded information about the extent to which company's measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 12, 2007, and interim periods within those fiscal years. Early adoption is permitted. We are currently evaluating whether the adoption of SFAS157 will have a material effect on our consolidated results of operations and financial condition.

For information concerning certain risks that may affect our operating results and the value of our Common Stock, please see Item 1A. Risk Factors in Part II Other Information.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to interest rate risk primarily associated with our cash and short-term investments. To date, we have not entered into any types of derivatives to hedge against interest-rate changes. There have been no significant changes in our exposure to changes in interest rates for the quarter ended June 30, 2007. Our exposure to interest rate changes is limited as we do not have any material borrowings.

We are exposed to exchange rate risk in connection with the relative value of the U.S. dollar and the Renminbi. Substantially all of our revenues and expenses relating to the service and software components of our business are denominated in Renminbi. As of June 30, 2007, the rate of exchange quoted by the People's Bank of China was US\$1.00 = RMB7.6155. If the exchange rate were to increase by 10% to US\$1.00 = RMB8.3771, our net assets would potentially decrease by \$10.7 million. If the exchange rate were to decrease by 10% to US\$1.00 = RMB6.8540, our net assets would potentially increase by \$13.1 million.

The value of our shares may 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 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 risk. We did not engage in any significant foreign exchange transactions during the six-month period ended June 30, 2007.

As in any other business, we are subject to the risk of macroeconomic changes such as recessions and inflation.

**ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-14 under the Exchange Act as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective.

**Changes in Internal Control over Financial Reporting**

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended June 30, 2007, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



---

**Table of Contents****PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

On December 4, 2001, a securities class action case was filed in New York City against us, certain of our officers and directors and the underwriters of our initial public offering, or IPO. The lawsuit alleged violations of the U.S. federal securities laws and was docketed in the United States District Court for the Southern District of New York as *Hassan v. AsiaInfo Holdings, Inc., et al.* The lawsuit alleged, among other things, that the underwriters of our IPO improperly required their customers to pay the underwriters excessive commissions and to agree to buy additional shares of our common stock in the aftermarket as conditions of their purchasing shares in our IPO. The lawsuit further claimed that the alleged practices of the underwriters should have been disclosed in our IPO prospectus and registration statement. The suit seeks rescission of the plaintiffs' alleged purchases of our common stock as well as unspecified damages. In addition to the case against us, 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 us, have all been transferred to a single federal district judge for purposes of case management.

In June 2003, based on a decision made by a special independent committee of our Board, we elected to participate in a proposed settlement agreement with the plaintiffs in this litigation. The proposed settlement contemplated 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. The proposed settlement also contemplated that we would assign any claims we may have against the underwriters of our IPO for excess commissions to the plaintiffs.

On October 13, 2004, the District Court certified six representative cases (out of hundreds of IPO cases that have been filed) as class actions. These cases were designated "focus cases" and the Court's rulings in those cases going forward were intended to be templates for the remaining hundreds of cases. After objection from the underwriter defendants to the appropriateness of treating these cases as class actions, the Second Circuit Court of Appeals heard the underwriter defendants' appeal of the District Court's class certification decision and on April 6, 2007 ruled that none of the six focus cases can be certified as a class action.

Based on the rulings from the Second Circuit Court of Appeals regarding class certification, the District Court entered an order formally removing the proposed settlement from the Court's docket. The plaintiffs asked the Court to certify new proposed classes of IPO investors and the Court set dates by when the parties must file briefs addressing the viability of the plaintiffs' new proposed classes, with the plaintiffs' opening briefs due on September 27, 2007, the defendants' opposition briefs due on December 21, 2007, and plaintiffs' briefs responding to the defendants' arguments due on February 15, 2008. If the litigation proceeds, we intend to continue to defend the litigation vigorously. Moreover, if the litigation proceeds, we believe that the underwriters may have an obligation to indemnify us for the legal fees and other costs of defending this suit and that our directors' and officers' liability insurance policies would also cover the defense and potential exposure in the suit. While we cannot guarantee the outcome of these proceedings, we believe that the final result of these actions will have no material effect on our consolidated financial condition, results of operations or cash flows.

During the fiscal quarter ended June 30, 2007, we did not have any other material legal proceedings pending against us.

**ITEM 1A. RISK FACTORS**

*The growth of our business is dependent on government telecommunications infrastructure and budgetary policies, particularly the allocation of funds to sustain the growth of the telecommunications industry in China.*

Our telecommunications customers are directly or indirectly owned or controlled by the government of China. Accordingly, their business strategies, capital expenditure budgets and spending plans are largely decided in accordance with government policies, which, in turn, are determined on a centralized basis at the highest level by the National Development and Reform Commission of China. As a result, the growth of our business is heavily dependent on government policies for telecommunications infrastructure. Insufficient government allocation of funds to sustain the growth of China's telecommunications industries in the future could reduce the demand for our products and services and have a material adverse effect on our ability to grow our business.

Historically, China's telecommunications sector has been subject to a number of state-mandated restructurings. For example, in 2002 China Telecom was split geographically into a northern division (comprising 10 provinces) and a southern division (comprising 21 provinces). Under the restructuring, the northern division of China Telecom merged with China Netcom and was renamed China Network Communications Group

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Corporation, or China Netcom Group, while the southern division continued to use the China Telecom name. As a result of the restructuring, new orders for telecommunications infrastructure expansion and improvement projects decreased, adversely that affected our revenue. Any similar restructurings of this nature could cause our operating results to vary unexpectedly from quarter to quarter in the future.

***Our customer base is concentrated and the loss of one or more of our customers could cause our business to suffer significantly.***

We have derived, and believe that we will continue to derive, a significant portion of our revenues from a limited number of large customers in the telecommunications industry, such as China Mobile, China Unicom, China Telecom and China Netcom Group. China Mobile accounted for 61% of our revenues in 2006. The loss, cancellation or deferral of any large contract by any of our large customers would have a material adverse effect on our revenues, and consequently our profits. Despite our business development in the security products and services market following the acquisition of Lenovo-AsiaInfo's IT service business unit in 2004, the revenue expected to be generated by our business outside the telecommunications industry is still limited compared to our overall revenues. Moreover, we cannot provide any assurance that a material proportion of our revenues will be derived from other industries in the future.

---

**Table of Contents**

***Our acquisition of Lenovo's IT services business and any future acquisitions or investments may expose us to potential risks and have an adverse effect on our ability to manage our business.***

Selective acquisitions, such as our 2004 acquisition of Lenovo's non-telecommunications IT service division, form part of our strategy to further expand our business. If we are presented with appropriate opportunities that we feel will enhance our revenue growth, operations and profitability, we may acquire additional businesses, services or products that are complementary to our core business. Such acquisitions could result in the use of significant amounts of cash and/or dilutive issuances of our common stock. Such acquisitions involve other significant risks. For example, our integration of such acquired entities and/or operations into our business may not be successful and may not enable us to expand into new business platforms as well as we expect. This would significantly affect the expected benefits of these acquisitions. Moreover, the integration of new businesses into our operations has required significant attention from our management. Future acquisitions will also likely present similar challenges.

The security products and services business unit we acquired from Lenovo in 2004 faced strong challenges in the final months of 2005. It experienced significantly lower shipment volume than we anticipated and made only a nominal contribution to our revenue for the fourth quarter of 2005. As a result, full year earnings for Lenovo-AsiaInfo were significantly below our expectations. Following the disappointing quarter, Mr. Yu Bing, formerly Chief Executive Officer of the Lenovo-AsiaInfo division and member of our Board, submitted his resignation. We also received resignations from approximately 45 other employees in our Lenovo-AsiaInfo division. Our management team, under the guidance of our Board, has conducted an inquiry into the events surrounding the revenue shortfall in the fourth quarter of 2005 and the resignations from the Lenovo-AsiaInfo division. On January 24, 2007, we entered into a Settlement and Release Agreement with Lenovo to resolve certain claims arising out of that inquiry.

The acquisition of Lenovo's non-telecommunications IT services division and possible future acquisitions may also expose us to other potential risks, including risks associated with unforeseen or hidden liabilities, the diversion of resources from our existing businesses and potential loss, or harm to, relationships with employees and clients as a result of our integration of new businesses. In addition, we cannot be sure that we will be able to realize the benefits we anticipate from acquiring any companies, or that we will not incur costs, including those relating to intangible assets or goodwill, in excess of our projected costs for these transactions. The occurrence of any of these events could have a material and adverse effect on our ability to manage our business, our financial condition and our results of operations.

***The long and variable sales cycles for our products and services can cause our revenues and operating results to vary significantly from period to period and may adversely affect the trading price of our common stock.***

Our revenues and operating results will vary significantly from quarter to quarter due to a number of factors, many of which are outside of our control and any of which may cause our stock price to fluctuate. A customer's decision to purchase our services and products involves a significant commitment of its resources and extended evaluation. As a result, our sales cycle tends to be lengthy. We spend considerable time and expense educating and providing information to prospective customers about features and applications of our services and products. Because our major customers often operate large and complex networks, they usually expand their networks in large increments on a sporadic basis. The combination of these factors can cause our revenues and results of operations to vary significantly and unexpectedly from quarter to quarter.

A large part of the contract amount of our projects sometimes relates to hardware procurement. Since we recognize most of the revenues relating to hardware plus a portion of services and software revenues at the time of hardware delivery, the timing of hardware delivery can cause our quarterly gross revenues to fluctuate significantly. Due to the foregoing factors, we believe that quarter to quarter comparisons of our operating results may not be a good indication of our future performance and should not be overly relied upon. It is likely that our operating results in some periods may be below the expectations of public market analysts and investors. In this event, the price of our common stock will probably decline, perhaps significantly more in percentage terms than any corresponding decline in our operating results.

***Our working capital requirements may increase significantly.***

We typically purchase hardware for our customers as part of our turn-key total solutions services. We generally require our customers to pay 80% to 90% of the invoice value of the hardware upon delivery. We typically place orders for hardware against back-to-back orders from customers and seek favorable payment terms from hardware vendors. This policy has historically minimized our working capital requirements. However, for certain large and strategically important projects, we have agreed to payment of less than 80% to 90% of the invoice value of the hardware upon delivery in order to maintain competitiveness. Wider adoption of less favorable payment terms or delays in hardware deliveries could cause our working capital needs to increase significantly.

***We have sustained losses in prior years and may incur slower earnings growth, earnings declines or net losses in the future.***

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Although we had net income in 2002, 2004 and 2006, we sustained net losses in 2003 and 2005. There are no assurances that we can sustain profitability or avoid net losses in the future. We continue to expect that certain of our operating expenses will increase as our business grows. The level of these expenses will be largely based on anticipated organizational growth and revenue trends and a high percentage of those expenses, particularly compensation expenses, will be fixed. As a result, any delays in expanding sales volume and generating revenue could result in substantial operating losses.

---

**Table of Contents**

*Our high level of fixed costs, as well as increased competition in the software market, could result in reduced operating margins.*

We maintain a relatively stable work force of software and network engineers engaged in all phases of planning and executing projects on behalf of our customers. As a result, our operating costs are relatively fixed from quarter to quarter, regardless of fluctuations in our revenues. Future fluctuations in our revenues could result in decreases in our operating margins. In addition, enhanced competition in the software market and other markets in which we operate could result in reduced prices, which, together with our relatively fixed operating costs, could also result in reduced operating margins.

*PRC laws and regulations currently prohibit foreign-invested companies from engaging in systems integration businesses involving state secrets, which is part of the IT services business we acquired from Lenovo in 2004. PRC laws and regulations also restrict certain foreign invested companies from participating in the value-added telecommunications services ( VATS ) business, which we are exploring the possibility of entering. Substantial uncertainties exist with respect to our contractual arrangements with Lenovo Computer, Lenovo Security and Star VATS, due to uncertainties regarding the interpretation and application of current and future PRC laws and regulations.*

In 2001, the State Secrecy Bureau of China promulgated the Administrative Measures for Qualification of Computer Information Systems Integration Involving State Secrets, which expressly prohibits foreign persons or foreign-invested enterprises from engaging in systems integration businesses involving state secrets, also referred to as restricted businesses .

We and our PRC operating subsidiaries are considered foreign persons or foreign-invested enterprises under PRC laws. In addition to a number of other types of IT services, one of the businesses operated by the IT services division we acquired from Lenovo in 2004 was a restricted business. We operate the restricted businesses primarily through Lenovo Security Technologies (Beijing), Inc. ( Lenovo Security ). Lenovo Computer System and Technology Services Limited ( Lenovo Computer ), which is owned by certain subsidiaries of Lenovo and has been operating the information security solutions business for more than four years, continues to perform certain previously executed contracts. When we acquired the restricted business, we intended to operate the restricted business through Lenovo Security, upon Lenovo Security's receipt of all requisite business licenses and qualifications. Lenovo Security has now obtained most of the requisite business licenses and qualifications, such as the Computer Information System Integration Involving State Secrets Qualification Certificate issued by the State Secrecy Bureau of China for Protection of State Secrets. Lenovo Security is in the process of applying for the remaining licenses. Since September, 2006, Lenovo Security has conducted most of our operations related to the restricted business and, consequently, generates most of our revenue derived from the restricted business.

Lenovo Computer is owned by certain subsidiaries of Lenovo. Lenovo Security is owned by Legend Holdings Limited, the parent company and controlling shareholder of Lenovo, and two of our employees who are PRC citizens. We do not currently have any equity interest in Lenovo Computer or in Lenovo Security, but instead enjoy economic benefits substantially similar to equity ownership in such companies through contractual arrangements between Lenovo-AsiaInfo Technologies, Inc. ( Lenovo-AsiaInfo ), our wholly-owned subsidiary, and these affiliated entities and their respective shareholders. Further information on these arrangements is set forth under the heading Certain Relationships and Related Transactions in the definitive proxy statement for our 2007 annual meeting of stockholders, filed with the SEC on March 14, 2007.

At the closing of our acquisition of Lenovo's IT services business, our Chinese legal counsel, T&C Law Office, and Chinese legal counsel to Lenovo Group, Tian Yuan Law Firm, each delivered legal opinions to the effect that our ownership structure of Lenovo Computer and Lenovo Security, and the contractual arrangements among us, Lenovo-AsiaInfo, these affiliated entities and their respective shareholders, are in compliance with all existing PRC laws and regulations. There are, however, substantial uncertainties regarding the interpretation and application of current or future PRC laws and regulations, including regulations governing the validity and enforcement of such contractual arrangements. Accordingly, we cannot assure you that PRC government authorities will not ultimately take a view contrary to the opinion of our and Lenovo's Chinese counsel. If the PRC government finds that our contractual arrangements with Lenovo Computer and Lenovo Security do not comply with the prohibition on foreign-invested companies from engaging in systems integration businesses involving state secrets, we could be subject to severe penalties.

In June of 2004 we entered into similar contractual arrangements with Star VATS, a domestic company owned by certain of our employees who are PRC citizens, which has been established to engage in the VATS business in China. Star VATS is in the process of developing VATS products and services that we hope to offer in China. We anticipate that if we successfully launch our VATS products and services, all of our business related to such products and services will be conducted through Star VATS. Star VATS will generate any revenue relating to such business and will make use of the licenses and approvals that are essential to such business. We do not have any equity interest in Star VATS, but instead have the right to enjoy economic benefits similar to equity ownership through our contractual arrangements with Star VATS and its shareholders. In the opinion of our Chinese legal counsel, T&C Law Firm, delivered at the time Star VATS was established, the contractual arrangements among us, Star VATS, and the shareholders of Star VATS were in compliance with all existing PRC laws and regulations. There are, however, substantial uncertainties regarding the interpretation and application of current and future PRC laws and regulations, including regulations governing the validity and enforcement of such contractual arrangements. Accordingly, we cannot assure you that PRC government

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

authorities will not ultimately take a view contrary to the opinion of our Chinese legal counsel. If the PRC government finds that our contractual arrangements with Star VATS do not comply with the restrictions on certain foreign invested companies from engaging in VATS businesses, we could be subject to severe penalties.

---

**Table of Contents**

***Our contractual arrangements with Lenovo Computer, Lenovo Security and Star VATS may not be as effective in providing operational control as direct ownership of these affiliated entities and may be difficult to enforce.***

Although we have been advised by Chinese legal counsel that our contractual arrangements with Lenovo Computer, Lenovo Security and Star VATS are valid, binding and enforceable under current PRC laws, these arrangements may not be as effective as direct ownership of these affiliated entities would be. For example, these affiliated entities and their respective shareholders could fail to perform or make payments as required under such contractual arrangements. In such event, we would have to rely on the PRC legal system to enforce these agreements. Any legal proceedings would be uncertain as to outcome and could result in the disruption of our business, damage to our reputation, diversion of our resources and the incurrence of substantial costs.

***We may not be able to operate the systems integration businesses involving state secrets if we acquire all of the equity interest in Lenovo Computer and Lenovo Security.***

PRC laws and regulations currently prohibit foreign persons or foreign-invested enterprises from engaging in systems integration businesses involving state secrets. We and our subsidiaries are considered foreign persons or foreign-invested enterprises under PRC laws. Unless such prohibition is lifted in the future, we will not be able to operate such business after we acquire all of the equity interest in Lenovo Computer and Lenovo Security pursuant to the terms of our contractual arrangements with Lenovo Computer and Lenovo Security and their respective shareholders. The loss of this line of business may materially and adversely affect our business, financial condition and results of operations.

***PRC regulations relating to acquisitions of PRC companies by foreign entities may limit our ability to acquire PRC companies and adversely affect the implementation of our acquisition strategy and the failure by our shareholders who are PRC residents to make or obtain any required registrations pursuant to such regulations may subject us to legal sanctions.***

On October 21, 2005 the PRC State Administration of Foreign Exchange, or SAFE, issued a notice, known as Circular 75, which sets forth a new regulatory framework for acquisitions of PRC businesses involving offshore companies. Under Circular 75, if an acquisition of a PRC company by an offshore company controlled by PRC residents occurred prior to the issuance of the SAFE notice, certain PRC residents were required to submit a registration form to the local SAFE branch to register their ownership interests in the offshore company prior to March 31, 2006. Such PRC residents must also amend the registration form if there is a material event affecting the offshore company, such as, among other things, a change in share capital, a transfer of shares, or if such company is involved in a merger, acquisition or a spin-off transaction or uses its assets in China to guarantee offshore obligations. In the past, we have acquired a number of assets from, or equity interests in, PRC companies through issuances of our shares of common stock to individuals who may be deemed to be PRC residents for the purpose of the SAFE notices. However, there is substantial uncertainty as to whether we would be considered an offshore company for purposes of Circular 75 and, at present, it is unclear whether Circular 75 requires a company such as ours to register.

As it is uncertain how the SAFE notice will be interpreted or implemented, we cannot predict how these regulations will affect our future acquisition strategies and business operations. For example, if we decide to acquire additional PRC companies, we cannot assure you that we or the owners of such companies will be able to complete the filings and registrations, if any, required by the SAFE notice. This may restrict our ability to implement an acquisition strategy and could adversely affect our business and prospects.

In addition, six PRC regulatory authorities, including the PRC Ministry of Commerce and the Chinese Securities Regulatory Commission, or CSRC, jointly promulgated a new rule entitled Provisions regarding Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, or the New M&A Rules, which became effective on September 8, 2006. The New M&A Rules establish additional procedures and requirements that could make merger and acquisition activities by foreign investors more time-consuming and complex, including, in some circumstances, advance notice to the Ministry of Commerce of any change-of-control transaction in which a foreign investor takes control of a PRC domestic enterprise. Compliance with the New M&A Rules, and any related approval processes, including obtaining approval from the Ministry of Commerce, may delay or inhibit our ability to complete such transactions, which could affect our ability to expand our business or maintain our market share.

***Asset impairment reviews may result in future periodic write-downs.***

Effective January 1, 2002, we adopted SFAS No. 142, which requires us, among other things, to conduct annual reviews of goodwill, and SFAS No. 144, which requires us to test intangible assets for impairment whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. In connection with our business acquisitions, we make assumptions regarding estimated future cash flows and other factors to determine the fair value of goodwill and intangible assets. In assessing the related useful lives of those assets, we have to make assumptions regarding their fair value, our recoverability of those assets and our ability to successfully develop and ultimately commercialize acquired technology. If those assumptions change in the future when we conduct our periodic reviews in accordance with applicable accounting

standards, we may be required to record impairment charges.

We recorded a non-cash impairment charge of \$21.2 million as a result of an independent valuation during the fourth quarter of 2005 of the goodwill and acquired intangible assets mainly attributable to our acquisition of Lenovo-AsiaInfo's IT service business unit in 2004. It is possible that future reviews will result in further write-downs of goodwill and other intangible assets.



## **Table of Contents**

### ***We are highly dependent on our executive officers.***

Each of our executive officers is responsible for an important segment of our operations. Although we believe that we have significant depth at all levels of management, the loss of any of our executive officers' services could be detrimental to our operations. We do not have, and do not plan to obtain, key man life insurance on any of our officers.

### ***We face a competitive labor market in China for skilled personnel and therefore are highly dependent on the skills and services of our existing key skilled personnel and our ability to hire additional skilled employees.***

Competition for highly skilled software design, engineering and sales and marketing personnel is intense in China. Our failure to attract, assimilate or retain qualified personnel to fulfill our current or future needs could impair our growth. Competition for skilled personnel comes primarily from a wide range of foreign companies active in China, many of which have substantially greater resources than we have. Limitations on our ability to hire and train a sufficient number of personnel at all levels would limit our ability to undertake projects in the future and could cause us to lose market share.

### ***We extend warranties to our customers that expose us to potential liabilities.***

We customarily provide our customers with one to three year warranties, which cover both hardware and our proprietary and third-party software products. Although we seek to arrange back-to-back warranties with hardware and software vendors, we have the primary responsibility with respect to their warranties. Our contracts often lack disclaimers or limitations on liability for special, consequential and incidental damages, nor do we typically cap the amounts our customers can recover for damages. In addition, we do not currently purchase any insurance policy with respect to our exposure to warranty claims. The failure of our installed projects to operate properly could give rise to substantial liability for special, consequential or incidental damages, which in turn could materially and adversely affect us.

### ***We sell our services on a fixed-price, fixed-time basis, which exposes us to risks associated with cost overruns and delays.***

We sell most of our services on a fixed-price, fixed-time basis. In contracts with our customers, we typically agree to pay late completion fines of up to 5% of the total contract value. In large scale telecommunications infrastructure projects, there are many factors beyond our control which could cause delays or cost overruns. In this event, we would be exposed to cost overruns and liability for late completion fines.

### ***We may become less competitive if we are unable to develop or acquire new products, or enhancements to our existing products, that are marketable on a timely and cost-effective basis.***

Our future operating results will depend, to a significant extent, upon our ability to enhance our existing products and services and to introduce new products and services to meet the requirements of our customers in a rapidly developing and evolving market. If we do not enhance our existing products and services or introduce new successful products and services in a timely manner, our products and services may become obsolete, and our revenues and operating results may suffer. Moreover, unexpected technical, operational, distribution or other problems could delay or prevent the introduction of any products or services that we may plan to introduce in the future. We cannot be sure that any of these products or services will achieve widespread market acceptance or generate incremental revenues.

### ***Our proprietary rights may be inadequately protected and there is a risk of poor enforcement of intellectual property rights in China.***

Our success and ability to compete depend substantially upon our intellectual property rights, which we protect through a combination of confidentiality arrangements and copyright, trademark, and patent registrations. We have registered some marks and filed trademark applications for other marks with the United States Patent and Trademark Office, the Trademark Bureau of the State Administration of Industry and Commerce in China and the Trade Marks Registry in Hong Kong. We have also registered copyrights with the State Copyright Bureau in China with respect to certain of our software products, although we have not applied for copyright protection elsewhere (including the U.S.). We have filed some patent applications and have acquired some existing patents in the PRC for certain hardware and software products used or developed in our business. Despite these precautions, the legal regime protecting intellectual property rights in China is weak. Because the Chinese legal system in general and the intellectual property regime in particular, are relatively weak, it is often difficult to enforce intellectual property rights in China. In addition, there are other countries where effective copyright, trademark and trade secret protection may be unavailable or limited.

We enter into confidentiality agreements with most of our employees and consultants, and control access to, and distribution of, our documentation and other licensed information. Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use our licensed services or technology without authorization, or to develop similar technology independently. Policing unauthorized use of our licensed technology is difficult and there can be no assurance that the steps we take will prevent misappropriation or infringement of our

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

proprietary technology. In addition, litigation may be necessary to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others, which could result in substantial costs and diversion of our resources.

A portion of our business involves the development and customization of software applications for customers. We generally retain significant ownership or rights to use and market such software for other customer projects, where possible. However, our customers sometimes retain co-ownership and rights to use the applications, processes, and intellectual property so developed. In some cases, we may have no right or only limited rights to reuse or provide these developments to projects involving other customers. To the extent that we are unable to negotiate contracts which permit us to reuse source-codes and methodologies, or to the extent that we have conflicts with our customers regarding our ability to do so, we may be unable to provide similar solutions to our other customers.

---

**Table of Contents**

***We are exposed to certain business and litigation risks with respect to technology rights held by third parties.***

We currently license technology from third parties and intend to do so increasingly in the future as we introduce services that require new technology. There can be no assurance that these technology licenses will be available to us on commercially reasonable terms, if at all. Our inability to obtain any of these licenses could delay or compromise our ability to introduce new services. In addition, we may or may allegedly breach the technology rights of others and incur legal expenses and damages, which could be substantial.

***Investors may not be able to enforce judgments entered by United States courts against certain of our officers and directors.***

We are incorporated in the State of Delaware. However, a majority of our directors and executive officers, and certain of our principal shareholders, live outside of the U.S., principally in Beijing and Hong Kong. As a result, you may not be able to:

effect service of process upon those persons within the U.S.; or

enforce against those persons judgments obtained in United States courts, including judgments relating to the federal securities laws of the U.S.

***We do not intend to pay and may be restricted from paying dividends on our common stock.***

We have never declared or paid dividends on our capital stock and we do not intend to declare any dividends in the foreseeable future. We currently intend to retain future earnings to fund our growth. Furthermore, if we decide to pay dividends, foreign exchange and other regulations in China may restrict our ability to distribute retained earnings from China or convert those payments from Renminbi into foreign currencies.

***The fact that our business is conducted in both U.S. dollars and Renminbi may subject us to currency exchange rate risk due to fluctuations in the exchange rate between those two currencies.***

Substantially all of our revenues, expenses and liabilities are denominated in either U.S. dollars or Renminbi. As a result, we are subject to the effects of exchange rate fluctuations between those currencies. On July 21, 2005, the PRC government changed its decade-old policy of pegging the value of the Renminbi to the U.S. dollar. Under the new policy, the Renminbi is permitted to fluctuate within a narrow and managed band against a basket of certain foreign currencies, including the U.S. dollar. This change in policy has resulted in approximately 9% appreciation of the Renminbi against the U.S. dollar. The PRC government may decide to adopt an even more flexible currency policy in the future, which could result in further and more significant appreciation of the Renminbi against the U.S. dollar.

Certain of our revenues and expenses relating to hardware sales are denominated in U.S. dollars, and substantially all our revenues and expenses relating to the software and services component of our business are denominated in Renminbi. The value of our shares may be affected by the foreign exchange rate between the U.S. dollar and the 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.

AsiaInfo Holdings, Inc., our ultimate holding company, uses U.S. dollars as its reporting and functional currency. The financial records of our PRC subsidiaries are maintained in Renminbi, their functional currency and the currency of the PRC. Their balance sheets are translated into U.S. dollars based on the rates of exchange existing on the balance sheet date. Their statements of operations are translated using a weighted average rate for the period. Foreign currency translation adjustments are reflected as accumulated other comprehensive income (loss) in stockholders' equity. Fluctuation in exchange rate might result in significant foreign currency translation adjustments. We reported foreign currency translation adjustments of \$2.6 million and \$2.3 million in other comprehensive income (loss) in 2006 and 2005, respectively.

***The markets in which we sell our services and products are competitive and we may not be able to compete effectively.***

We operate in a highly competitive environment, both in the telecommunications market and in the market for IT security services and solutions. In the telecommunications market, our competitors include both multinational and local companies such as Amdocs, Digital China, Huawei, Linkage and Neusoft. In the security products and services market, our competitors are mainly local players such as Topsec and Netscreen and international players such as Cisco.

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Our competitors, many of whom have greater financial, technical and human resources than we have, may be able to respond more quickly to new and emerging technologies and changes in customer requirements or devote greater resources to the development, promotion and sale of new products or services. It is possible that competition in the form of new competitors or alliances, joint ventures or consolidation among existing competitors may decrease our market share. Increased competition could result in lower personnel utilization rates, billing rate reductions, fewer customer engagements, reduced gross margins and loss of market share, any one of which could materially and adversely affect our profits and overall financial condition.

***Political and economic policies of the Chinese government could affect our industry in general and our competitive position in particular.***

Since the establishment of the People's Republic of China in 1949, the Communist Party has been the governing political party in China. The highest bodies of leadership are the Politburo of the Communist Party, the Central Committee and the National People's Congress. The State Council, which is the highest institution of government administration, reports to the National People's Congress and has under its supervision various commissions, agencies and ministries, including the MII, the telecommunications regulatory body of the Chinese government. Since the late 1970s, the Chinese government has been reforming the Chinese economic system. Although we believe that economic reform and the macroeconomic measures adopted by the Chinese government has had and will continue to have a positive effect on economic development in China, there can be no assurance that the economic reform strategy will not from time to time be modified or revised. Such modifications or revisions, if any, could have a material adverse effect on the overall economic growth of China. Such developments could reduce, perhaps significantly, the demand for our products and services. Furthermore, changes in political, economic and social conditions in China, adjustments in policies of the Chinese government or changes in laws and regulations could adversely affect our industry in general and our competitive position in particular.

---

**Table of Contents**

Recently, the Chinese government's increased measures to control economic growth have contributed and will continue to contribute to cautious spending by our telecommunications customers. Such measures may also result in the delay of certain large telecommunications-related projects, which could have a material adverse effect on our business.

*High technology and emerging market shares have historically experienced extreme volatility and may subject you to losses.*

The trading price of our shares may be subject to significant market volatility due to investor perceptions of investments relating to China and Asia, as well as developments in the telecommunications industry. In addition, the high technology sector of the stock market frequently experiences extreme price and volume fluctuations, which have particularly affected the market prices of many software companies and which have often been unrelated to the operating performance of those companies.

*If our stock price is volatile, we may become subject to securities litigation, which is expensive and could result in a diversion of resources.*

In the past, periods of volatility in the market price of a particular company's securities have often been followed by the institution of securities class action litigation against that company. Many companies in our industry have been subject to this type of litigation in the past, and we are currently involved in this type of litigation as a result of allegedly improper allocation procedures relating to the sale of our common stock in connection with our initial public offering in March of 2000. For more information on that litigation, please see the discussion under the heading "Item 1. Legal Proceedings" in Part II of this Report. Litigation is often expensive and diverts management's attention and resources, which could materially and adversely affect our business.

*Future sales of shares by existing stockholders could cause the market price of our common stock to fall.*

If our stockholders sell substantial amounts of our common stock in the public market, including shares issued upon the exercise of outstanding options, the market price of our common stock could fall. Such sales also might make it more difficult for us to sell equity or equity-related securities in the future at a time and price that we deem appropriate.

*We are subject to anti-takeover provisions that could prevent a change of control and prevent our stockholders from realizing a premium on their common stock.*

Our Board has the authority to issue up to 10,000,000 shares of our preferred stock. Without any further vote or action on the part of our stockholders, the Board has the authority to determine the price, rights, preferences, privileges and restrictions of the preferred stock. This preferred stock, if it is ever issued, may have preference over and harm the rights of the holders of our common stock. Although the issuance of this preferred stock will provide us with flexibility in connection with possible acquisitions and other corporate purposes, such an issuance may make it more difficult for a third party to acquire a majority of our outstanding voting stock.

We currently have authorized the size of our Board to be not less than three or more than ten directors. The terms of the office of the eight-member board of directors have been divided into three classes: Class I, whose term will expire at the annual meeting of the stockholders to be held in 2009; Class II, whose term will expire at the annual meeting of stockholders to be held in 2010; and Class III, whose term will expire at the annual meeting of stockholders to be held in 2008. This classification of the Board may have the effect of delaying or preventing changes in our control or management.

We are subject to the provisions of Section 203 of the Delaware General Corporation Law. In general, the statute prohibits a publicly-held Delaware corporation from engaging in a "business combination" with an "interested stockholder" for a period of three years after the date when the person became an interested stockholder unless, subject to certain exceptions, the business combination or the transaction in which the person became an interested stockholder is approved in a prescribed manner. Generally, a "business combination" includes a merger, asset or stock sale, or other transaction resulting in a financial benefit to the stockholder; and an "interested stockholder" includes any person that owns 15% or more of our outstanding voting stock or that is our affiliate or associate.

*Our change of control severance agreements with executive officers may discourage a change of control.*

We have entered into change of control severance agreements with most of our executive officers. These agreements provide, among other things, that the executive officers would be entitled to various benefits upon the occurrence of a covered termination (as defined therein) which occurs within one year after a change of control (as defined therein), including payment of one year of base salary and bonus, immediate vesting of 50% of any outstanding unvested stock options held by the executive officer and the provision of medical benefits and housing allowance. If a change of control occurs, and regardless of whether a covered termination takes place, the executive officers may be entitled to accelerated vesting of 50% of any outstanding unvested stock options held by the executive officer. The potential obligations to pay executive officers such

severance amounts may discourage a potential acquirer from effecting a change of control.

---

**Table of Contents**

***Failure to comply with the United States Foreign Corrupt Practices Act could subject us to penalties and other adverse consequences.***

Since we are a Delaware Corporation, we are subject to the United States Foreign Corrupt Practices Act, which generally prohibits United States companies from engaging in bribery or other prohibited payments to foreign officials for the purpose of obtaining or retaining business. Non-U.S. companies, including some that may compete with our company, are not subject to these prohibitions. Corruption, extortion, bribery, pay-offs, theft and other fraudulent practices may occur in the PRC. We can make no assurance, however, that our employees or other agents will not engage in such conduct for which we might be held responsible.

If our employees or other agents are found to have engaged in such practices, we could suffer severe penalties and other consequences that may have a material adverse effect on our business, financial condition and results of operations.

***We are subject to potential liabilities and anticipate recurring costs in complying with the Sarbanes-Oxley Act.***

In July 2002, President George W. Bush signed the Sarbanes-Oxley Act of 2002, or the Act, into law. Among other things, the Act imposes corporate governance, reporting, and disclosure requirements; introduces stricter independence and financial expertise standards for audit committees; and sets stiff penalties for securities fraud.

The Act and the related rules and regulations have increased the scope, complexity and costs of our corporate governance, reporting, and disclosure practices, and may increase the risk of personal liability for our Board members, chief executive officer, and chief financial officer. Any such liabilities may adversely affect our reputation, our business, or our ability to meet listing criteria.

Section 404 of the Act requires our management and our independent auditors to assess our internal controls over financial reporting on an annual basis. During the course of this evaluation, documentation and attestation, we may identify deficiencies that we may not be able to remedy in time to meet the deadline imposed by the Act for compliance with the requirements of Section 404. If we fail to achieve and maintain the adequacy of our internal controls, we may not be able to conclude that we have effective internal controls, on an ongoing basis, over financial reporting in accordance with the Act. Moreover, effective internal controls, particularly those related to revenue recognition, are necessary for us to produce reliable financial reports and are important to help prevent fraud. As a result, our failure to achieve and maintain effective internal controls over financial reporting could result in the loss of investor confidence in the reliability of our financial statements, which in turn could harm our business and negatively impact the trading price of our common stock. Furthermore, we will incur recurring costs and expend management time and other resources necessary to comply with Section 404 and other requirements of the Act.

***We are exposed to certain tax risks with respect to tax benefits enjoyed by certain of our subsidiaries.***

One of our PRC subsidiaries, which was certified as a High and New Technology Enterprise, has enjoyed a favorable 7.5% enterprise income tax rate since 2002. Recently, we were unofficially notified by local tax authorities that the subsidiary may not be entitled to this preferential tax rate. In late 2006, this risk was mitigated by our receipt of advanced technology enterprise status for the aforementioned company. We believe that our tax return positions are justifiable, but tax authorities may formally challenge certain positions we have asserted. The tax positions we have asserted may not be fully sustained and could expose us to litigation, administrative fines and penalties and other potential liabilities if the relevant tax authorities take a position contrary to ours, and could adversely affect our operating results.

If these tax benefits to our subsidiary are no longer available, certain of our subsidiaries may be subject to higher rates of enterprise income tax in China, which could cause a reduction in our after-tax-income. In addition, as our operations are subject to income and transaction of profits between our subsidiaries and may challenge certain tax benefits claimed on our tax returns, and we may not prevail in any such challenge. If we were not to prevail, we could be subject to higher tax rates or lose certain tax benefits that could result in higher tax rate.

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

None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None

**ITEM 5. OTHER INFORMATION**

None.



**Table of Contents**

**ITEM 6. EXHIBITS**  
*(a) Exhibits*

Please see Exhibit Index.

**Table of Contents**

SIGNATURE

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

Date: August 9, 2007

AsiaInfo Holdings, Inc.

By: /s/ Eileen Chu

Name: Eileen Chu

Title: Chief Financial Officer

**Table of Contents**

## EXHIBIT INDEX

The following exhibits are filed as a part of this Report.

**Exhibit**

<b>Number</b>	<b>Description</b>
3.1 (1)	Certificate of Incorporation of AsiaInfo Holdings, Inc., dated June 8, 1998
3.2 (1)	Certificate of Amendment to Certificate of Incorporation of AsiaInfo Holdings, Inc., dated August 27, 1999
3.3 (2)	Certificate of Amendment to Certificate of Incorporation of AsiaInfo Holdings, Inc., dated November 15, 2000
3.4 (2)	Certificate of Correction to Certificate of Amendment to Certificate of Incorporation of AsiaInfo Holdings, Inc., dated January 18, 2001
3.5 (5)	Amended and Restated By-Laws of AsiaInfo Holdings, Inc., dated April 24, 2007
4.1 (1)	Specimen Share Certificate representing AsiaInfo Holdings, Inc. shares of common stock
10.1 (1)	Lease of AsiaInfo's headquarters at 6 Zhongguancun South Street, Beijing, China, dated August 31, 1999
10.2 (4)	Master Executive Employment Agreement between AsiaInfo Holdings, Inc. and Steve Zhang dated April 1, 2004*
10.3 (4)	Change of Control Severance Agreement between AsiaInfo Holdings, Inc. and Steve Zhang dated April 1, 2004*
10.4 (7)	Acquisition Agreement between AsiaInfo Holdings, Inc. and Lenovo Group Limited dated July 27, 2004
10.5 (5)	Supplement and Amendment No.1 to Acquisition Agreement dated as of October 1, 2004
10.6 (8)	Trademark License Agreement between Bonson Information Technology Limited and Lenovo (Beijing) Limited dated October 19, 2004
10.7 (8)	Patent, Copyright and Technology License Agreement between Lenovo (Beijing) Limited, Legend Holdings Limited, Bing Yu and Zheng Wang dated October 19, 2004
10.8 (8)	Patent Assignment Agreement between Lenovo (Beijing) Limited, Legend Holdings Limited, Bing Yu and Zheng Wang dated October 19, 2004
10.9 (8)	Exclusive Business Cooperation Agreement between Lenovo-AsiaInfo Technologies, Inc. and Lenovo Computer System and Technology Services Co., Ltd. dated October 19, 2004
10.10 (8)	Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Lenovo (Beijing) Limited and Lenovo Computer System and Technology Services Co., Ltd. dated October 19, 2004
10.11 (8)	Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Lenovo Manufacturing Limited and Lenovo Computer System and Technology Services Co., Ltd. dated October 19, 2004
10.12 (8)	Equity Transfer Arrangement Agreement between Lenovo-AsiaInfo Technologies, Inc., Lenovo Group Limited, Lenovo (Beijing) Limited, Lenovo Manufacturing Limited, Lenovo Computer System and Technology Services Co., Ltd. and Bonson Information Technology Limited dated October 19, 2004
10.13 (8)	Power of Attorney executed by Lenovo (Beijing) Limited dated October 19, 2004
10.14 (8)	Power of Attorney executed by Lenovo Manufacturing Limited dated October 19, 2004
10.15 (8)	Loan Agreement between Lenovo-AsiaInfo Technologies, Inc. and Legend Holdings Limited dated October 19, 2004
10.16 (9)	AsiaInfo Holdings, Inc. 2005 Stock Incentive Plan, as amended through April 8, 2005*

**Table of Contents**

10.17 (10) Power of Attorney executed by Legend Holdings Limited dated December 2, 2004

10.18 (10) Exclusive Business Cooperation Agreement between Lenovo-AsiaInfo Technologies, Inc. and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004

10.19 (10) Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Legend Holdings Limited and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004

10.20 (10) Equity Transfer Arrangement Agreement between Lenovo-AsiaInfo Technologies, Inc., Legend Holdings Limited and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004

10.21 (10) Loan Agreement executed by Lenovo-AsiaInfo Technologies, Inc. and Zheng Wang dated October 19, 2004

10.22 (10) Power of Attorney executed by Zheng Wang dated December 2, 2004

10.23 (10) Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Zheng Wang and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004

10.24 (10) Exclusive Option Agreement between Lenovo-AsiaInfo Technologies, Inc., Zheng Wang and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004\*

10.25 (12) Frame Contract by and among James Ding, Lenovo-AsiaInfo Technologies, Inc., Lenovo Security Technologies (Beijing), Inc. and Jian Qi, dated June 2, 2006

10.26 (12) Equity Interest Transfer Agreement between James Ding and Jian Qi, dated June 2, 2006

10.27 (12) Exclusive Option Agreement by and among Lenovo-AsiaInfo Technologies, Inc., Jian Qi and Lenovo Security Technologies (Beijing), Inc., dated June 2, 2006

10.28 (12) Share Pledge Agreement by and among Lenovo-AsiaInfo Technologies, Inc., Jian Qi and Lenovo Security Technologies (Beijing), Inc., dated June 2, 2006

10.29 (12) Loan Agreement between Lenovo-AsiaInfo Technologies, Inc. and Jian Qi, dated June 2, 2006

10.30 (12) Power of Attorney executed by Jian Qi, dated June 2, 2006

10.31 (11) Employment Contract between AsiaInfo Technologies (China), Inc. and Steve Zhang, dated December 8, 2005 (English Translation) \*

10.32 (11) Confidentiality and Non-Competition Agreement between AsiaInfo Technologies (China), Inc. and Steve Zhang, dated December 8, 2005 (English Translation) \*

10.33 (13) Master Executive Employment Agreement between AsiaInfo Holdings, Inc. and Eileen Chu dated January 1, 2007\*

10.34 (13) Change of Control Severance Agreement between AsiaInfo Holdings, Inc. and Eileen Chu dated January 1, 2007 \*

10.35 (13) Employment Contract between AsiaInfo Technologies (China), Inc. and Eileen Chu, dated January 1, 2007 (English Translation) \*

10.36 (13) Confidentiality and Non-Competition Agreement between AsiaInfo Technologies (China), Inc. and Eileen Chu, dated January 1, 2007 (English Translation) \*

10.37 (13) Employment Contract between AsiaInfo Technologies (China), Inc. and Yinhu Zhang, dated August 18, 2006(English Translation) \*

10.38 (13) Confidentiality and Non-Competition Agreement between AsiaInfo Technologies (China), Inc. and Yinhu Zhang, dated August 18, 2006 (English Translation) \*

10.39 (13) Employment Contract between AsiaInfo Technologies (China), Inc. and Jian Qi, dated July 1, 2005 (English Translation) (filed herewith) \*

10.40 (13) Confidentiality and Non-Competition Agreement between AsiaInfo Technologies (China), Inc. and Jian Qi, dated July 1, 2005 (English Translation) \*

**Table of Contents**

10.41 (13) Employment Contract between AsiaInfo Technologies (China), Inc. and Feng Liu, dated December 30, 2005(English Translation)  
\*

10.42 (13) Confidentiality and Non-Competition Agreement between AsiaInfo Technologies (China), Inc. and Feng Liu, dated December 30, 2005 (English Translation) \*

10.45 (6) Master Executive Employment Agreement between AsiaInfo Holdings, Inc. and Jian Qi dated April 1, 2004\*

10.46 (6) Change of Control Severance Agreement between AsiaInfo Holdings, Inc. and Jian Qi dated April 1, 2004\*

10.47 (14) Strategic Investors Agreement dated November 29, 2006, by and among AsiaInfo Holdings, Inc., CITIC Capital MB Investment Limited and PacificInfo Limited.

24.1 Power of Attorney (included on signature page to this report)

31.1 Certification of Principal Executive Officer required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Principal Financial Officer required by Rules 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* Management contract, or compensatory plan or arrangement.

- (1) Incorporated by reference to our Registration Statement on Form S-1 (No.333-93199).
- (2) Incorporated by reference to our Annual Report on Form 10-K for the fiscal year ended December 31, 2000.
- (3) Incorporated by reference to our Quarterly Report on Form 10-Q filed on August 14, 2003.
- (4) Incorporated by reference to our Annual Report on Form 10-K for the fiscal year ended December 31, 2004.
- (5) Incorporated by reference to our Current Report on Form 8-K filed on April 25, 2007.
- (6) Incorporated by reference to our Quarterly Report on Form 10-Q filed on May 10, 2004.
- (7) Incorporated by reference to our Quarterly Report on Form 10-Q filed on August 9, 2004.
- (8) Incorporated by reference to our Quarterly Report on Form 10-Q filed on November 9, 2004.
- (9) Incorporated by reference to our Revised Proxy Statement for the 2004 Annual Meeting of Stockholders filed on April 14, 2004.
- (10) Incorporated by reference to our Quarterly Report on Form 10-Q filed on May 10, 2005.
- (11) Incorporated by reference to our Annual Report on Form 10-K filed on March 15, 2006.
- (12) Incorporated by reference to our Quarterly Report on Form 10-Q filed on August 9, 2006.
- (13) Incorporated by reference to our Annual Report on Form 10-K filed on March 14, 2007.
- (14) Incorporated by reference to our Current Report on Form 8-K filed on November 30, 2006.