

PACIFICNET INC  
Form 10-K  
June 12, 2008

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U.S. SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007

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: 000-24985

PACIFICNET INC.  
(Exact name of registrant in its charter)

DELAWARE 91-2118007  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification Number)

23/F, TOWER A, TIMECOURT, NO.6  
SHUGUANG XILI,  
CHAOYANG DISTRICT, BEIJING,  
CHINA 100028 N/A  
(Address of principal executive offices) (Zip Code)

Registrant's Telephone Number: 0086-10-59225000

Room 4203, Jinzhonghuan Business Building, Futian District, Shenzhen, China. Postal Code: 518040  
(Former Name and Address)

Securities Registered under Section 12(b) of the Exchange Act: NONE

Securities Registered under Section 12(g) of the Exchange Act: Common Stock, par value \$0.0001

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act  
YES  NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act  
YES  NO

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such

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reports), and (2) has been subject to such filing requirements for the past 90 days YES x NO o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is contained herein, and will not be contained, to the best of the registrant's knowledge in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

Large Accelerated Accelerated Filer o Non-Accelerated Filer Small Reporting  
Filer o x Company o

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

The aggregate market value of the common stock held by non-affiliates of the registrant as of December 31, 2007 was approximately \$51,171,987 based upon the closing sale price of \$4.27 per share as reported by The NASDAQ Global Market on such date. There were 14,314,072 shares of the Company's common stock outstanding on December 31, 2007.

TABLE OF CONTENTS

|   |     |
|---|-----|
| PART I  | 3   |
| ITEM 1. BUSINESS  | 3   |
| ITEM 2. PROPERTIES  | 35  |
| ITEM 3. LEGAL PROCEEDINGS   | 35  |
| ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS   | 37  |
| PART II   | 38  |
| ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND PURCHASES OF EQUITY SECURITIES | 38  |
| ITEM 6. SELECTED FINANCIAL DATA   | 40  |
| ITEM 7. MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS                   | 40  |
| ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK   | 53  |
| ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA   | F-1 |
| ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE                  | 54  |
| ITEM 9A. CONTROLS AND PROCEDURES  | 54  |
| ITEM 9B. OTHER INFORMATION  | 55  |
| PART III  | 55  |
| ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE  | 55  |
| ITEM 11. EXECUTIVE COMPENSATION   | 59  |
| ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS       | 65  |
| ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE                             | 66  |

|   |    |
|---|----|
| ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES     | 66 |
| PART IV   | 67 |
| ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES | 67 |

This annual report contains forward-looking statements within the meaning of the federal securities laws. These include statements about our expectations, beliefs, intentions or strategies for the future, which we indicate by words or phrases such as "anticipate," "expect," "intend," "plan," "will," "we believe," "the Company believes," "management believes" and similar language. The forward-looking statements are based on our current expectations and are subject to certain risks, uncertainties and assumptions, including those set forth in the discussion under "Description of Business," including the "Risk Factors" described in that section, and "Management's Discussion and Analysis or Plan of Operation." Our actual results may differ materially from results anticipated in these forward-looking statements. We base our forward-looking statements on information currently available to us, and we assume no obligation to update them.

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## PART I

### ITEM 1. BUSINESS

As used in this report, "we", "us," "our," "Company", "PacificNet" or "PACT" refers to PacificNet Inc., a Delaware corporation.

#### OVERVIEW

PacificNet, Inc. (NASDAQ: PACT) is a leading developer and provider of gaming technology for the land-based, online and mobile game operators in Asia. Established in 2000 as a provider of e-commerce and Customer Relationship Management (CRM) solutions for the China market, the company changed focus in 2006 and has been divesting its legacy telecom and CRM business while pursuing a strategy to focus on gaming technology and games development for the global gaming market. Due to the contribution of the highly experienced executives of our gaming subsidiaries, including PacificNet Games (PactGames) and Take1 Technologies (Take 1), PacificNet is able to offer world-leading solutions in casino equipment supply and in the development, installation and support of systems and game content for the casino, lottery and Amusement With Prizes (AWP) markets. Positioning itself as a systems integrator for the gaming industry, with a special focus on the emerging markets, PacificNet enables customers to integrate gaming operations, linking electronic gaming machines, tables and larger networks so that operators can build efficient and highly attractive gaming operations that drive revenue growth and profit opportunity and enhance the customer experience. PacificNet's gaming clients include leading hotels, casinos, and gaming operators in Asia, Europe, and other gaming markets around the world. The Company employs approximately 500 staff in its various subsidiaries with offices in Macau, Hong Kong, China, Philippines, and the US.

During the year we took decisive measures to address the negative impact on our overall profitability as a result of China Mobile's VAS policy change and the increasingly competitive telecom products market in China. These measures included considering strategic alternatives for our low-margin telecom businesses, such as sales, spin-offs and mergers and turning our focus to the higher margin and rapidly expanding gaming and entertainment industries. To do this, in September 2006, we opened an office in Macau. By leveraging the entertainment software and hardware development expertise of our CRM and telecom businesses in combination with the access to market of our newly-acquired PacificNet Games Limited subsidiary, we seek to brand ourselves as a leading gaming technology provider in the emerging gaming markets in Macau and Asia. We believe that due to the success of our new generation Asian oriented gaming software, our gaming business has begun to draw the attention of some other first tier gaming operators in Macau, North Asia, South America and Italy. Going forward, while we are focused on increasing market share in the aforementioned rapidly growing gaming markets, we intend to take full benefit of our first-mover advantage in the Asian market by entering into long term gaming software licensing and servicing agreements with both land-based and on-line gaming operators in those less developed South-East Asian gaming markets, in particular the Philippines and Cambodia.

PacificNet's Operations include the following four groups:

1. Software Outsourcing Services. We provide (1) Business Process Outsourcing (BPO), such as call centers, CRM and telemarketing services and (2) IT Outsourcing (ITO), such as outsourced software programming and development services in our CMM3 Certified software development center in China. Our business process outsourcing services generate revenues from call center services, call center management software sales, and training and consulting. We invoice our call center clients monthly at per seat monthly rates, a base price plus commission per call, or a per hour charge rate, depending on the client's preference. Our call center software clients pay per license, for which there is usually a one-time charge on sale of the software and annual maintenance fees for service.



2. Telecom Value-Added Services (VAS). We are value-added resellers and providers of Content Providing (CP), Platform Providing (PP) and Service Providing (SP) telecom VAS, such as Interactive VoiceResponse (IVR) systems, call center management systems and Voice Over Internet Protocol (VOIP), as well as mobile phone VAS, such as Short Messaging Services (SMS) and Multimedia Messaging Services (MMS). We charge per project for our consulting and training services and for our telecom VAS, which are invoiced throughout the project. Our telecom VAS often includes a post-sale service contract for systems integration and consulting services for which we bill separately.

3. Telecom and Gaming Products and Services. Our telecom and gaming products and services include distribution services, multimedia interactive self-service kiosk distribution, online mobile phone distribution, and the design, manufacture, and marketing of gaming machines (Asian multi-player electronic gaming machines). In addition to gaming machines, we also offer the leading hotel, casino and slot hall operators based in Macau, China and other Asian gaming markets a wide range of gaming technology solutions including gaming related maintenance. Our products (telecom & gaming) and services group generates revenue from two main streams. We generate revenue from the sale of entertainment kiosks and cell phones (which are sold cash-on-delivery) and we generate revenue from the sale of Asian multi-player electronic gaming machines and gaming technology solutions. Going forward, we intend to earn gaming operations revenue from offering our customers a wide range of lease and rental options and earn royalty income from game content licensing agreements.

4. Other Business Services. We have a number of subsidiaries that we use primarily for administration, internal control and acquisition purposes.

## CORPORATE STRUCTURE

We conduct our business operations through operating subsidiaries in our Gaming Technology Business Unit and our Legacy Business Unit:

### (I) GAMING TECHNOLOGY BUSINESS

#### TAKE1 TECHNOLOGIES GROUP LIMITED ("TAKE1")

Take1 Technologies (<http://www.take1technologies.com>), is in the business of designing and manufacturing electronic multimedia entertainment kiosks, coin-op kiosks and machines, Electronic Gaming Machines (EGM), bingo and slot machines, Amusements With Prizes(AWP) games, server-based downloadable games systems, and Video Lottery Terminals (VLT) such as Keno and Bingo machines, including hardware, software, client-server systems and cabinets. Take1 is a leading designer, developer and manufacturer of multimedia entertainment and communication kiosk products including photo and video entertainment kiosks, digital camera photo development stations, Multimedia Messaging Services (MMS) and mobile content download stations for mobile phones, and other coin-operated peripherals and consumables. Take1 Technologies is based in Hong Kong and markets and distributes its products around the world including the USA, Canada, Mexico, Europe, China, and Southeast Asia.

#### PACIFICNET GAMES LIMITED (PactGames)

PacificNet Games Limited ("PactGames", [www.PactGame.com](http://www.PactGame.com)) is a leading provider of Asian multi-player electronic gaming machines, gaming technology solutions, gaming related maintenance, IT and distribution services for the leading hotel, casino and slot hall operators based in Macau, China and other Asian gaming markets.

### (II) LEGACY TELECOM AND CRM BUSINESS

#### (A) SOFTWARE & OUTSOURCING SERVICES GROUP

1) PACIFICNET EPRO HOLDINGS LIMITED: PacificNet Epro Holdings Limited (referred to herein as "Epro"), a company incorporated in the Hong Kong Special Administrative Region of the PRC, is engaged in the business of providing call center and Customer Relationship Management (CRM) services, mobile marketing and promotion services, call center training, management and consulting services. Epro was sold on April 18, 2008 for an aggregate purchase price of HK\$21 million.

2) PACIFIC SMARTIME SOLUTIONS LIMITED / PACIFIC SOLUTIONS TECHNOLOGY (SHENZHEN) CO. LTD. (PactSo): Pacific Smartime Solutions Limited (referred to herein as "Smartime") is an IT outsourcing company incorporated in Hong Kong that operates through its China subsidiary Pacific Solutions Technology (Shenzhen) Co. Ltd. (referred to herein as: PactSo), which is a leading provider of outsourcing services including software development, R&D, and project management services in China. Smartime employs over 280 staff and provides outsourcing services to the leading telecom, banking and financial services companies in China, including Huawei, IBM, and Bank of East Asia. In December 2004, Smartime launched a new software development outsourcing center in Shenzhen, currently occupying one floor with 13,000 square feet. PacificNet's software R&D and outsourcing unit, Pacific Solutions Technology, is a CMM Level 3 certified software development center with over 200 software programmers and specializes in the development of high-end client-server application software, internet e-commerce software, online and casino gaming systems and slot machines, banking and telecom applications using Microsoft Visual C++, Java, and other rapid application development tools.

(B) TELECOM VALUE-ADDED SERVICES (VAS) PROVIDER

GUANGZHOU WANRONG INFORMATION TECHNOLOGY CO., LIMITED (Incorporated in the PRC)

Guangzhou Wanrong Information Technology Co., Ltd. ("Guangzhou Wanrong,") is one of the leading value-added telecom service providers in China. Since its inception in 2003, Guangzhou Wanrong has achieved strong growth in its VAS including SMS, WAP, JAVA, MMS, IVR, multimedia entertainment download services, media interactive products, mobile email services, life, sports, entertainment, and business information services. Guangzhou Wanrong was granted nationwide SMS service numbers "2388" for China Mobile and "9928" for China Unicom.

(C) PRODUCTS GROUP

1) PACIFICNET COMMUNICATIONS LIMITED

PacificNet Communications Limited (referred to herein as "PactCom"), incorporated in Hong Kong, is a wholly owned subsidiary of PacificNet that specializes in the sales and distribution of mobile communication products, accessories, phone cards and mobile SIM cards, and telecom related services in Hong Kong and Greater China.

2) PACIFICNET IMOBILE (BEIJING) TECHNOLOGY CO., LIMITED (Incorporated in the PRC)

PacificNet iMobile (Beijing) Technology Co., Ltd ("iMobile") is the leading internet e-commerce distributor of mobile products in China. It provides Internet, email, customer service centers, pre and post-sale services, logistics and Cash On Delivery (COD) services to mobile consumers in China. iMobile's 18900.com e-commerce operations combine online internet services with its offline customer services network comprised of a nationwide chain of logistics and customer service centers covering 21 provinces and 40 major cities in China including Beijing, Shanghai, Chongqing, Tianjin, Chengdu, Dalian, Qingdao, Guangzhou, Shenzhen, Zhuhai, Dongguan, Hangzhou, Suzhou, Ningbo, Wenzhou, Nanjing, Wuhan, Xian, Harbin, Qiqihaer, Hunan and Changsha. iMobile has developed into the largest online mobile phone sales company in China and has partnered with Sina, Netease, China.com, joyo.com, and 263.net on e-commerce cooperation. iMobile's 18900.com operation is the designated Internet distributor for Motorola, Nokia, and NEC's mobile products in China.

OTHER BUSINESS ENTITIES

1) PACIFICNET LIMITED (INCORPORATED IN HONG KONG)

PacificNet Limited is incorporated in Hong Kong as a wholly owned subsidiary of PacificNet Inc. Its primary purpose is to handle the general administrative operations of PacificNet in Hong Kong.



2) PACIFICNET STRATEGIC INVESTMENT HOLDINGS LIMITED (Incorporated in the BVI)

PacificNet Strategic Investment Holdings Limited (referred to herein as "PactInvest"), incorporated in the British Virgin Islands (BVI), is a wholly owned subsidiary of PacificNet that specializes in strategic investment, direct investment, mergers and acquisitions, joint venture development, and other financial and investment services in Hong Kong and Greater China. Its primary purpose is to help PacificNet identify strategic investment opportunities, process deal flow, conduct due diligence, negotiate terms and valuation, monitor investment performance and conduct synergy development, with a focus in China investment opportunities related to PacificNet's business.

3) PACIFICNET TECHNOLOGY (SHENZHEN) LIMITED (Incorporated in the PRC)

PacificNet Technology (Shenzhen) Limited (referred to herein as "PactSZ") incorporated in the PRC as a Wholly Owned Foreign Enterprise (WOFE), is a wholly owned subsidiary of PacificNet Limited Hong Kong. Its primary purpose is to provide administrative support back-office, IT support and software development services, to support PacificNet's operations in China and to conduct the general administrative operations of PacificNet in China.

4) PACIFICNET BEIJING LIMITED (Incorporated in the PRC)

PacificNet Beijing Limited (referred to herein as "PactBJ") incorporated in the PRC as a wholly owned foreign enterprise (WOFE) is a wholly owned subsidiary of PacificNet Limited Hong Kong. Its primary purpose is to provide administrative back-office support, IT support and software development services, to support PacificNet's operations in China, and to conduct the administrative operations of PacificNet in China.

DEVELOPMENTS DURING FISCAL YEAR 2007

1) JOINT VENTURE WITH BELLSYSTEM24 JAPAN TO PROVIDE CALL CENTER & CRM SERVICES IN SHANGHAI, CHINA (BELL-PACT)

On January 5, 2007, we entered into a joint venture agreement with Bellsystem24, the largest telemarketing call center in Japan, to form a new joint venture company called BELL-PACT Consulting Limited. The new joint venture company is jointly owned 40% by PacificNet and 60% by Bellsystem24. The joint venture offers CRM call center consulting and training services, technical and business consulting services, network product sales, software development, system integration, as well as value-added services and other relevant services out of Shanghai catering to the Greater China markets.

2) ACQUISITION OF ADDITIONAL SHARES IN TAKE1 TECHNOLOGIES IN Q1 2007

On January 5, 2007, we entered into a Securities Subscription Agreement to exercise an option to acquire an additional 31% interest in Take 1 Technologies Limited "Take 1". On May 3, 2007, we consummated the purchase for \$594,847 (to be paid entirely with shares of PacificNet: 149,459 PACT Shares, valued at \$3.98 per share). As a result, we became the majority and controlling shareholder of Take1 with our ownership percentage increased from 20% to 51%.

3) COMPLETION OF \$5 MILLION PRIVATE PLACEMENT FINANCING FOR GAMING TECHNOLOGY EXPANSION IN MACAU AND ASIA

On February 6, 2007, PactGames entered into a definitive agreement for a \$5 million financing in the form of a secured convertible note with Pope Asset Management, LLC (Pope), an institutional investor. Proceeds from the financing were used to provide PactGames with additional working capital to expand its gaming technology operations, funding for strategic acquisitions in China and funding for general corporate purposes. The \$5 million

convertible note issued by PactGames to Pope matures on February 6, 2010, and may be converted into 26% to 32% ownership interest in PactGames based on reaching certain net income milestones during fiscal year 2007. The interest rate on the convertible note will initially be set at 8%, and shall increase to 15% if the note is not converted prior to maturity.

#### 4) PRIVATE PLACEMENT OF CONVERTIBLE DEBENTURES AND WARRANTS

On March 13, 2006, we completed a private placement in which we sold \$8,000,000 in convertible debentures and issued warrants to purchase up to an aggregate of 400,000 shares of common stock. The debentures are convertible at any time into shares of our common stock at an initial fixed conversion price of \$10.00 per share, subject to adjustments for certain dilutive events. The debentures are due March 13, 2009. The warrants are exercisable for a period of five years at an exercise price of \$12.20 per share. We will pay interest in shares, provided that certain conditions are met, or in cash at the rate of 6% for the second year the debentures are outstanding and then 7% for the third year.

Under the terms of a registration rights agreement entered into at the time of the private placement, the Company was obligated to file a registration statement with respect to the shares issuable under the debenture and the warrants by April 30, 2006, and have the registration statement declared effective by the SEC no later than June 28, 2006. Due to various factors, the Company did not file the registration statement until May 15, 2006, and it was not declared effective until December 8, 2006. Therefore, under the terms of the registration rights agreement, the Company was obligated to pay liquidated damages to the investors at the rate of 2% of the principal amount of the debenture each month beginning on June 28, 2006 up to a maximum of 20% per holder, in the event we suspend use of the prospectus for longer than 15 consecutive calendar days or more than an aggregate of 30 calendar days during any 12-month period. Moreover, at the election of the debenture holder, our debenture could be declared in default, resulting in acceleration of the amounts due, if such suspension continues more than 20 consecutive trading days or 60 non-consecutive trading days during any 12-month period, which was equal to \$1,120,000, in the aggregate as at December 31, 2006.

In February 2007, upon reaching an agreement on the amount and payment of accrued liquidated damages, the Company signed a Settlement and Release Agreement with each of the investors. Under the terms of the Settlement and Release Agreements, the Company paid an aggregate \$140,000 in cash as satisfaction in full of liquidated damages owed to Basso Fund Ltd., Basso Multi-Strategy Holding Fund Ltd., and Basso Private Opportunities Holding Fund Ltd. Partial liquidated damages owed to Whalehaven Capital Fund Ltd. were paid in the amount of \$35,000 in cash, with the remaining liquidated damages in the amount of \$105,000 paid in the form of a new convertible debenture due February 2009, on substantially the same terms as the original debentures, except that interest only is paid on the new debentures until October 2008 and beginning in November 2008 until February 2009, when the new debentures are due, the monthly redemption amount under the new debentures shall be equal to \$315,000. The remaining investors also agreed to accept the aggregate \$840,000 in liquidated damages owed to them in the form of the new convertible debentures for the amount of their respective portion of the liquidated damages. The Company also agreed to amend the original debentures to shorten the term for payment of the original principal amount to a 22 month term. As a result the monthly redemption amount for the original debentures increased from \$320,000 to \$363,638. All other terms and conditions of the original debenture remain in full force and effect.

In July 2007, we failed to timely make scheduled principal and interest payments under the Amended Debenture in the aggregate amount of \$8,000,000. Pursuant to the terms of the Amended Debenture, we were obligated to make monthly redemption payments commencing on January 1, 2007, until the Amended Debenture was redeemed in full. On August 1, 2007, the Company made the July monthly redemption and interest payments to all of the debenture holders. The Company has calculated the amount of the direct financial obligation as accelerated and increased to be \$3,079,091.

#### 5) SALE OF GUANGZHOU 3G

As part of our strategy to move away from telecom VAS, on April 30, 2007, through our wholly-owned subsidiary, PacificNet Strategic Investment Holdings Limited (“PSI Holdings”), we entered into a stock purchase and sale agreement with Heyspace International Limited to sell PSI Holdings’ 51% interest in Guangzhou 3G’s parent company,

Pacific 3G Information & Technology Co. Limited. The purchase price is \$6,000,000 payable in installments over a six month period or earlier if Heyspace completes its initial public offering prior to October 31, 2007. Heyspace paid an initial purchase price of \$1,000,000. On November 25, 2007, we entered into a memorandum of understanding (“MOU”) with Heyspace. Pursuant to the MOU, we agreed with Heyspace that for a period commencing on November 25, 2007 through March 31, 2008, we are free to seek new buyers to purchase PSI Holdings’ share ownership in Guangzhou 3G at a consideration and term which at a minimum will not cause any disposal loss to us. In addition, Heyspace agreed to return to us as part of the collateral the 46% ownership of Guangzhou3G which Heyspace had agreed to purchase, but did not complete its payment obligations under the stock purchase and sale agreement.

PacificNet and Heyspace entered into a Supplement Agreement for 3G's deal on 20th March, 2008. According to this supplement agreement, Heyspace should pay the remaining USD\$5,000,000 on or before 31 March, 2009, otherwise PacificNet has right to reclaim the unpaid 46% shares of Pacific 3G Information & Technology Co., Limited, and demand for an annual interest rate of 12%.

## RECENT DEVELOPMENTS

### 1) SALE OF EPRO TELECOM - CRM CALL CENTER

On April 18, 2008, PacificNet, consummated the sale of the Company's subsidiary, PacificNet Epro Holdings Limited, a company incorporated in the Hong Kong Special Administrative Region of the PRC ("Epro"), which is primarily engaged in the business of providing call center telecom and customer relationship management services as well as other business outsourcing services in China. Pursuant to the terms of the Sales and Purchase Agreement (the "Agreement") entered into between the Company and Epro Group International Limited (the "Epro Group International"), PacificNet sold its entire share ownership of 7,766,993 shares in Epro for HK\$21 million.

Upon execution of the Agreement, the Company received a payment of HK\$3 million. PacificNet shall receive the remaining purchase price in installments over the next twenty-four months.

Pursuant to the terms of the Agreement, within sixty days of the closing, Epro shall repay PacificNet HK\$2 million for an interest bearing loan granted from PacificNet to Epro.

### 2) NOTICE OF DELISTING OR FAILURE TO SATISFY A CONTINUED LISTING RULE OR STANDARD; TRANSFER OF LISTING.

On April 16, 2008, PacificNet received a letter from The NASDAQ Stock Market indicating that as a result of the Company's failure to file with the Securities and Exchange Commission the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2007, the Company is not in compliance with the NASDAQ requirements for continued listing set forth in NASDAQ Marketplace Rule 4310(c)(14). NASDAQ Marketplace Rule 4310(c)(14) which requires the Company to make on a timely basis all filings with the Securities and Exchange Commission, as required by the Securities Exchange Act of 1934, as amended.

As a result of failure to timely file the Annual Report on Form 10-K, PacificNet's securities were subject to delisting from the NASDAQ Stock Market at the opening of business on April 25, 2008, unless PacificNet appealed such determination. PacificNet has appealed the NASDAQ Staff's determination and requested a hearing before the NASDAQ Listing Qualifications Panel, which automatically stayed the delisting of PacificNet's common stock pending the Panel's review and determination. The hearing has been set for June 12, 2008.

Although there can be no assurance that the Panel will grant the Company's request for continued listing, once the 10-K and 10-Q are filed, the Company believes the NASDAQ non-compliance situation will be remedied.

## PRODUCTS AND SERVICES OFFERED

### Gaming Technology Operations

Through our gaming technology subsidiaries in Macau, China, we design, manufacture and market innovative electronic gaming machines, bingo machines, AWP and VLTs for customers in legalized gaming jurisdictions in Macau, Asia, and Europe. Our video gaming machines include localized Chinese and Asian themes, content, advanced graphics and digital sound effects and music. Amusing, entertaining or familiar graphics and musical themes with Chinese and Asian contents add to the player appeal of our games in Asia.



For our gaming technology operations, we generate revenue in two principal ways. First, we generate product sales revenues from the sale to casinos and other licensed gaming machine operators of new and used gaming machines and VLTs, conversion kits (including theme and/or operating system conversions), parts, and original equipment manufacturing (“OEM”) for third parties. Second, we earn gaming operations revenues from leasing participation gaming machines and VLTs, and earn royalties that we receive from third parties under license agreements to use our game content.

## Product Sales

We offer the following gaming technology products for sale:

Electronic Gaming Machines (EGM). Our line of electronic gaming machines combine localized Chinese and Asian themes and content, advanced graphics, digital sound effects and music, and secondary bonus games.

- Multi-player Electronic Table Games, eTable Series of Multiplayer Gaming Machines
- Multi-player Electronic Baccarat Machines
- Multi-player Electronic Sicbo Machines
- Multi-player Electronic Roulette Machines
- Multi-player Electronic Fish-Prawn-Crab Machines
- Slot Machines
- Electronic Bingo Machines
- Video Lottery Terminals (VLTs)
- Server-Based Gaming Machines (SBG)
- Amusement With Prizes (AWP) Machines
- Online Gaming Software Development
- Client-Server Gaming Systems
- CMM Level 3 Certified Gaming Software Development Center in China
- Cabinet Design and Sales, Parts Sales, OEM Games. We design and sell gaming machine cabinets, replacement parts.

## PACT Gaming Technology

1. Participation games: Company-owned gaming machines that we lease to casino operators based upon any of the following payment methods: (1) a percentage of the net win of the gaming machines, (2) fixed daily fees, or (3) in the case of wide-area progressive gaming machines, a percentage of the amount wagered or a combination of a fixed daily fee and a percentage of the amount wagered.

2. Wide Area Game Network, Community Gaming: Electronically linked gaming machines that are located across multiple casinos within a gaming jurisdiction contribute to and compete for large, system-wide progressive jackpots. They are designed to increase gaming machine play for participating casinos by giving the players the opportunity to win a larger jackpot than on a stand-alone gaming machine.

3. Local Area Progressive Jackpots (LAP) participation games: Electronically linked gaming machines that are located within a single casino to a progressive jackpot for that specific casino.

4. Lottery Products, Video Lottery Terminals, Mobile Lottery Terminals, Online Paperless Lottery Sales Systems: Video gaming machines featuring with localized Chinese and Asian themes and content, advanced graphics, digital sound effects and many of the same features as our other gaming machines.



5. Server-based Gaming: A gaming system in which game content and peripherals are configured, maintained and refreshed over a network that links groups of gaming machines to a remote server that also enables custom configuration by operators and central determination of game outcomes.

#### Legacy Business Operations

Customer Relationship Management (CRM) and gaming technology, are both rapidly expanding business sectors in Asia. The services offered by each of our subsidiaries can be classified within one of the following three business groups:

#### 1. OUTSOURCING SERVICES

##### A) BUSINESS PROCESS OUTSOURCING

Epro operated our call center offering 24 hour answering and automatic-answering service hotlines in our service areas, handling customer inquiries regarding services, billing, and technical support, as well as customer complaints. Epro was sold on April 18, 2008. See "Recent Developments".

##### B) SOFTWARE DEVELOPMENT OUTSOURCING

Pacific Solutions Technology (PactSo) provides outsourced consulting services and programming services, including software development, R&D, and project management to leading telecom, banking and financial services companies that include Huawei, IBM, Bank of East Asia and others. PactSo specializes in software application development and software outsourcing services for the telecom and gaming industries. The scope of PactSo's products and services includes smart card solutions, web-based front-end applications and web-based connections to backend enterprise planning systems.

#### 2) TELECOM PRODUCTS

PacificNet Communications Limited (referred to herein as "PactCom"), incorporated in Hong Kong, is a wholly owned subsidiary of PacificNet that specializes in the sale and distribution of mobile communication products, accessories, phone cards and mobile SIM cards, and telecom related services in Hong Kong and Greater China.

iMobile's Internet portal has been one of the top ranked traffic sites and has achieved 5.4 million registered online users and over 1,200,000 active users, with 10 million daily page views and 40,000 blog postings per day, which makes iMobile the top ranked site in its category in China.

#### FINANCIAL INFORMATION ABOUT OUR BUSINESS SEGMENTS

We identify and classify our operating segments based on reporting entities that exhibit similar long-term financial performance based on the nature of the products and services with similar economic characteristics such as margins, business practices and target market. The operating segments are classified into four major segments which include outsourcing services, telecom value-added services, products (telecom & gaming) and services and other business. For financial information about these operating segments, see Note 15 to our Consolidated Financial Statements.

#### PRINCIPAL CUSTOMERS

Our principal customers in each of our business groups are located in Hong Kong, mainland China and other regions of Asia. Our key clients consist of leading telecom operators, banks, insurance, travel, marketing, government, services companies and telecom consumers, casinos and gaming operators.



## 1. GAMING CUSTOMERS

Our gaming customers include some of the leading casinos, hotels, gaming operators, bingo, slot and AWP operators in Macau, SE Asia, and Europe. Some of the famous casinos that are using our gaming products include Sociedade de Jogos de Macau (SJM), Sociedade de Turismo e Diversoes de Macau (STDM), Casino Lisboa, SJM Slot, Macau Jockey Club, Paradise Casino, Jai Alai Casino Macau, Galaxy Waldo Casino Macau (Galaxy Entertainment Group), and other land-based gaming operators and bingo operators in Asia and Europe. Our lottery customers include the leading lottery operators in China and Asia, including the China Welfare Lottery.

## 2. OUTSOURCING SERVICES (INCLUDING BPO, ITO, CALL CENTER SERVICES) CUSTOMERS

The following is a brief description of some of the Company's customers in the outsourcing services group:

BELLSYSTEM24, Japan - Established in 1982, Bellsystem24 (<http://www.bell24.com>) is the largest telemarketing call center services company in Japan, with over 5,000 clients, 27,348 communication service representatives and 33 offices in Japan. Bellsystem24 has built a client base of multinational firms and industry leaders by developing and nurturing long-term relationships. Bellsystem24's commitment to quality, technological innovation, and value-added services has made it the leading provider of outsourced customer care and marketing solutions in Japan. Bellsystem24 focuses on developing long-term strategic relationships with clients in customer-intensive industries, including telecommunications, cable, broadband, satellite broadcasting, Internet services, technology, and financial services. Through a nationwide network of contact centers utilizing a unique blend of one-on-one marketing media, knowledge-based tools, advanced technology, and expert recruiting, staffing, training, and certifications, Bellsystem24 has fostered a leading position in the customer care industry.

## 3. TELECOM VALUE-ADDED SERVICES CUSTOMERS

CHINA TELECOM - The largest fixed service telecommunications provider in China, which includes data, Internet, and the XiaoLingTong PAS wireless system.

CHINA NETCOM - One of the four major telecom carriers in China, which includes fixed line, data, Internet, and the XiaoLingTong wireless system.

CHINA MOBILE - The largest mobile operator in China.

CHINA UNICOM - One of the major mobile operators in China operating both GSM and CDMA mobile networks, long-distance and local landlines, data communication including Internet service and IP phones, value-added telecom services, wireless paging and a variety of relevant services.

NOKIA - Nokia is the world leader in mobile communications, driving the growth and sustainability of the broader mobile communications industry. Nokia connects people to each other and the information that matters to them with easy-to-use and innovative products like mobile phones, devices, and solutions for imaging, games, media and businesses. Nokia provides equipment, solutions and services for network operators and corporations.

MOTOROLA - Motorola is one of the top mobile brands in China in terms of both popularity and market share.

## 4. TELECOM PRODUCTS

Our telecom products customers include China Telecom, China Netcom, China Mobile, China Unicom, and major mobile phone manufacturers such as Motorola and Nokia.



## SALES AND MARKETING

We advertise our services by attending various internet, gaming, e-commerce, telecom, CRM and VAS trade shows and conferences in China. There are a limited number of competitors in our industry; accordingly, new business opportunities are generated mainly through business contacts and by word of mouth. We rely on our reputation for quality and efficiency among our customers and leveraging our strategic investors to obtain new business.

## GOVERNMENT REGULATION

We operate our business in Macau, Hong Kong, China, and Asia under several regulators, ministries and agencies under a number of government jurisdictions, including:

- The Macau Gaming Inspection and Coordination Bureau (“Direcção de Inspecção e Coordenação de Jogos”, “DICJ”), provides guidance and assistance to the Chief Executive of Macao SAR on the definition and execution of the economic policies for the operation of casino games of fortune or other ways of gaming, Pari-Mutuels and gaming activities offered to the public. For more information, please visit <http://www.dicj.gov.mo/>
- The Philippine Amusement and Gaming Corporation (PAGCOR, <http://www.pagcor.ph>) is the government-owned and controlled corporation established to regulate all games of chance in the Philippines. It was created in 1976 to oversee the operation of gaming casinos, to generate funds for the government's developmental projects, and to help curb illegal gambling. Currently, PAGCOR operates 13 Casinos, 8 VIP clubs and 3 slot machine arcades in major cities across the Philippines. It also oversees and regulates more than 180 bingo parlors across the country. PAGCOR employs more than 11,000 employees.
- China: the State Council is the highest authority of the executive branch of the PRC central government, and several ministries and agencies under its leadership, including:
  - The Ministry of Information Industry (MII)
  - The China Securities Regulatory Commission (CSRC)
  - The Ministry of Culture
  - The General Administration of Press and Publication of the P.R. China
  - The State Copyright Bureau
  - The State Administration of Industry and Commerce (SAIC)
  - The Ministry of Public Security
  - The Ministry of Commerce

The State Council and these ministries and agencies have issued a series of rules that regulate a number of different substantive areas of our business, which are discussed below.

## FOREIGN OWNERSHIP RESTRICTION ON BUSINESSES ENGAGED IN PROVIDING INTERNET CONTENT

PRC regulations currently limit foreign ownership of companies that provide Internet content services to 50%. This limitation extends to our IVR, call center e-commerce and telecom VAS and to our business of providing financial information and data to Internet users. To comply with this foreign ownership restriction, with respect to our Internet content services, we operate our website in China for example, through Beijing Xing Chang Xin Science and Technology Development Co. Limited (“Xinchangxin”), which is 100% owned by Mr. Liu Lei and Gao Chunhui, the Chairman and CEO of Xinchangxin, who are both PRC citizens. Under PRC law, BEIJING PACIFICNET IMOBILE TECHNOLOGY CO., LTD., PRC registered wholly owned foreign enterprise (IMOBILE-WOFE), conducts its VAS and e-commerce operations with Beijing Xing Chang Xin Science and Technology Development Co. Limited (“iMobile-DE”), a PRC registered Domestic Enterprise (DE), through a series of contractual agreements. Under these agreements, the shareholders of iMobile-DE are required to transfer their ownership in these entities to our subsidiaries when permitted by PRC laws and regulations and all voting rights are assigned to us. Through iMobile-WOFE, we have also entered into a consulting and services agreements with iMobile-DE, under which

iMobile-WOFE provides technical services and other services to iMobile-DE in exchange for all of the net income of iMobile-DE. In addition, the shareholders of iMobile-DE have pledged their shares in iMobile-DE as collateral for non-payment of fees for the services we provide.

12

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There are substantial uncertainties regarding the interpretation and application of current or future PRC laws and regulations with respect to foreign ownership of internet content providing companies. In the opinion of our in-house PRC legal counsel, our current ownership structure, the contractual arrangements among our wholly owned subsidiaries and the operating company and their shareholders comply with all existing applicable PRC laws, rules and regulations. We cannot assure that the PRC regulatory authorities will not ultimately take a view that is contrary to the opinion of our PRC legal counsel. If the PRC government finds that the agreements that establish the structure of our operations in China do not comply with PRC government restrictions on foreign investment in our industry, we could be subject to severe penalties.

## LICENSES AND PERMITS

There are a number of aspects of our business which require us to obtain licenses from a variety of PRC regulatory authorities. For example, in order to host our website, Xinchangxin is required to hold an Internet content provider, or ICP, license issued by the Ministry of Information Industry or its local offices. Xinchangxin currently holds an ICP license issued by Ministry of Information Industry Beijing department.

## REGULATION OF INTERNET CONTENT

The PRC government has promulgated measures relating to Internet content through a number of ministries and agencies, including the Ministry of Information Industry, the Ministry of Culture and the State Press and Publications Administration. These measures specifically prohibit Internet activities that result in the publication of any content which is found to, among other things, propagate obscenity, gambling or violence, instigate crimes, undermine public morality or the cultural traditions of the PRC, or compromise State security or secrets. If an ICP license holder violates these measures, the PRC government may revoke its ICP license and shut down its websites. Xinchangxin's ICP license expressly states that it is not allowed to publish news, among other things, in relation to its Internet content provision. Specifically, Shenzhen, Beijing and Guangzhou branches of the General Administration of Press and Publication of the PRC, the government authority regulating news publication, confirmed with us that so long as we do not provide general news on politics, society or culture, or establish a "news column," or provide such information under express heading of "news," we are not required to obtain a license to publish financial or economic related news content.

## REGULATION OF INFORMATION SECURITY

Internet content in China is also regulated and restricted by the PRC government to protect State security. The National People's Congress, China's national legislative body has enacted a law that may subject to criminal punishment in China any effort to: (1) gain improper entry into a computer or system of strategic importance; (2) disseminate politically disruptive information; (3) leak State secrets; (4) spread false commercial information; or (5) infringe on intellectual property rights.

The Ministry of Public Security has promulgated measures that prohibit use of the Internet in ways which, among other things, would result in a leakage of State secrets or a spread of socially destabilizing content. The Ministry of Public Security has supervision and inspection rights in this regard and we may be subject to the jurisdiction of the local security bureaus. If an ICP license holder violates these measures, the PRC government may revoke its ICP license and shut down its websites.

## INTELLECTUAL PROPERTY RIGHTS

The State Council and the State Copyright Bureau have promulgated various regulations and rules relating to protection of software in China. Under these regulations and rules, software owners, licensees and transferees should register their rights in software with the State Copyright Bureau or its local offices and obtain software copyright

registration certificates. Although such registration is not mandatory under PRC law, software owners, licensees and transferees are encouraged to go through the registration process. Therefore persons with registered software rights may receive better protection. We have registered all of our self-developed software with the State Copyright Bureau.

PRC law requires owners of Internet domain names to register their domain names with qualified domain name registration agencies approved by the Ministry of Information Industry and obtain a registration certificate from such registration agencies. A registered domain name owner has an exclusive use right over its domain name. Unregistered domain names may not receive proper legal protections and may be misappropriated by unauthorized third parties.

## PRIVACY PROTECTION

PRC law does not prohibit Internet content providers from collecting and analyzing personal information from their users. On our website, our users are required to accept a user agreement whereby they agree to provide certain personal information to us. PRC law prohibits Internet content providers from disclosing to any third parties any information transmitted by users through their networks unless otherwise permitted by law. If an Internet content provider violates these regulations, the Ministry of Information Industry or its local offices may impose penalties and the Internet content provider may be liable for damages caused to its users.

## ADVERTISING REGULATION

PRC law requires entities conducting advertising activities to obtain an advertising permit from the SAIC's local offices. Entities conducting advertising activities without such permit may be charged a fine or imposed other penalties by the SAIC's local offices. Currently, foreign investors cannot own more than 70% equity interest in an advertising agency.

## INTERNATIONAL REGULATION

Many foreign jurisdictions permit the importation, sale and/or operation of gaming equipment in casino and non-casino environments. Where importation is permitted, some countries prohibit or restrict the payout feature of the legacy slot machine or limit the operation of slot machines to a controlled number of casinos or casino-like locations. Each gaming machine must comply with the individual jurisdiction's regulations. Some jurisdictions require the licensing of gaming machine operators and manufacturers. We manufacture and supply gaming equipment to various international markets including Asia, Australia, Canada, Europe, South America and South Africa with our partners who have the required licenses to manufacture and distribute our products in the foreign jurisdictions in which we do business.

## COMPETITION

Competition in Gaming Technology Business:

Electronic Gaming Machine Competitors

PACT's primary focus areas are gaming technology products for land-based casinos and Internet casinos. For land-based casino operators, the Electronic Gaming Machine (EGM) market is intensely competitive and is characterized by the continuous introduction of new game titles and new technologies. Our ability to compete successfully in this market is based, in large part, upon our ability to:

- Create an expanding and constantly refreshed portfolio of games with high earnings performance

- Offer gaming machines that consistently out-perform gaming machines manufactured by our competitors

- Identify and develop or obtain rights to commercially marketable intellectual properties

- Adapt our products for use with new technologies

In addition, successful competition in this market is based upon:

- Engineering innovation and reliability
- Mechanical and electronic reliability

- Brand recognition
- Marketing and customer support

- Competitive prices and lease terms

We estimate that about 25 companies in the world manufacture gaming machines and video lottery terminals (VLTs) for legalized gaming markets. Of these companies, we believe that International Game Technology (“IGT”), Shuffle Master/StarGames, WMS Industries, Bally Technologies (formerly Alliance Gaming), Aristocrat Technologies, Novomatic, Atronic, Casino Technology, DEQ, and Lottomatica’s recently acquired subsidiary G-Tech Holdings have a majority of this worldwide market. In the video gaming machine market, we compete with market leader IGT, as well as Aristocrat Technologies, Bally Technologies, Atronic, Casino Technology, Progressive Gaming, Konami, Aruze, Franco and Unidesa. In the VLT market, we compete primarily with IGT, G-Tech Holdings and Scientific Games. Aruze Corp. is a world leader in the manufacturing of Pachi-Slot, Pachi-Com, Reel Spinning Slots and Video Gaming Devices. Aruze Corp. also develops Arcade Games, Amusement Games and Consumer Game Software.

Our competitors vary in size from small companies with limited resources to a few large corporations with greater financial, marketing and product development resources than ours. The larger competitors, particularly IGT, have an advantage in being able to spend greater amounts than us to develop new technologies, games and features that are attractive to players and customers. In addition, some of our competitors have developed, sell or otherwise provide to customers security, centralized player tracking and accounting systems which allow casino operators to accumulate accounting and performance data about the operation of gaming machines. We do not currently offer these systems. Several of our competitors pooled their intellectual property patents that provide cashless gaming alternatives, specifically ticket-in ticket-out technology, so that when a casino patron cashes out from a gaming machine they may receive a printed ticket instead of coins.

PACT has been extending its international reach into Asia. In 2006 and 2007, we acquired interests in several Asian internet and mobile game developers in China. Industry experts expect Asia to be the fastest growing and ultimately the largest online gaming market in the world. China alone has over 135 million Internet users, making it the world’s second largest user group after the U.S. While we believe that Asia will be the next major Internet gaming market, there are currently regional legislative issues and limited payment forms to adequately support the industry.

#### Online Gaming Software Competitors

Online casinos were first developed more than a decade ago and are a new development area for PACT. Internet casinos constituted 33.5% of the global online gaming market in 2006 (excluding the U.S.) (source: GBGC). Online casino growth outside the U.S. is predicted to remain healthy at over 21% per year in the next two years (source: GBGC). Industry experts forecast Internet casino revenue to reach \$3.9 billion by 2012, excluding the U.S. (source: GBGC).

In the online gaming software market, we compete with CryptoLogic (CRYP) and Gigamedia (GIGM). Online gaming is a rapidly-growing industry and has become increasingly competitive and sophisticated. GBGC, a U.K. consulting firm focused on the land-based and online interactive gaming industries, estimates that the global market for online gaming, which is comprised of casino games, sports betting, poker, bingo, and lotteries, reached \$7.2 billion in annual revenue in 2006 (excluding the U.S.), up from \$2.7 billion in 2003. While it is difficult to confirm the exact number of Internet gaming sites since most companies are private, current estimates are around 2,400 online gaming

properties, down from more than 2,800 (source: GBGC) several years ago. This decrease points to industry consolidation. As Internet gaming has developed and increased in sophistication, so have the players who can choose from a proliferation of sites. Competition for players' attention and share of wallet is intensifying, and players are demanding more value, more games and a better entertainment experience.

We compete with a number of public and private companies, which provide electronic commerce and/or Internet gaming software. Given the stage of development of the industry and the number of private organizations operating in the industry, information about the nature of our competitors, their operations and their resources is difficult to compile. In addition to current known competitors, traditional land-based gaming operators and other entities, many of which have significant financial resources and name brand recognition, may provide Internet gaming services in the future, and thus become competitors of the Company. Increased competition and expenditures from current and future competitors have and could continue to result in the reduction of our margins or could result in the loss of our market share.

## Competition in our Legacy Business

We expect competition to persist and intensify in the future. Our competitors include small firms offering specific applications, divisions of large entities and large independent firms. A number of competitors have or may develop greater capabilities and resources than ours. We face the risk that new competitors with greater resources than ours will enter our market. Our competitors are mainly leaders in the CRM and VAS markets. Competitive pressures from current or future competitors could cause our services to lose market acceptance or require a significant reduction in the price of our services.

### 1. OUTSOURCING SERVICES (INCLUDING BPO, ITO, AND CALL CENTER SERVICES) COMPETITORS:

Chinasoft International Limited, or ICSS, is a leading e-government solution provider and software developer in the PRC, and has entered the software outsourcing, interrelated systems integration, consultancy and training services industry.

### 2. TELECOM VALUE-ADDED SERVICES (VAS) COMPETITORS:

SINA Corporation (NASDAQ: SINA), is a leading online media company and Value-Added information Service (VAS) provider for China and for Chinese communities worldwide offering Internet users and government and business clients an array of services.

## GAMING MACHINE MANUFACTURING

We manufacture all of our gaming machines at our facilities in Shenzhen and Guangdong, China. In 2007, we began reconfiguring our assembly lines in order to lower our product lead times and effectively increase our practical capacity with added production efficiencies.

Manufacturing commitments are generally based on sales orders from customers. In some cases, however, component parts are purchased and assembled into finished goods that are inventoried in order to be able to quickly fill anticipated customer orders. Our manufacturing process generally consists of assembling component parts to complete a gaming machine. We generally warranty our gaming machines sold internationally for a period of 180 days to one year.

The raw materials used in manufacturing our gaming machines include various metals, plastics, wood, glass and numerous component parts, including electronic subassemblies, main boards and circuit boards, money acceptors, and LCD screens. We believe that our sources of supply of component parts and raw materials are generally adequate.

In order to improve the efficiency of our manufacturing processes and reduce time to market, we continue to make improvements in sourcing and supply management, in inventory and warehouse management, and other manufacturing processes. We also have ongoing manufacturing initiatives, such as enhanced strategic sourcing and supplier management, engineering the product for maximum customer value and designing product for both ease of manufacturability and installation, which we expect will help improve gross margins in future quarters.

The European Union (“EU”) has adopted the Restriction on the Use of Certain Hazardous Substances in Electrical and Electronic Equipment (“RoHS”) directive to facilitate the recycling of electrical and electronic equipment sold in the EU. The RoHS directive restricts the use of lead, mercury, and certain other substances in electrical and electronic products placed on the market in the EU after July 1, 2006. We have worked with our suppliers to develop RoHS-compliant products and, as of the effective date of the directive, we were able to provide RoHS-compliant gaming machines to the EU. We expect that any cost increases incurred due to the RoHS directive will be offset by savings from design and other changes we made to our component parts.



## EMPLOYEES

As of March 31, 2008, together with our subsidiaries, we had approximately 545 employees and contractors. We have not experienced any labor stoppages. None of our employees are covered by collective bargaining agreements. The breakdown of number of employees for each of the business units of the Company is as follows:

| COMPANY AND<br>SUBSIDIARIES       | NUMBER OF<br>EMPLOYEES |
|-----------------------------------|------------------------|
| Smartime / PactSo<br>(Soluteck)   | 300                    |
| iMobile                           | 70                     |
| PacificNet Games<br>Limited       | 50                     |
| Wanrong                           | 40                     |
| PacificNet Beijing                | 30                     |
| PacificNet Shenzhen               | 25                     |
| PacificNet Limited<br>(Hong Kong) | 12                     |
| Take 1 Technologies               | 12                     |
| PacificNet Inc. (USA)             | 3                      |
| PacificNet Guangzhou              | 3                      |
| Total                             | 545                    |

## RESEARCH AND DEVELOPMENT

Our gaming research and development department is dedicated to developing fun and exciting electronic table games and slot machines that focus on enhancing Asian player entertainment value and to introducing leading, innovative systems products that increase our customers' revenue stream and facilitate operating efficiencies. Our dedicated China R&D center has approximately 300 employees who possess significant experience in software development and content design. Our current emphasis is on developing new technologies to expand and improve the functionalities of Multiplayer Electronic Gaming Machines, Online Game Software Development, Slot Machines, including software, hardware and cabinets, and developing new game content through third parties to refresh and grow our installed base of gaming devices.

We conduct extensive testing on the products we offer to ensure they meet the key performance and quality standards as required by gaming regulators. In addition, our R&D personnel constantly work with our customers on responding to their needs and to also ensure compatibility with other products currently available in the market. Moreover, we closely monitor the evolving standards in the gaming industry so that we are able to respond and address new technologies as they emerge.

## INTELLECTUAL PROPERTY

We believe that our trademarks, intellectual property rights, and propriety Asian gaming software product development expertise are significant assets. Currently, we have over five customized Asian gaming products. This portfolio took over three years to develop and is expected to continue to be a main focus of our R&D resources. Our company will continue to evolve as we look towards the next generation of server-based gaming products. In addition to internally developed and acquired emerging gaming technologies, we will also rely on strategic partnerships to obtain access to intellectual property.

We intend to vigorously protect the investment in our intellectual property and the unique features of our products and services by actively applying intellectual property patent protection. However, we cannot ensure that intellectual property rights will not be infringed upon.

#### EXECUTIVE OFFICES

Our executive offices are located in Hong Kong, Macau, Beijing, Shenzhen and Guangzhou, China and in Aberdeen, South Dakota, USA.

17

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We maintain a website at <http://www.PacificNet.com>. Information contained on or accessed through our website is not intended to constitute and shall not be deemed to constitute part of this Annual Report on Form 10-K..

### ITEM 1A. RISK FACTORS

Investing in our securities involves a great deal of risk. Careful consideration should be made of the following factors as well as other information included in this annual report on Form 10-k before deciding to purchase our common stock. You should pay particular attention to the fact that we conduct a majority of our operations in China and are governed by a legal and regulatory environment that in some respects differs significantly from the environment that may prevail in other countries. Our business, financial condition or results of operations could be affected materially and adversely by any or all of these risks.

THE FOLLOWING MATTERS MAY HAVE A MATERIAL ADVERSE EFFECT ON OUR BUSINESS, FINANCIAL CONDITION, LIQUIDITY, RESULTS OF OPERATIONS OR PROSPECTS, FINANCIAL OR OTHERWISE. REFERENCE TO THIS CAUTIONARY STATEMENT IN THE CONTEXT OF A FORWARD-LOOKING STATEMENT OR STATEMENTS SHALL BE DEEMED TO BE A STATEMENT THAT ANY ONE OR MORE OF THE FOLLOWING FACTORS MAY CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE IN SUCH FORWARD-LOOKING STATEMENT OR STATEMENTS.

#### RISKS RELATED TO OUR BUSINESS

The adoption of new laws or changes to or the application of existing laws relating to Internet commerce may affect the growth of our business.

In addition to regulations pertaining specifically to online gaming, we may become subject to any number of laws and regulations that may be adopted with respect to the Internet and electronic commerce. New laws and regulations that address issues such as user privacy, pricing, online content regulation, taxation, advertising, intellectual property, information security, and the characteristics and quality of online products and services may be enacted. As well, current laws, which predate or are incompatible with the Internet and electronic commerce, may be applied and enforced in a manner that restricts the electronic commerce market. The application of such pre-existing laws regulating communications or commerce in the context of the Internet and electronic commerce is uncertain. Moreover, it may take years to determine the extent to which existing laws relating to issues such as intellectual

property ownership and infringement, libel and personal privacy are applicable to the Internet.

The adoption of new laws or regulations relating to the Internet, or particular applications or interpretations of existing laws, could decrease the growth in the use of the Internet, decrease the demand for our products and services, increase our cost of doing business or could otherwise have a material adverse effect on our business, revenues, operating results and financial condition.

Our business has been and may continue to be materially affected by changes to, or interpretation of, government regulation around the world that may apply to online gaming.

The Company and our licensees are subject to applicable laws in the jurisdictions in which they operate. Our licensees hold government licenses to operate Internet gaming sites in the Philippines. Some jurisdictions have introduced regulations attempting to restrict or prohibit Internet gaming, while other jurisdictions have taken the position that Internet gaming is legal and have adopted or are in the process of considering legislation to regulate Internet gaming.

As companies and consumers involved in Internet gaming are located around the globe, including our licensees and their players, there is uncertainty regarding which government has authority to regulate or legislate the industry. On October 13, 2006, the Unlawful Internet Gambling Enforcement Act (“UIGEA”) legislation designed to prohibit Internet gaming was enacted in the United States (“U.S.”), and similar legislation may be adopted in other jurisdictions.

Future government actions may have a material impact on our operations and financial results. There is a risk that governmental authorities may view us or our licensees as having violated the local law of their end users, despite the Company’s requirement that each licensee is licensed to operate an Internet gaming business by the governmental authority of the country in which the gaming servers associated with the licensees’ gaming operations are located. Therefore, there is a risk that civil and criminal proceedings, including class actions brought by or on behalf of public entities or private individuals, could be initiated against us, our licensees, Internet service providers, credit card processors, advertisers and others involved in the Internet gaming industry and could involve substantial litigation expense, penalties, fines, injunctions or other remedies or restrictions being imposed upon us or our licensees or others while diverting the attention of our key executives. Such proceedings could have a material adverse effect on our business, revenues, operating results and financial condition.

There can be no assurance that legislation prohibiting Internet gaming or regulating various aspects of Internet gaming or the Internet gaming industry will not be proposed and passed in potentially relevant jurisdictions. The burden of compliance with any such legislation may have a material adverse effect on our business, financial condition and results of operations.

The Unlawful Internet Gambling Enforcement Act (“UIGEA”), enacted in the USA in October 2006, made it illegal to accept any funds connected with unlawful Internet gaming. Although the Company historically derived a majority of its product and licensing revenues from sources outside of the U.S., the UIGEA may still impact the business of the company.

We are subject to risks associated with a significant portion of our business conducted in non-North American jurisdictions.

As companies and consumers involved in Internet gaming, including the players of our licensees, are located around the globe, there is uncertainty regarding exactly which government has jurisdiction or authority to regulate or legislate with respect to various aspects of the industry. The uncertainty surrounding the regulation of Internet gaming in the various jurisdictions in which we operate could have a material adverse effect on our business, revenues, operating results and financial condition.

There are certain difficulties and risks inherent in doing business internationally, including the burden of complying with multiple and conflicting regulatory requirements, foreign exchange controls, potential restrictions or tariffs on gaming activities that may be imposed, potentially adverse tax consequences and tax risks, and changes in the political and economic stability, regulatory and taxation structures, and the interpretation thereof, of jurisdictions in which we, our subsidiaries and our licensees operate, and in which our licensees’ customers are located, all of which could have a material adverse effect on our business, revenues, operating results and financial condition.

There can be no assurance that we will be able to sustain or increase revenue derived from international operations or that we will be able to penetrate linguistic, cultural or other barriers to new foreign markets.

Our financial results are reported in U.S. currency, which is subject to fluctuations in respect of the currencies of the countries in which we operate, including Hong Kong Dollars (HKD), Macau Pataca (MOP), China Yuan or Renminbi (CNY or RMB), Philippine Peso (PHP), Malaysian Ringgit (MYR), New Taiwan Dollar (NT\$ or TWD), Thai Baht (THB), Vietnamese Dong (VND), Cambodia Riel (KHR), Lao Kip (LAK), Euros, and US Dollars. Accordingly, fluctuations in the exchange rate of world currencies could have a positive or negative effect on our reported results. We may utilize a hedging program from time to time and/or take advantage of the natural hedge in having operations in multiple currencies to mitigate a portion of our currency risks, but there can be no assurance that we will not experience currency losses in the future, which could have a material adverse effect on our business, revenues, operating results and financial condition.

Our business depends on the reliability of the infrastructure that supports the Internet and the viability of the Internet.

The growth of Internet usage has caused frequent interruptions and delays in processing and transmitting data over the Internet. There can be no assurance that the Internet infrastructure or the Company's own network systems will continue to be able to support the demands placed on it by the continued growth of the Internet, the overall online gaming industry or that of our customers. The Internet's viability could be affected if the necessary infrastructure is not sufficient, or if other technologies and technological devices eclipse the Internet as a viable channel.

End-users of our software depend on Internet Service Providers ("ISPs"), online service providers and our system infrastructure for access to the Internet gaming sites operated by our licensees. Many of these services have experienced service outages in the past and could experience service outages, delays and other difficulties due to system failures, stability or interruption. Our licensees may lose customers as a result of delays or interruption in service, including delays or interruptions relating to high volumes of traffic or technological problems. As a result, we may not be able to meet a level of service that we have contracted for, and we may be in breach of our contractual commitments, which could materially adversely affect our business, revenues, operating results and financial condition.

Internet gaming is a developing industry and therefore, we do not know if the market will continue to develop and our products and services will continue to be in demand.

The Internet gaming industry continues to evolve rapidly and is characterized by an increasing number of market entrants. The demand and acceptance for new products and services are subject to a level of uncertainty and growing competition, and if our production services do not continue to receive market acceptance, our business, revenues, operating results and financial condition could be materially adversely affected.

Internet gaming software and electronic commerce services are subject to security risks, which may inhibit the growth of the industry and the acceptance of our products and services.

Our Internet gaming software and electronic commerce services are reliant on technologies and network systems to securely handle transactions and user information over the Internet, which may be vulnerable to system intrusions, unauthorized access or manipulation. As users become increasingly sophisticated and devise new ways to commit fraud, our security and network systems may be tested and subject to attack. We have experienced such system attacks in the past and implemented measures to protect against these intrusions. However, there is no assurance that all such intrusions or attacks will or can be prevented in the future, and any system intrusion/attack may cause a delay, interruption or financial loss, which could have a material adverse effect on our business, revenue, operating results and financial condition.

We may be vulnerable to delays or interruptions due to our reliance on other parties.

Our electronic commerce product relies on ISPs to allow our licensees' customers and servers to communicate with each other. If ISPs experience service interruptions, it may prevent communication over the Internet and impair our ability to carry on business. In addition, our ability to process e-commerce transactions depends on bank processing and credit card systems. In order to prepare for system problems, we are strengthening and enhancing our current facilities and the capability of our system infrastructure and support. Nevertheless, any system failure as a result of reliance on third parties, including network, software or hardware failure, which causes a delay or interruption in our e-commerce services could have a material adverse effect on our business, revenues, operating results and financial condition.

We face growing competition from known competitors and new entrants in the Internet gaming, e-commerce and broader entertainment industries.

Customers and licensees of our software compete with existing and established recreational services and products, in addition to other forms of entertainment. Our success will depend, in part, upon our ability to enhance our products and services to keep pace with technological developments, respond to evolving customer requirements and achieve continued market acceptance.

We compete with a number of public and private companies, which provide electronic commerce and/or Internet gaming software. In addition to known current competitors, traditional land-based casino operators and other entities, many of which have significant financial resources, an entrenched position in the market and name-brand recognition, may provide Internet gaming services in the future, and thus become our competitors. As well, such companies may be able to require that their own software, rather than the software of others, including our gaming software or our e-cash systems and support, be used in connection with their payment mechanisms.

The barriers to entry into most Internet markets are relatively low, making them accessible to a large number of entities and individuals. We believe the principal competitive factors in our industry that create certain barriers to entry include reputation, technology, financial stability and resources, proven track record of successful operations, critical mass (particularly relating to online poker), regulatory compliance, independent oversight and transparency of business practices. While these barriers will limit those able to enter or compete effectively in the market, it is likely that new competitors will be established in the future, in addition to our known current competitors.

Increased competition from current and future competitors has and may in the future result in price reductions and reduced margins, or may result in the loss of our market share, any of which could materially adversely affect our business, revenues, operating results and financial condition.

If a third-party asserts that we are infringing its intellectual property, whether successful or not, it could subject us to costly and time-consuming litigation or expensive licenses, which could harm our business.

There is considerable patent and other intellectual property development activity in our industry. Our success depends, in part, upon our ability not to infringe upon the intellectual property rights of others. Our competitors, as well as a number of other entities and individuals, own or claim to own intellectual property relating to our industry. From time to time, third parties have asserted and may continue to claim that we are infringing upon their intellectual property rights, and we may be found to be infringing upon such rights. Third-parties have in the past sent us correspondence regarding their intellectual property and in the future we may receive claims that our products infringe or violate their intellectual property rights. Furthermore, we may be unaware of the intellectual property rights of others that may cover some or all of our technology or products. Any claims or litigation could cause us to incur significant expenses and, if successfully asserted against us, could require that we pay substantial damages or royalty payments, prevent us from selling our products, or require that we comply with other unfavorable terms. In addition, we may decide to pay substantial settlement costs and/or licensing fees in connection with any claim or litigation, whether or not successfully asserted against us. Even if we were to prevail, any litigation regarding our intellectual property could be costly and time-consuming and divert the attention of our management and key personnel from our business operations. As such, the outcome of such matters cannot be predicted with certainty, and could have a material adverse affect on our business, revenues, operating results and financial condition.

We may fail to protect our intellectual property and thereby reduce our competitive position.

We rely on a combination of laws and contractual provisions to establish and protect our rights in our software and proprietary technology. We believe that our competitive position is dependent in part upon our ability to protect our proprietary technology. We generally enter into non-disclosure and invention agreements with employees, licensees, consultants and customers, and historically have restricted access to our software products' source codes. We regard our source codes as proprietary information, and attempt to protect the source code versions of our products as trade secrets and unpublished copyrighted works. Despite our precautions and measures implemented to protect against such attempts, unauthorized parties may have or could in the future copy or otherwise reverse engineer portions of our products or otherwise obtain and use information that we regard as proprietary.

Our Company has patent and trademarks in certain jurisdictions and is in the process of applying for further trademark registrations and patents, which may provide such protection in relevant jurisdictions. However, there can be no

assurance that this will be sufficient to fully protect our proprietary technology. In addition, certain provisions of our license agreements, including provisions protecting against unauthorized use, transfer and disclosure, may be found to be unenforceable in certain jurisdictions.

We believe that patent, trademark, copyright and other legal protections are less significant to our success than other factors such as the knowledge, ability and experience of our personnel, new product and service developments, frequent product enhancements, customer service and ongoing product support.

We also have a proprietary interest in our name. The names “PacificNet”, “iMobile”, “PACT” and “PacificNet Games” have become known in the Internet and gaming industry. Accordingly, our competitive position could be affected if our name was misappropriated and our reputation in any way compromised.

There can be no assurance that the steps we have taken to protect our proprietary rights will be adequate to deter misappropriation of our technology or independent development by others of technologies that are substantially equivalent or superior to our technology. Any misappropriation of our name, technology or development of competitive technologies could have a material adverse effect on our business, revenues, operating results and financial condition.

Due to the complex, sophisticated and global nature of the business, there can be no assurance that there has been no breach of third parties’ intellectual property rights by the Company, and any adverse judgment in this regard could have a material adverse effect on our business, revenues, operating results and financial condition.

We may fail to maintain effective internal controls in accordance with Section 404 of the Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 imposes certain duties on us and our executives and directors. Our efforts to comply with the requirements of Section 404 have resulted in increased general and administrative expense and a diversion of management time and attention, and we expect these efforts to require the continued commitment of resources. Section 404 of the Sarbanes-Oxley Act requires (i) management’s annual review and evaluation of our internal control over financial reporting and (ii) a statement by management that its independent registered public accounting firm has issued an attestation report on our internal control over financial reporting, in connection with the filing of the annual report on Form 10-K for each fiscal year. Failure to maintain effective internal controls over financial reporting could result in investigation or sanctions by regulatory authorities, and could have a material adverse effect on our operating results, investor confidence in our reported financial information, and the market price of our securities shares.

Our stock price has been and may continue to be volatile.

The market price of our Common Shares has experienced significant fluctuation and may continue to fluctuate significantly. The market price of our Common Shares may be adversely affected by various factors, such as proposed Internet gaming legislation or enforcement of existing laws, the loss of a customer, the announcement of new products or enhancements, innovation and technological changes, quarterly variations in revenue and results of operations, changes in earnings estimates by financial analysts, speculation in the press or analyst community and general market conditions or market conditions specific to particular industries, including the Internet and gaming. In addition, the stock market has from time to time experienced extreme price and volume fluctuations. These company-specific or broad market fluctuations may adversely affect the market price for our Common Shares. Anti-gaming or anti-online gaming legislation could also impact our ability to remain listed.

There is no assurance that there will always be a liquid market for our shares.

Although our Common Shares are listed and traded on the NASDAQ Market, there may not be a liquid market in our Common Shares. Company-specific or broader market fluctuations may adversely affect the market price of the Common Shares, and there can be no assurance that there will continue to be an active market for these securities.

Growth in revenues may be slow as a result of the disposition of our legacy business and the transition to gaming business operations

Although our revenues have grown rapidly in past years, primarily as a result of our acquisition activity, we cannot assure investors that we will maintain our profitability or that we will not incur net losses in the future as a result of recent dispositions. Furthermore, we expect that our operating expenses will increase as we continue to move the focus of our business to the gaming industry. Any significant failure to realize anticipated revenue growth could result in significant operating losses. We will continue to encounter risks and difficulties in implementing our business model, including our potential failure to:

Increase awareness of our brands, protect our reputation and develop customer loyalty

Manage our expanding operations and service offerings, including the integration of any future acquisitions

Maintain adequate control of our expenses

Anticipate and adapt to changing conditions in the markets in which we operate as well as the impact of any changes in government regulation, mergers and acquisitions involving our competitors, technological developments and other significant competitive and market dynamics

If we are not successful in addressing any or all of these risks, our business may be materially and adversely affected.

The acquisition of new businesses is costly and such acquisitions may not enhance our financial condition.

Our growth strategy is to acquire companies and identify and acquire assets and technologies from businesses in greater China that have services, products, technologies, industry specializations or geographic coverage that extend or complement our existing business. The process to undertake a potential acquisition is time-consuming and costly. We expend significant resources to undertake business, financial and legal due diligence on our potential acquisition target and there is no guarantee that we will acquire the company after completing due diligence. Any future acquisitions will be subject to a number of challenges, including:

- Diversion of management time and resources and the potential disruption of our ongoing business
- Difficulties in maintaining uniform standards, controls, procedures and policies
- Potential unknown liabilities associated with acquired businesses
- Difficulty of retaining key alliances on attractive terms with partners and suppliers
- Difficulty of retaining and recruiting key personnel and maintaining employee morale

Our acquisitions could result in the use of substantial amounts of cash, potentially dilutive issuances of equity securities, significant amortization expenses related to goodwill and other intangible assets and exposure to undisclosed or potential liabilities of acquired companies. To the extent that the goodwill arising from the acquisitions carried on the financial statements do not pass the annual goodwill impairment test, excess goodwill will be charged to future earnings.

We intend to operate each of our acquired businesses on a standalone basis.

We do not intend to integrate the information or communications systems, management, or other aspects of the businesses we acquire. If we integrated the businesses, we might be able to reduce expenses by eliminating duplicative personnel, facilities, or technology and other costs. In addition, facilities and technology integration might make inter-company communications and transactions more efficient. By declining to integrate the acquired businesses, we might forego opportunities to operate more profitably. Furthermore, our decision not to integrate these businesses

might result in difficulties in evaluating the effectiveness of our internal control over financial reporting, which could complicate compliance with Section 404 of the Sarbanes-Oxley Act of 2002.

Because we do not have employment agreements with management of the acquired companies, our business operations might be interrupted if they were to resign.

As part of our acquisition strategy, we do not use our own employees or members of our management team to operate the acquired companies. Key management at these companies has been in place for several years and has established solid relationships with their customers. Competition in our industry for executive-level personnel is strong and we can make no assurance that we will be able to retain the highly effective executive employees. Although we provide incentives to management to stay with the acquired business, we have not entered into employment agreements with them. If such key persons were to resign we might face impairment of relationships with remaining employees or customers, which might result in further resignation by employees, and might cause long-term clients to terminate their relationship with us. Furthermore, we have not entered into any non-competition and confidentiality agreements with these employees and management. Due to the limited enforceability of these types of agreements in China, we face the risk that employees of the acquired subsidiaries might divulge our software and other protected intellectual property secrets to competitors.

We may not be able to attract or retain the management or employees necessary to remain competitive in our industries.

Tony Tong, our Chairman and Chief Executive Officer, and Victor Tong, our President, are essential to our ability to continue to grow through acquisitions. Tong and Tong have established relationships within our industry. Their business contacts have been critical in identifying, and negotiating with acquisition candidates and in developing and expanding our gaming operations.

Our future success depends on the retention and continued contributions of our key management, finance, marketing, and staff personnel, many of whom would be difficult or impossible to replace. Our success is also tied to our ability to recruit additional key personnel in the future. We may not be able to retain our current personnel or recruit additional key personnel required. The loss of services of any of our personnel could have a material adverse effect on our business, financial condition, results of operations and prospects. If either of them were to leave our employ, our growth strategy might be hindered, which could limit our ability to increase revenue.

The establishment and expansion of international operations require significant management attention.

All of our current, as well as any anticipated future revenue, are or are expected to be mainly derived from Asia. Our international operations are subject to risks, including the following, which, if not planned and managed properly, could materially adversely affect our business, financial condition and operating results:

- Legal uncertainties or unanticipated changes regarding regulatory requirements, liability, export and import restrictions, tariffs and other trade barriers
- Longer customer payment cycles and greater difficulties in collecting accounts receivable
- Uncertainties of laws and enforcement relating to the protection of intellectual property and potentially uncertain or adverse tax consequences

Our operations could be curtailed if we are unable to obtain required additional financing.

Since inception our investments and operations primarily have been financed through sales of our common stock. In the future we may need to raise additional funds through public or private financing, which may include the sale of equity securities, including securities convertible into our common stock. The issuance of these equity securities could result in dilution to our stockholders. If we are unable to raise capital when needed, our business growth strategy may be slowed down, which could severely limit our ability to increase revenue.

Fluctuations in the value of the Hong Kong Dollar or RMB relative to foreign currencies could affect our operating results.

We have historically conducted transactions with customers outside the United States in United States dollars. Payroll and other costs of foreign operations are payable in foreign currencies, primarily Hong Kong dollars and Chinese Renminbi. To the extent future revenue is denominated in foreign currencies, we would be subject to increased risks relating to foreign currency exchange rate fluctuations that could have a material adverse affect on our business, financial condition and operating results. The value of Hong Kong dollars and Chinese Renminbi against the U.S. dollar and other currencies may fluctuate and is affected by changes in the PRC's political and economic conditions. As our operations are primarily in Asia, any significant revaluation of Hong Kong dollars or the Chinese Renminbi may materially and adversely affect our cash flows, revenue and financial condition. For example, we may need to convert U.S. dollars into Hong Kong dollars or Chinese Renminbi as appreciation of either currency against the U.S. dollar could have a material adverse effect on results of our business, financial condition and operations. Conversely, if we decide to convert our Hong Kong dollars or Chinese Renminbi into U.S. dollars for other business purposes and the U.S. dollar appreciates against either currency, the U.S. dollar equivalent of the respective currency we convert would be reduced. To date, we have not engaged in any hedging transactions in connection with our international operations.

We have never paid cash dividends and are not likely to do so in the foreseeable future.

We have never declared or paid any cash dividends on our common stock. We currently intend to retain any future earnings for use in the operation and expansion of our business. We do not expect to pay any cash dividends in the foreseeable future but will review this policy as circumstances dictate.

## RISKS RELATED TO OUR GAMING BUSINESS

If we fail to keep pace with rapid innovations in product design and related marketing strategies, or if we are unable to quickly adapt our development and manufacturing processes to release innovative products or systems, our business could be negatively impacted.

Our future success depends to a large extent upon our ability to continue to rapidly design and market technologically sophisticated and entertaining products that achieve high levels of player acceptance. Our revenues depend on the earning power and life span of our games. Newer game themes tend to have a shorter life span than more legacy game themes, and as a result, we face pressure to design and deploy successful game themes to maintain our revenue stream and to remain competitive. Our ability to develop new and innovative products could be adversely affected by an inability to roll out new games, services or systems on schedule as a result of delays in connection with regulatory product approval in the applicable jurisdictions, or otherwise.

Our future success also depends upon our ability to adapt our manufacturing capabilities and processes to meet the demands of producing new and innovative products. Because our newer products are generally more technologically sophisticated than those we have produced in the past, we must continually refine our production capabilities to meet the needs of continuing product innovation. In addition, the shorter lifespan of newer products means that we must update our production capabilities more frequently and rapidly than in the past. If we cannot adapt our manufacturing infrastructure to meet the needs of our product innovations, or if we are unable to make upgrades to our production capacity in a timely manner, our business could be negatively impacted.

If the current popularity and acceptance of gaming declines, our business plans and operation would be negatively impacted.

The gaming industry can be affected by public opinion of gaming. Our success depends on continually developing and successfully marketing new games and gaming machines with strong and sustained player appeal. A new game or gaming machine will be accepted by casino operators only if we can show that it is likely to produce more revenues to the operator than competitors' products. Gaming machines can be installed in casinos on a trial basis, and only after a successful trial period are the machines purchased by the casinos. Participation gaming machines are replaced by casino operators if the gaming machines do not meet and sustain revenue and profitability expectations. Therefore, these gaming machines are particularly susceptible to pressure from competitors, declining popularity, changes in economic conditions and increased taxation and are at risk of replacement by the casinos, which would end our recurring revenues from these machines.

We cannot assure you that the new products that we introduce will achieve any significant degree of market acceptance or that the acceptance will be sustained for any meaningful period. In the event that there is a decline in public acceptance of gaming, either through unfavorable legislation affecting the introduction of gaming into emerging markets, or through legislative and regulatory changes, including tax increases, in existing gaming markets, our ability to continue to sell and lease our gaming machines in those markets and jurisdictions would be adversely affected.

The gaming industry is intensely competitive. We face competition from a number of companies, some of which have greater resources, and if we are unable to compete effectively, our business could be negatively impacted.

Competition among gaming technology developers is based on, among other things, competitive pricing and financing terms made available to customers, appeal of game themes and features to the end player and product quality, features and functionality of hardware and software. The gaming technology provider market includes leading technology providers such as IGT, Aristocrat, WMS, Bally Gaming and Systems, Novomatic, Aruze, Konami, Progressive Gaming Corporation, DEQ, CryptoLogic and Gigamedia comprising the primary competition. The competition is intense due to the number of providers, as well as the limited number of casino operators and jurisdictions in which they operate. Pricing, product feature and function, accuracy and reliability are amongst the factors in determining a provider's success in selling its system. Certain of these competitors have access to greater financial, marketing and product development resources than we do, and as a result, may be better positioned to compete in the marketplace.

In addition, new competitors may enter our key markets. Obtaining space and favorable placement on casino gaming floors is a competitive factor in our industry. Competitors with a larger installed base of gaming machines than ours have an advantage in retaining the most space and best positions in casinos. These competitors may also have the advantage of being able to convert their installed machines to newer models in order to maintain their share of casino floor space. In addition, some of our competitors have developed and sell or otherwise provide to customers centralized player tracking and accounting systems which allow operators to accumulate accounting and performance data about the operation of gaming machines. We do not offer a centralized player tracking and accounting system and that has put us at a competitive disadvantage.

The unpredictable growth of non-legacy gaming markets may affect our business and prospects.

The continued growth of non-legacy gaming markets for gaming machines and systems depends heavily on the public's acceptance of gaming in these markets, as well as the ongoing development of the regulatory approval process by national and local governmental authorities. A portion of our growth is directly tied to our ability to access these new markets. We cannot predict which new jurisdictions or markets, if any, will approve the operation of electronic gaming machines, the timing of any such approval, the public's acceptance of our gaming machines in these markets or our market share or profitability in these markets. Any decline in the popularity of our gaming products with players, or if we are unsuccessful in developing new products, services or systems, will have a negative impact on our revenues.

The gaming industry is heavily regulated and changes in regulation by gaming authorities may adversely impact our ability to operate the business.

The manufacture and distribution of gaming machines, development of systems and the conduct of gaming operations are subject to extensive national, provincial local and foreign regulation by various gaming authorities.

Our ability to continue to operate in certain jurisdictions could be adversely affected by:

- Unfavorable public referendums

- Unfavorable legislation affecting or directed at manufacturers or gaming operators, such as referendums to increase taxes on gaming revenues

- Adverse changes in, or finding of non-compliance with, applicable governmental gaming regulations

- Delays in approvals from regulatory agencies

Limitations, conditioning, suspension or revocation of any of our gaming licenses

Unfavorable determinations or challenges of suitability by gaming regulatory authorities with respect to our officers, directors, major stockholders or key personnel

Although the laws, rules and regulations of the various jurisdictions in which we operate vary in their technical requirements, virtually all jurisdictions require licenses, permits, qualification documentation, including evidence of integrity and financial stability, and other forms of approval to engage in gaming operations or the manufacture and distribution of gaming machines. Delays in, amendments to, or repeals of legislation approving gaming in jurisdictions in which we operate or plan to commence operations, or delays in approvals of our customers' operations, may adversely affect our operations

Our officers, directors, major stockholders and key personnel are also subject to significant regulatory scrutiny. In the event that gaming or governmental authorities determine that any person is unsuitable to act in such capacity with respect to the Company, we could be required to terminate our relationship with such person. To our knowledge, the Company and our key personnel have obtained, or applied for, all government licenses, registrations, findings of suitability, permits and approvals necessary to conduct their respective activities in the various jurisdictions that we operate. However, there can be no assurance those licenses, registrations, findings of suitability, permits or approvals will be renewed in the future, or that new forms of approval necessary to operate in emerging or existing markets will be granted.

Furthermore, some jurisdictions require gaming manufacturers to obtain government approval before engaging in some transactions, such as business combinations, reorganizations, borrowings, stock offerings and repurchases. Obtaining licenses and approvals can be time consuming and costly. We cannot assure you that we will be able to obtain or maintain all necessary registrations, licenses, permits, approvals or findings of suitability or that the approval process will not result in delays or changes to our business plans.

#### RISKS RELATED TO OUR INTELLECTUAL PROPERTY

Our intellectual property protections may be insufficient to properly safeguard our technology.

We rely on a combination of patent and other technical security measures to protect our products and we intend to file patents for protection of such technologies. Our success may depend in part on our ability to obtain trademark protection for the names or symbols under which we market our products and to obtain copyright protection and patent protection for our proprietary software and other game innovations. We also rely on trade secrets and proprietary know-how. We enter into confidentiality agreements with our employees regarding our trade secrets and proprietary information. We cannot assure that we will be able to build and maintain goodwill in our trademarks or obtain trademark or patent protection, that any trademark, copyright or issued patent will provide competitive advantages for us or that our intellectual properties will not be successfully challenged or circumvented by competitors. Furthermore, despite various confidentiality agreements and other trade secret protections, our trade secrets and proprietary know-how could become known to, or independently developed by, competitors.

Notwithstanding these safeguards, our competitors may still be able to obtain our technology or to imitate our products. Furthermore, others may independently develop products similar or superior to ours.

Expenses incurred with respect to monitoring, protecting and defending our intellectual property rights could adversely affect our business.

Competitors and other third parties may infringe on our intellectual property rights, or may allege that we have infringed on their intellectual property rights. Monitoring infringement on and/or misappropriation of intellectual property can be difficult and expensive and we may not be able to detect any infringement on or misappropriation of our proprietary rights. We may also incur significant litigation expenses protecting our intellectual property or defending our use of intellectual property, reducing our ability to fund product initiatives. These expenses could have an adverse effect on our future cash flow and results of operations. Litigation can also divert management focus from running the day-to-day operations of the business. There can be no assurances that certain of our products, including those with currently pending patent applications, will not be determined to have infringed upon an existing third party patent.

The intellectual property rights of others may prevent us from developing new products or entering new markets.

The gaming industry is characterized by the rapid development of new technologies, our success depends in part on our ability to continually adapt our products and systems to incorporate new technologies and to expand into new

markets that may be created by new technologies. However, to the extent technologies are protected by the intellectual property rights of others, including our competitors, we may be prevented from introducing products based on these technologies or expanding into new markets created by these technologies. If our products use processes or other subject matter that is claimed under existing patents, or if other companies obtain patents claiming subject matter that we use, those companies may bring infringement actions against us. We might then be forced to discontinue such products or be required to obtain licenses from the company holding the patent, if it is willing to give us a license, to develop, manufacture or market our products. We also might then be limited in our ability to market new products. We might also be found liable for treble damage claims relating to past use of the patented subject matter if the infringement is found to be willful.

If the intellectual property rights of others prevent us from taking advantage of innovative technologies, our financial condition, operating results or prospects may be harmed.

The discontinuation or limitation of any existing licenses from third parties could adversely affect our business.

Some of our most popular games and gaming machine features, including certain branded games and ticket-in, ticket-out cashless gaming functionality, are based on trademarks and other intellectual properties licensed from third parties. Our future success may depend upon our ability to obtain, retain and/or expand licenses for additional popular intellectual properties in a competitive market. In the event that we cannot renew and/or expand this or other existing licenses, we may be required to discontinue the games using the licensed technology or bearing the licensed marks, or limit our use of such items.

Our gaming technology, particularly our wide area progressive networks and centrally determined systems, may experience losses due to technical difficulties or fraudulent activities.

Our success depends on our ability to avoid, detect, replicate and correct software and hardware errors and fraudulent manipulation of our gaming machines and associated software. To the extent any of our gaming machines or software experience errors or fraudulent manipulation, our customers may replace our products and services with those of our competitors. In addition, the occurrence of errors in, or fraudulent manipulation of, our gaming machines or software may give rise to claims for lost revenues and related litigation by our customers and may subject us to investigation or other action by gaming regulatory authorities, including suspension or revocation of our gaming licenses or disciplinary action. Additionally, in the event of such issues with our gaming machines or software, substantial engineering and marketing resources may be diverted from other areas to rectify the problem.

Our business is subject to other economic, market, and regulatory risks:

We face risks associated with doing business in international markets related to political and economic instability and related foreign currency fluctuations. Unstable governments and changes in current legislation may affect the gaming market with respect to gaming regulation, taxation, and the legality of gaming in some markets, as we experienced with the Russian market in fiscal 2007.

Customer financing is becoming an increasing prevalent component of the sales process and therefore increases business risk of non-payment, especially in emerging markets. In some instances, our gaming machines are installed in casinos on a trial basis, and only after a successful trial period are the machines purchased by the customers. These customer financing arrangements delay our receipt of cash and can negatively impact our ability to enforce our rights upon default if the customer is from a foreign country.

Our competitors have begun to provide free game theme conversions to customers in connection with product sales. While we intend to continue to charge our customers for game theme conversions including CPU-NXT upgrade kits, we cannot be sure that competitive pressure will not cause us to increase the number of free game theme conversions we offer to our customers, which would decrease the revenue we expect to receive for game theme conversions.

#### RISKS RELATED TO OUR CRM AND TELECOM VAS PRODUCTS AND SERVICES

A substantial portion of our business depends on mobile telecommunications operators in China and any loss or deterioration of such relationships may result in severe disruptions to our business operations.

We rely entirely on the networks and gateways of China Mobile and China Unicom to provide our wireless value-added services. Thus, we face certain risks in conducting our wireless value-added services business. Currently, China Mobile and China Unicom are the only mobile telecommunications operators in China that have platforms for

wireless value-added services. Our agreements with them are generally for a period of less than one year and generally do not have automatic renewal provisions. If neither of them is willing to continue to cooperate with us, we will not be able to conduct our existing wireless value-added services business. Furthermore, our agreements with China Mobile and China Unicom are subject to negotiation upon expiration. If any of the mobile telecommunications operators decides to change its content or transmission fees or its share of revenue, or does not comply with the terms of the agreement, our revenue and profitability could be materially adversely affected.

Our financial condition and results of operations may be materially affected by the changes in policies or guidelines of the mobile telecommunications operators.

The mobile telecommunications operators in China may, from time to time, issue certain operating policies or guidelines, requesting or stating its preference for certain actions to be taken by all wireless value-added service providers using their platforms. Due to our reliance on the mobile telecommunications operators, a significant change in their policies or guidelines may have a material adverse effect on us. For example, some mobile telecommunications operators recently revised their billing policies to request all wireless value-added service providers to confirm the subscription status of those users who have not been active for three months. Such change in policies or guidelines may result in lower revenue or additional operating costs for us, and we cannot assure investors that our financial condition and results of operations will not be materially adversely affected by any policy or guideline change by the mobile telecommunications operators in the future.

We may be subject to adverse actions for any breach or perceived breach by us of the policies or guidelines imposed by the mobile telecommunications operator with respect to content provided on or linked through our websites.

The mobile telecommunications operators in China may impose policies or guidelines to govern or restrict the content provided by all wireless value-added service providers, including content developed by us or content supplied by others to us. The mobile telecommunications operators from time to time have requested wireless value-added services providers, including us, to remove objectionable content or links to or from websites with certain categories of content, including content that they may deem to be sexually explicit. We aggregate and develop content that we consider attractive to our targeted user base and we cannot assure investors that the mobile telecommunications operators will not from time to time find certain portions of our content to be objectionable. In the case of a breach or perceived breach of such policies or guidelines, the mobile telecommunications operators may require us to reduce or curtail the content on our Internet portal, which may reduce our portal traffic, and the mobile telecommunications operators may have the right to impose monetary fines upon us, or terminate our cooperation with them. In addition, we would be liable to the mobile telecommunications operators for their economic losses pursuant to our agreements with these operators if we were found to be in breach of the policies or guidelines promulgated by them. As a result of the occurrence of any of the above, our financial condition and results of operations may be materially adversely affected.

Our dependence on the substance and timing of the billing systems of the mobile telecommunications operators may require us to estimate portions of our reported revenue for wireless value-added services from time to time. As a result, subsequent adjustments may have to be made to our wireless value-added services revenue in our financial statements.

As we do not bill our wireless value-added services users directly, we depend on the billing systems and records of the mobile telecommunications operators to record the volume of our wireless value-added services provided, charge our users through mobile telephone bills and collect payments from our users and pay us. In addition, we do not generally have the ability to independently verify or challenge the accuracy of the billing systems of the mobile telecommunications operators.

Our communication products are provided cash-on-delivery, which leaves us vulnerable to theft and employee embezzlement.

The purchase of calling cards, SIM cards and other mobile phone products are made with cash. Although there is a low risk that clients will not pay for these services when delivered, our retail stores maintain large sums of money which might make them robbery targets. We also face the risk that employees who collect the cash and others who may be aware that cash is available at these sites might embezzle the money. Theft or embezzlement could have a material adverse effect on the revenue generated and the financial condition of our business operations.

Our customers are concentrated in a limited number of industries.

Our clients are concentrated primarily in the telecommunications, telemarketing and technology industries, and to a lesser extent, the insurance and financial services industries, where the current trend is to outsource certain CRM and VAS. Our ability to generate revenue depends on the demand for our services in these industries. An economic downturn, or a slowdown or reversal of the tendency in any of these industries to rely on outsourcing could have a material adverse effect on our business, results of operations or financial condition.

29

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## RISKS ASSOCIATED WITH DOING BUSINESS IN GREATER CHINA

There are substantial risks associated with doing business in greater China, as set forth in the following risk factors.

Our operations and assets in Greater China are subject to significant political and economic uncertainties.

Changes in laws and regulations, or their interpretation, or the imposition of confiscatory taxation, restrictions on currency conversion, imports and sources of supply, devaluations of currency or the nationalization or other expropriation of private enterprises could have a material adverse effect on our business, results of operations and financial condition. Under its current leadership, the Chinese government has been pursuing economic reform policies that encourage private economic activity and greater economic decentralization. There is no assurance, however, that the Chinese government will continue to pursue these policies, or that it will not significantly alter these policies from time to time without notice.

Currency fluctuations and restrictions on currency exchange may adversely affect our business, including limiting our ability to convert Chinese Renminbi into foreign currencies and, if Chinese Renminbi were to decline in value, reducing our revenue in U.S. dollar terms.

Our reporting currency is the U.S. dollar and our operations in China and Hong Kong use their respective local currencies as their functional currencies. The majority of our revenue derived and expenses incurred are in Chinese Renminbi with a relatively small amount in Hong Kong dollars and U.S. dollars. We are subject to the effects of exchange rate fluctuations with respect to any of these currencies. For example, the value of the Renminbi depends to a large extent on Chinese government policies and China's domestic and international economic and political developments, as well as supply and demand in the local market. Since 1994, the official exchange rate for the conversion of Renminbi to U.S. dollars has generally been stable and the Renminbi had appreciated slightly against the U.S. dollar. However, on July 21, 2005, the Chinese government changed its policy of pegging the value of Chinese Renminbi to the U.S. dollar. Under the new policy, Chinese Renminbi may fluctuate within a narrow and managed band against a basket of certain foreign currencies. It is possible that the Chinese government could adopt a more flexible currency policy, which could result in more significant fluctuation of Chinese Renminbi against the U.S. dollar. We can offer no assurance that Chinese Renminbi will be stable against the U.S. dollar or any other foreign currency.

The income statements of our international operations are translated into U.S. dollars at the average exchange rates in each applicable period. To the extent the U.S. dollar strengthens against foreign currencies, the translation of these foreign currencies denominated transactions results in reduced revenue, operating expenses and net income for our international operations. Similarly, to the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign currency denominated transactions results in increased revenue, operating expenses and net income for our international operations. We are also exposed to foreign exchange rate fluctuations as we convert the financial statements of our foreign subsidiaries into U.S. dollars in consolidation. If there is a change in foreign currency exchange rates, the conversion of the foreign subsidiaries' financial statements into U.S. dollars will lead to a translation gain or loss which is recorded as a component of other comprehensive income. In addition, we have certain assets and liabilities that are denominated in currencies other than the relevant entity's functional currency. Changes in the functional currency value of these assets and liabilities create fluctuations that will lead to a transaction gain or loss. We have not entered into agreements or purchased instruments to hedge our exchange rate risks, although we may do so in the future. The availability and effectiveness of any hedging transaction may be limited and we may not be able to successfully hedge our exchange rate risks.

Although Chinese governmental policies were introduced in 1996 to allow the convertibility of Chinese Renminbi into foreign currency for current account items, conversion of Chinese Renminbi into foreign exchange for capital items, such as foreign direct investment, loans or securities, requires the approval of the State Administration of Foreign

Exchange, or SAFE, which is under the authority of the People's Bank of China. These approvals, however, do not guarantee the availability of foreign currency. We cannot be sure that we will be able to obtain all required conversion approvals for our operations or Chinese regulatory authorities will not impose greater restrictions on the convertibility of Chinese Renminbi in the future. Because a significant amount of our future revenue may be in the form of Chinese Renminbi, our inability to obtain the requisite approvals or any future restrictions on currency exchanges could limit our ability to utilize revenue generated in Chinese Renminbi to fund our business activities outside China, or to repay foreign currency obligations, including our debt obligations, which would have a material adverse effect on our financial condition and results of operation.

We are required to obtain licenses to expand our business into mainland China.

Our activities must be reviewed and approved by various national and local agencies of the Chinese government before they will issue business licenses to us. There can be no assurance that the current Chinese government, or successors, will continue to approve and renew our licenses. If we are unable to obtain licenses or renewals we will not be able to continue our business operations in mainland China, which would have a material adverse effect on our business, financial condition and results of operations.

We may have limited legal recourse under PRC law if disputes arise under our contracts with third parties.

The Chinese government has enacted some laws and regulations dealing with matters such as corporate organization and governance, foreign investment, commerce, taxation and trade. However, their experience in implementing, interpreting and enforcing these laws and regulations is limited, and our ability to enforce commercial claims or to resolve commercial disputes is unpredictable. If our new business ventures are unsuccessful, or other adverse circumstances arise from these transactions, we face the risk that the parties to these ventures may seek ways to terminate the transactions, or, may hinder or prevent us from accessing important information regarding the financial and business operations of these acquired companies. The resolution of these matters may be subject to the exercise of considerable discretion by agencies of the Chinese government, and forces unrelated to the legal merits of a particular matter or dispute may influence their determination. Any rights we may have to specific performance, or to seek an injunction under PRC law, in either of these cases, are severely limited, and without a means of recourse by virtue of the Chinese legal system, we may be unable to prevent these situations from occurring. The occurrence of any such events could have a material adverse effect on our business, financial condition and results of operations.

We must comply with the Foreign Corrupt Practices Act.

We are required to comply with the United States Foreign Corrupt Practices Act, which prohibits United States companies from engaging in bribery or other prohibited payments to foreign officials for the purpose of obtaining or retaining business. Foreign companies, including some of our competitors, are not subject to these prohibitions. Corruption, extortion, bribery, pay-offs, theft and other fraudulent practices occur from time-to-time in mainland China. If our competitors engage in these practices they may receive preferential treatment from personnel of some companies, giving our competitors an advantage in securing business or from government officials who might give them priority in obtaining new licenses, which would put us at a disadvantage. Although we inform our personnel that such practices are illegal, we cannot assure 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.

PRC laws and regulations restrict foreign investment in China's telecommunications services industry and substantial uncertainties exist with respect to our contractual agreements with Wanrong-DE and iMobile-DE to uncertainties regarding the interpretation and application of current or futures PRC laws and regulations.

Since we are deemed to be foreign persons or foreign funded enterprises under PRC laws and cannot directly invest in telecommunications companies, we operate our IVR, call center and telecom value-added services business in China through operating companies or Variable Interest Entities (VIEs) owned by PRC citizens. We control these companies and operate these businesses through contractual arrangements with the respective operating companies and their individual shareholders, but we have no equity control over these companies. Although we believe we are in compliance with current PRC regulations, we cannot be sure that the PRC government would view these operating arrangements to be in compliance with PRC licensing, registration or other regulatory requirements, with existing policies or with requirements or policies that may be adopted in the future. In the opinion of our in-house PRC legal counsel, our current ownership structure, the contractual arrangements among our wholly owned subsidiaries and the operating company and their shareholders comply with all existing applicable PRC laws, rules and regulations.

Because this structure has not been challenged or examined by PRC authorities, they have not commented on it and uncertainties exist as to whether the PRC government may interpret or apply the laws governing these arrangements in a way that is contrary to the opinion of our in-house PRC counsel. If we, or the operating companies, were found to be in violation of any existing PRC laws or regulations, the relevant regulatory authorities would have broad discretion to deal with such violation, including, but not limited to the following:

31

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- Levying fines
- Confiscating income
- Revoking licenses
- Shutting down servers or blocking websites
- Requiring a restructure of ownership or operations
- Requiring the discontinuance of wireless VAS and online advertising businesses

We may also encounter difficulties in obtaining performance under or enforcement of related contracts. Any of these or similar actions could cause significant disruption to our business operations or render us unable to conduct a substantial portion of our business operations and may materially adversely affect our business, financial condition and results of operations.

Our contractual agreements with Wanrong-DE and iMobile-DE may not be as effective in providing operational control as direct ownership of these businesses.

We depend on operating companies in which we have little or no equity ownership interest and must rely on contractual agreements to control and operate these businesses. Our contractual agreements with each of the operating companies may not be as effective in providing and maintaining control over the operating companies and their business operations as direct ownership of these businesses. For example, we may not be able to take control of the operating company upon the occurrence of certain events, such as the imposition of statutory liens, judgments, court orders, death or capacity. Furthermore, if the operating companies fail to perform as required under those contractual agreements, we will have to rely on the PRC legal system to enforce those agreements and there is no guarantee that we will be successful in an enforcement action. In addition, the PRC government may propose new laws or amend current laws that may be detrimental to our current contractual agreements with our operating companies, which may in turn have a material adverse effect on our business operations.

The PRC government may prevent us from advertising or distributing content that it believes is inappropriate.

China has enacted regulations governing Internet access and the distribution of news and other information. In the past, the Chinese government has stopped the distribution of information over the Internet or through VAS that it believes to violate PRC law, including content that it believes is obscene, incites violence, endangers national security, is contrary to the national interest or is defamatory. In addition, we may need the permission of the Chinese government prior to publishing certain news items, such as news relating to national security. Furthermore, the Ministry of Public Security has the authority to cause any local Internet service provider to block any website maintained outside China at its sole discretion. If the PRC government were to take any action to limit or prohibit the distribution of information through our network or via our VAS, or to limit or regulate any current or future content or services available to users on our network, our business could be significantly harmed. We are also subject to potential liability for content on our website that is deemed inappropriate and for any unlawful actions of our subscribers and other users of our systems. Furthermore, we are required to delete content that clearly violates the laws of China and report content that we suspect may violate PRC law. It is difficult to determine the type of content that may result in liability for us, and if we are wrong, we may be prevented from operating our website.

#### RISKS RELATED TO OUR TECHNOLOGY AND EQUIPMENT

We must respond quickly and effectively to new technological developments.

Our gaming, telecom and VAS businesses are highly dependent on our computer and telecommunications equipment and software systems. Our failure to maintain the superiority of our technological capabilities or to respond effectively to technological changes could adversely affect our business, results of operations or financial condition. Our future success also depends on our ability to enhance existing software and systems and to respond to changing technological

developments. If we are unable to successfully develop and bring to market new software and systems in a timely manner, our competitors' technologies or services may render our products or services noncompetitive or obsolete.

## RISKS RELATED TO OUR COMMON STOCK

Efforts to comply with recently enacted changes in securities laws and regulations will increase our costs and require additional management resources. Our failure to comply could adversely affect our stock price.

Our business operations grew rapidly by acquisition during 2006 and 2007. We do not integrate the business operations of our target companies and therefore have separate administration and accounting personnel at each subsidiary location. Due to the number of subsidiaries we have acquired, we have faced significant challenges with the timely reporting of information necessary to complete the financial statements to be filed with the Securities and Exchange Commission. These actions have required us to re-evaluate our disclosure controls and procedures and conclude that they are ineffective. We have sought to improve our existing disclosure controls and procedures and to that end, have substantially increased our accounting and administrative resources. Our failure to timely file our annual and quarterly reports may have an adverse affect on our stock price and may put our common stock in jeopardy of being delisted.

As directed by Section 404 of the Sarbanes-Oxley Act of 2002, public companies are required to include a report of management on the company's internal controls over financial reporting in their annual reports on Form 10-K, and the public accounting firm auditing a company's financial statements must attest to and report on management's assessment of the effectiveness of the company's internal controls over financial reporting. This requirement will first apply to our annual report on Form 10-K for our fiscal year ending December 31, 2007. We have only recently begun to evaluate our internal controls over financial reporting. Given the status of our efforts, coupled with the fact that guidance from regulatory authorities in the area of internal controls continues to evolve, substantial uncertainty exists regarding our ability to comply by applicable deadlines. If we are unable to conclude that we have effective internal controls over financial reporting, or if our independent auditors are unable to provide us with an unqualified report as to the effectiveness of our internal controls over financial reporting for future year ends, as required by Section 404 of the Sarbanes-Oxley Act, we could experience delays or inaccuracies in our reporting of financial information, or non-compliance with SEC reporting and other regulatory requirements. This could subject us to regulatory scrutiny and result in a loss of public confidence in our management, which could, among other things, adversely affect our stock price.

We issued \$8,000,000 in convertible debentures, which we may not be able to repay in cash and could result in dilution of our basic earnings per share.

In March 2006, we issued \$8 million in convertible debentures which were originally due in March 2009. The debentures are convertible at any time into shares of our common stock at an initial fixed conversion price of \$10.00 per share, subject to adjustments for certain events. If any event of default occurs under the debentures or other related documents, the holders may elect to accelerate the payment of the outstanding principal amount of the debenture, plus accrued, but unpaid interest, liquidated damages or other amounts, which shall become immediately due and payable. In 2007, we began to redeem up to \$363,638 every month, plus accrued, but unpaid interest, liquidated damages and penalties. We may choose to pay such redemption amount in cash, or, subject to meeting certain conditions, we may pay all or a part of the redemption amount in shares of common stock. We may not have enough cash on hand or have the ability to access cash to pay the redemption amount, or upon acceleration of the debenture in the case of an event of default, or at maturity. In addition, the redemption of the debentures with our shares or the conversion of the debentures into shares of common stock could result in dilution of our basic earnings per share.

We have to pay liquidated damages and our debentures are in default and we are unable to re-instate use of the prospectus contained in our Registration Statement on Form S-1

On March 27, 2007, we suspended use of the prospectus contained in our Registration Statement on Form S-1 (File No. 333-134127) that was declared effective on December 8, 2006, due to the lack of fiscal year end 2005 and 2004

audited financial statements. As a result 3,152,228 shares of common stock registered there under, are not freely tradable upon resale. Under the terms of our registration rights agreement with the holders of the debentures, we are subject to paying liquidated damages equal to 2% of the debenture amount on a monthly basis, up to a maximum of 20% per holder, in the event we suspend use of the prospectus for longer than 15 consecutive calendar days or more than an aggregate of 30 calendar days during any 12-month period. Our debentures are currently in default, which resulted in acceleration of the amounts due, we had an agreement and payment plan with the debenture holder which we were unable to adhere to and resulted in involuntary petition under Chapter 11 relief in federal bankruptcy court late Saturday, March 22, 2008 in Wilmington, DE filed by three debenture holders. We may not have cash on hand, or have the ability to access cash to pay the debenture in full if such a demand is made. If the debenture holders refuse to negotiate with us, our failure to pay upon demand could result in the debenture holders bringing claims against us for payment, which may include severe penalty payments. If they are successful in such claims, we may suffer significant losses, which may severely curtail our ability to continue business operations.

If we are not successful in defending against a lawsuit by one of our debenture holders our business operations could be severely curtailed.

One of our debenture holders has filed a complaint against us in the Supreme Court of the State of New York claiming that we are in default for failure to timely make payments under the debentures. The debenture holder is demanding payment of \$3,253,163.80 in the aggregate, together with any accrued but unpaid interest through the date of judgment and reimbursement of attorney fees and other costs and expenses incurred together with costs and disbursements of the action and such other further relief afforded by the Court. Although we intend to vigorously defend ourselves against this action, if the debenture holder is successful in its claims or, if based upon advice from legal counsel we choose to settle this litigation, such payments could put a severe strain on our available cash and we could suffer significant losses, which could curtail our ability to continue our business.

If we are unable to regain compliance with the NASDAQ rules for continued listing, our securities may be de-listed from the NASDAQ Global Market.

We are currently subject to possible delisting procedures by the NASDAQ Stock Market for failing to have audited financials for the fiscal years ended December 31, 2007. On April 16, 2008, PacificNet received a letter from The NASDAQ Stock Market indicating that as a result of the Company's failure to file with the Securities and Exchange Commission the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2007, the Company is not in compliance with the NASDAQ requirements for continued listing set forth in NASDAQ Marketplace Rule 4310(c)(14). NASDAQ Marketplace Rule 4310(c)(14) requires the Company to make on a timely basis all filings with the Securities and Exchange Commission, as required by the Securities Exchange Act of 1934, as amended. PacificNet has appealed the NASDAQ Staff's determination and a hearing has been set before the NASDAQ Listing Qualifications Panel, which automatically stays the delisting of PacificNet's common stock pending the Panel's review and determination. There can be no assurance that the Panel will grant the Company's request for continued listing, once the 10-K is filed.

The price of our stock has fluctuated in the past and may continue to do so.

Our stock price has fluctuated dramatically. There is a significant risk that the market price of our common stock will decrease in the future in response to any of the following factors, some of which are beyond our control:

- Variations in our quarterly operating results
- Announcements that our revenue or income are below analysts' expectations

- General economic slowdowns
- Changes in market valuations of similar companies

- Sales of large blocks of our common stock
- Announcements by us or our competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments

- Fluctuations in stock market prices and volumes, which are particularly common among highly volatile securities of companies with primarily international-based operations

Future sales of shares could have an adverse effect on the market price of our common stock

As of December 31, 2007, we had 11,984,072 shares of common stock outstanding, which shares will be available to be sold in the public market in the near future, subject to the volume restrictions and/or manner of sale requirements of

Rule 144 under the Securities Act., with respect to shares of common stock held by affiliates and shares issued between 12 and 24 months ago. Sales by our current shareholders of a substantial number of shares could significantly reduce the market price of our common stock.

As of December 31, 2007, we had warrants outstanding to purchase 1,007,138 shares of our common stock. To the extent that the warrants are exercised, they may be exercised at prices below the price of our shares of common stock on the public market, resulting in a significant number of shares entering the public market and the dilution of our common stock. In the event that any future financing should also be in the form of securities convertible into, or exchangeable for, equity securities, investors may experience additional dilution upon the conversion or exchange of such securities.

ITEM 1B. UNRESOLVED STAFF COMMENTS

NONE

ITEM 2. PROPERTIES

A description of our property is as follows:

CHINA - We maintain our corporate headquarters at 23/F, Building A, TimeCourt, No.6 Shuguang Xili, Chaoyang District, Beijing, China. Postal Code: 100028; and our Shenzhen finance center located at Room 4203, Jinzhonghuan Business Building, Futian District, Shenzhen, China; Postal Code: 518040. Both properties were purchased in 2006.

HONG KONG - We maintain our Hong Kong office at Room 2702, Richmond Commercial Building, 107-111 Argyle Street, Mongkok, Kowloon, HK.

UNITED STATES - We relocated our USA office from Minnesota to: 416 Production Street North, Aberdeen, SD 57401, USA.

| Locations  | Area<br>(Square<br>Feet) |
|--|--------------------------|
| PacificNet Beijing Office: 23/F, Building A, TimeCourt, No.6 Shuguang Xili, Chaoyang District, Beijing, China, Postal Code: 100028 | 11,324                   |
| PacificNet Shenzhen Office: Room 4203, Jinzhonghuan Business Building, Futian District, Shenzhen, China, Postal Code: 518026       | 4,950                    |
| Room 2702, Richmond Commercial Building, 107 -111 Argyle Street, Mong Kok, Kowloon, Hong Kong                                      | 637                      |
| 416 Production Street North, Aberdeen, SD 57401, USA   | 200                      |

We believe that our offices are adequate for our current operations.

ITEM 3. LEGAL PROCEEDINGS

1. Johnson Controls Hong Kong Limited (JCHKL) vs. PacificNet Power Limited

On January 19, 2007, Johnson Controls Hong Kong Limited filed a civil claim against PacificNet Power Limited (a 51% owned subsidiary of PacificNet) in the High Court of the Hong Kong Special Administrative Region seeking HK\$4,800,000 as payment for services rendered to replace 3 sets of rain water-cooled chillers, together with energy saving performance (the "Chiller System"), at the Fortress Tower in Hong Kong.

In connection with the claim, PacificNet Power reviewed a letter from its client, China Weal Property Management Ltd., dated January 22, 2007 stating that the construction work by JCHKL had not been completed as of the date of the letter, and that certain violations itemized in a letter issued by the Hong Kong Environment Protection Department (EPD) (Noise Abatement Notice No. N806030) addressed to JCHKL with respect to acoustic problems with JCHKL's

equipment had not been abated.

The board of directors of PacificNet Power Limited has reviewed the case with its client, China Weal Property Management Ltd., and our Hong Kong legal counsel and it is the honest belief of the board that the project work undertaken JCHKL is defective in numerous aspects. As a result, the board believes that the construction work has not been completed by JCHKL, and therefore, JCHKL is not entitled to payment for its services.

35

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On February 13, 2007, the board instructed the Hong Kong legal counsel to issue a Defense and Counterclaim to JCHKL to counter-claim that ( i ) JCHKL's construction work has not complied with the applicable rules and regulations of various government authorities in Hong Kong; (ii) the Chiller System provided by JCHKL was defective and merchantable unfit and JCHKL has failed and/or refused to rectify such defective works; and (iii) JCHKL shall return the work deposit in the amount of HK\$1,500,000 to PacificNet Power Limited and shall compensate and keep PacificNet Power Limited indemnified against all the loss and damages suffered as a result of any claims from the China Weal Property Management Ltd..

The case is now in the discovery stage before proceeding to the stage of fixing a date for trial in the High Court of Hong Kong and the board intends to vigorously defend against the allegations. We are unable to predict the outcome of these actions, or a reasonable estimate of the range of possible loss, if any.

## 2. PacificNet Power Limited vs Johnson Controls Hong Kong Limited (JCHKL)

On or about December 2005, Johnson Controls Hong Kong Limited approached PacificNet Power Limited (a 51% owned subsidiary of PacificNet) and made a representation that they had submitted a tender to “The Incorporated Owners of Nan Fung Centre, Tsuen Wan (“the Employer”) for the “construction and replacement works of existing air-cooled chiller plant by new water-cooled chiller plant for Tsuen Wan Nan Fung Centre and energy saving performance contract” (“the Contract”). JCHKL invited and induced PacificNet Power Limited to act as the main contractor for the Contract and it would then act as a sub-contractor.

PacificNet Power also expressly made known to JCHKL that the said construction and replacement works and the guaranteed energy saving should meet all the tender requirements if PacificNet Power accepted the invitation to act as the main contractor for the Contract, and PacificNet Power further said that if there should be any quality defects with the system and/ or the construction work, the Employer and/ or their prospective tenants would claim against JCHKL and JCHKL should compensate.

PacificNet Power however received some correspondences and complaints from the Employer about the poor and/or sub-standard works done by JCHKL. PacificNet Power, after separate investigation, discovered the poor workmanship and sub-standard works done by JCHKL. Accordingly, the Employer and/or their representatives have delayed the monthly installments payment to PacificNet Power.

On April 23, 2007, PacificNet Power instructed the Hong Kong lawyers to issue a letter to the Defendant requesting and demanding them, being the sub-contractor of the Construction and Replacement Works Contract, to take immediate rectification action within seven days from the date of the said letter to (i) rectify and complete all outstanding defective works of the Construction and Replacement Works Contract; (ii) replace the water-cooled chiller plant and/or equipments which are not conformed with the requirements of the tender documents previously submitted by the Defendant to the Employer; and (iii) improve the poor performance of energy saving of the new water-cooled chiller plant.

Despite the said letter, JCHKL had failed and/or refused to rectify and complete all outstanding works and/or replace the defective system. And therefore PacificNet Power claims against JCHKL for: (i) refund HK\$6,414,300.00, being the Contract Price paid by PacificNet Power to JCHKL; (ii) costs and expenses incurred by PacificNet Power to rectify all defective works of the Contract; (iii) all damage and loss suffered by PacificNet Power, and further and other relief.

On July 25, 2007, JCHKL issued a Defense and Counterclaim to PacificNet Power to argue that: (i) they had carried out the works according to the Contract terms; (ii) the works had been approved by PKL Consultants Limited, the consultant representative of the Employer; and (iii) a sum of HK\$30,000 is still due and owing by PacificNet Power to JCHKL.

The case is now in the discovery stage before proceeding to the stage of fixing a date for trial in the High Court of Hong Kong. We are unable to predict the outcome of these actions, or a reasonable estimate of the range of possible loss, if any.

3. PacificNet Inc. vs. HLB Hodgson Impey Cheng (HLB or Defendant), a firm of Chartered Accountants and Certified Public Accountants in Hong Kong

On September 20, 2007, PacificNet Inc. filed a claim against its former auditors HLB Hodgson Impey Cheng (HLB), a firm of Chartered Accountants and Certified Public Accountants, in the High Court of the Hong Kong Special Administrative Region seeking refund of the professional fees, compensation of professional fees and expenses for Company to engage and deploy new auditors to take over the incomplete audit works from the Defendant and returning and/or providing all relevant accounting records, vouchers, audit program and working papers retained by the Defendant and losses and damages incurred.

The case is now in the pleadings stage. We are unable to predict the outcome of these actions, or a reasonable estimate of the range of possible loss, if any.

#### 4. Iroquois Master Fund, Ltd. vs. Pacificnet Inc.

On or about October 3, 2007 Iroquois Master Fund, Ltd. filed a complaint in the Supreme Court of the State of New York against PacificNet Inc., claiming that the Company is in default under the Amended and Restated Convertible Debenture due March 2009 (the Amended Debenture”) in the principal amount of \$3,000,000 and the Convertible Debenture due February 2009 (the New Debenture”) in the principal amount of \$420,000.

Iroquois Master Fund, Ltd. is seeking damages of \$3,253,163.80 in the aggregate, together with any accrued but unpaid interest through the date of judgment. Iroquois Master Fund, Ltd. has also demanded reimbursement of its attorney fees and other costs and expenses incurred together with costs and disbursements of this action.

On or about December 5, 2007, PacificNet filed its answer which denies that PacificNet is in default and asserts an agreement that would enable it to bring the interest payments up to date by the issuance of stock in the near future.

On March 27, 2008, three holders of PACT's Convertible Subordinated Debentures filed an involuntary petition for Chapter 11 relief in federal bankruptcy court late Saturday, March 22, 2008 in Wilmington, DE. The Company has retained counsel to oppose the filing because the petition fails to meet the standard for invoking an involuntary bankruptcy and fails to take into consideration other agreements between the Company and the petitioning creditors. The Company intends to vigorously oppose the petition and move for dismissal of the filing, and if successful will seek damages and attorney fees. Subsequently, PACT also received default notice from all but one of the debenture holders including Iroquois Master Fund Ltd., Alpha Capital AG, Whalehaven Capital Fund Limited, DKR Soundshore Oasis Holding Fund Ltd., Basso Fund Ltd., Basso Multi-Strategy Holding Fund Ltd., and Basso Private Opportunities Holding Fund Ltd. from the same Convertible Subordinated Debentures related to the private offering of \$8,000,000 principal amount variable debentures consummated on March 13, 2006, and due March 2009.

PACT has retained counsel to oppose the above petition. The amount of the debt in question is as follows: Iroquois Master Fund Ltd. \$2.5 million, Whalehaven Capital Fund Limited \$958,000, Alpha Capital AG \$685,000 DKR Soundshore Oasis Holding Fund Ltd \$960,000, and Basso Fund Ltd., Basso Multi- Strategy Holding Fund Ltd., and Basso Private Opportunities Holding Fund Ltd., a combined amount of \$500,000.

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

The Company held its annual meeting on October 17, 2007 at the Company's executive offices located at 23rd Floor, Building A, TimeCourt, No.6 Shuguang Xili, Chaoyang District, and Beijing, China for the following purposes:

1. To elect seven (7) directors to the Board of Directors of the Company to serve until the next annual meeting of stockholders and until their successors are duly elected and qualified.
2. To ratify the appointment of Kabani & Company, Inc. as the Company's independent auditors.
3. To transact any other business as may properly be presented at the Annual Meeting or any adjournment or postponement thereof.

At such meeting the following proposals were voted upon:

- The following directors were elected to the Board of Directors of Company, after each receiving a plurality of the votes cast: 1. Tony Tong (8,853,833 votes or 61.60% voted for), 2. Victor Tong (8,853,275 votes or 61.60% voted for), 3. ShaoJian (Sean) Wang (8,854,233 votes or 61.60% voted for), 4. Tao Jin (8,856,177 votes or 61.62% voted for), 5. Jeremy Goodwin (8,856,535 votes or 61.62% voted for), 6. Michael Chun Ha (8,856,233 votes or 61.62% voted for), 7. Ho-Man (Mike) Poon (8,854,177 votes or 61.60% voted for).
- Ratification and approval of the appointment of Kabani & Company, Inc. as the Company's independent auditors: 8,891,214 shares of the Company's common stock, constituting a 61.86% majority of the shares of common stock present in person or by proxy entitled to vote at the meeting voted in favor of this proposal while 45,392 voted against and 11,858 votes abstain.

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND PURCHASES OF EQUITY SECURITIES

Our common stock is listed on the NASDAQ Global Market, under the symbol "PACT". Prior to that time, our common stock was listed on the NASDAQ Capital Market under the same symbol. The following table sets forth the range of high and low sales prices of common stock reported by NASDAQ in each fiscal quarter from January 1, 2006 to December 31, 2007 and for the first quarter of 2008.

|  | HIGH    | LOW     |
|--|---------|---------|
| FISCAL 2006  |         |         |
| Quarter Ended March 31, 2006                       | \$ 8.88 | \$ 6.57 |
| Quarter Ended June 30, 2006                        | \$ 8.52 | \$ 7.05 |
| Quarter Ended September 30, 2006                   | \$ 7.62 | \$ 4.62 |
| Quarter Ended December 31, 2006                    | \$ 6.28 | \$ 5.05 |
| FISCAL 2007  |         |         |
| Quarter Ended March 31, 2007                       | \$ 7.60 | \$ 4.80 |
| Quarter Ended June 30, 2007                        | \$ 5.80 | \$ 3.77 |
| Quarter Ended September 30, 2007                   | \$ 6.10 | \$ 3.92 |
| Quarter Ended December 31, 2007                    | \$ 7.15 | \$ 3.91 |
| FISCAL 2008  |         |         |
| Quarter Ended March 31, 2008                       | \$ 4.35 | \$ 1.36 |
| Quarter Ended June 30, 2008 (through May 12, 2008) | \$ 1.63 | \$ 0.91 |

### HOLDERS OF RECORD

As of March 31, 2008, there were 184 record holders of our common stock. However, the total number of beneficial holders is unknown as they hold our common stock in street name.

### DIVIDENDS

We have not paid any cash dividends on our common stock, and we currently intend to retain any future earnings to fund the development and growth of our business.



## EQUITY COMPENSATION PLAN INFORMATION

The following table sets forth aggregate information regarding the Company's equity compensation plans in effect as of December 31, 2007:

|   | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights (\$) | Remaining available for further issuance under equity compensation plans |
|---|---|--|--|
| Equity compensation plans approved by security holders (under 2005 Stock Option Plan) (1) | 33,000  | \$4.31   | 2,000,000  |
| Equity compensation plans not approved by security holders                                | N/A   | N/A  | N/A  |

(1) Reflects options granted and available for issuance under the 2005 Stock Option Plan.

## STOCK PRICE PERFORMANCE PRESENTATION

The following chart compares the cumulative total stockholder return on the Company's shares of Common Stock with the cumulative total stockholder return of (i) the NASDAQ Stock Market Index and (ii) a peer group index consisting of companies reporting under the Standard Industrial Classification Code 3669 (Communications Equipment):

Since we have begun a new focus on the gaming industry, we are also providing a chart comparing the cumulative total stockholder return on the Company's shares of Common Stock with the cumulative total stockholder return of (i) the NASDAQ Stock Market Index and (ii) a peer group index, which includes companies engaged in the manufacturing of gaming machines, reporting under the Standard Industrial Classification Code 3990 (Miscellaneous Manufacturing Industries):

|                               | 2002   | 2003   | 2004   | 2005   | 2006   | 2007   |
|-------------------------------|--------|--------|--------|--------|--------|--------|
|                               | (\$)   | (\$)   | (\$)   | (\$)   | (\$)   | (\$)   |
| PACIFICNET, INC.              | 100.00 | 273.85 | 521.03 | 347.18 | 316.92 | 218.97 |
| SIC CODE INDEX - 3669         | 100.00 | 239.47 | 278.09 | 215.79 | 248.03 | 136.99 |
| N A S D A Q M A R K E T INDEX | 100.00 | 150.36 | 163.00 | 166.58 | 183.68 | 201.91 |
| SIC CODE INDEX - 399          | 100.00 | 163.14 | 165.69 | 149.34 | 192.26 | 290.00 |

The material in the charts are not soliciting material, are not deemed filed with the SEC and are not incorporated by reference in any filing of the Company under the Securities Act of 1933, as amended or the Exchange Act, whether made before or after the date of this Form 10-K and irrespective of any general incorporation language in such filing.

#### RECENT SALES OF UNREGISTERED SECURITIES

There were no sales of unregistered securities during the period covered by the report that were not previously reported on a Form-8K or Form 10-Q.

#### REPURCHASES OF COMPANY COMMON STOCK

There were no repurchases made during the fourth quarter of the fiscal year covered by this Annual Report.

#### ITEM 6. SELECTED FINANCIAL DATA.

The following selected financial data should be read in conjunction with our consolidated financial statements and related notes and the following subsection - Results of Operations as set out in this Annual Report on Form 10-K.

The table below sets forth a summary of our selected financial data for each of the five years ended December 31, (amounts in thousands except per share amounts):

|  | For the Years Ended December 31, |                  |                  |                  |                  |
|--|----------------------------------|------------------|------------------|------------------|------------------|
|  | 2007<br>Audited                  | 2006<br>restated | 2005<br>restated | 2004<br>restated | 2003<br>restated |
| Statement of Operations Data:                        |                                  |                  |                  |                  |                  |
| Total revenue  | \$ 18,994                        | \$ 29,073        | \$ 7,081         | \$ 10,857        | \$ 1,217         |
| Cost of revenues                                     | 15,292                           | 25,529           | 5,722            | (7,887)          | 698              |
| Operating expenses                                   | 20,129                           | 10,979           | 7,578            | 9,212            | 3,042            |
| Loss from operations                                 | (16,427)                         | (7,435)          | (6,219)          | (6,242)          | (2,523)          |
| Loss available to common stockholders                | (14,195)                         | (12,415)         | (5,145)          | (5,446)          | (1,878)          |
| Basic & Diluted Loss Per Share                       | \$ (1.20)                        | \$ (1.08)        | \$ (0.21)        | \$ (0.78)        | \$ (0.36)        |
| Shares used in computing earnings:                   |                                  |                  |                  |                  |                  |
| Weighted average number of shares-Basic & Diluted    | 11,850,840                       | 11,538,664       | 21,695,473       | 7,015,907        | 5,234,744        |
| Balance Sheet Data:                                  |                                  |                  |                  |                  |                  |
| Cash and cash equivalents (excludes restricted cash) | \$ 3,750                         | \$ 1,778         | \$ 3,331         | \$ 9,433         | \$ 3,823         |
| Working capital                                      | 3,205                            | (6,925)          | 7,965            | 12,711           | 1,442            |
| Total assets   | 24,720                           | 32,671           | 25,225           | 29,442           | 7,173            |

|                            |    |       |    |        |    |        |    |        |    |       |
|----------------------------|----|-------|----|--------|----|--------|----|--------|----|-------|
| Total stockholders' equity | \$ | 2,792 | \$ | 13,977 | \$ | 23,205 | \$ | 24,108 | \$ | 1,912 |
|----------------------------|----|-------|----|--------|----|--------|----|--------|----|-------|

PART II

ITEM 7. MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

**FORWARD-LOOKING STATEMENTS** This annual report on Form 10-K, contains forward-looking statements within the meaning of the federal securities laws. These include statements about our expectations, beliefs, intentions or strategies for the future, which we indicate by words or phrases such as "anticipate," "expect," "intend," "plan," "will," "we believe," "management believes" and similar language. The forward-looking statements are based on our current expectations and are subject to certain risks, uncertainties and assumptions, including those set forth in the discussion under "Description of Business," including the "Risk Factors" described in that section, and "Management's Discussion and Analysis or Plan of Operation." Our actual results may differ materially from results anticipated in these forward-looking statements.

## FACTORS THAT COULD AFFECT FUTURE RESULTS

Factors that might cause actual results, performance or achievements to differ materially from those projected or implied in such forward-looking statements include, among other things:

- The impact of competitive products
- Changes in laws and regulations
- Limitations on future financing
- Increases in the cost of borrowings and unavailability of debt or equity capital
- The inability of the Company to gain and/or hold market share
- Exposure to and expense of resolving and defending litigation
- Consumer acceptance of the Company's products
- Managing and maintaining growth
- Customer demands
- Market and industry conditions
- The success of product development and new product introductions into the marketplace
- The departure of key members of management
- The effect of the United States War on Terrorism, as well as other risks and uncertainties that are described from time to time in the Company's filings with the Securities and Exchange Commission

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis or plan of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities.

On an on-going basis, we evaluate our estimates, including those related to accounts receivable reserves, provisions for impairment losses of affiliated companies and other intangible assets, income taxes and contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Management believes the following critical accounting policies reflect our more significant estimates and assumptions used in the preparation of our consolidated financial statements:

### Allowance for Doubtful Accounts

We evaluate the collectibility of our trade receivables based on a combination of factors. We regularly analyze our significant customer accounts, and, when we become aware of a specific customer's inability to meet its financial obligations to us, such as in the case of bankruptcy filings or deterioration in the customer's operating results or financial position, we record a specific reserve for bad debt to reduce the related receivable to the amount we reasonably believe is collectible. We also record reserves for bad debt for all other customers based on a variety of factors including the length of time the receivables are past due, the financial health of the customer, macroeconomic considerations and historical experience. If circumstances related to specific customers change, our estimates of the recoverability of receivables could be further adjusted. In the event that our trade receivables become uncollectible, we would be forced to record additional adjustments to receivables to reflect the amounts at net realizable value. The accounting effect of this entry would be a charge to earnings, thereby reducing our net earnings. Although we consider the likelihood of this occurrence to be remote based on past history and the current status of our accounts, there is a

possibility of this occurrence.

41

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In the beginning of the third quarter of 2006, the Chinese government announced that it would implement several new policies regarding mobile phone value-added service providers effective from July 10, 2006. These policies include a “double confirmation” policy and the requirement that value-added service providers provide one-month trial subscriptions. By requiring that mobile phone customers “double-confirm” their intention to purchase services, and by requiring free subscriptions, these policies have negatively affected value-added service providers.

#### Inventory

Our inventory purchases and commitments are made in order to build inventory to meet forecasted demand for our products. We perform a detailed assessment of inventory for each period, which includes a review of, among other factors, demand requirements, product life cycle and development plans, component cost trends, product pricing and quality issues. Based on this analysis, we record adjustments to inventory for excess, obsolescence or impairment, when appropriate, to reflect inventory at net realizable value. Revisions to our inventory adjustments may be required if actual demand, component costs or product life cycles differ from our estimates. In the event we were unable to sell our products, the demand for our products diminished, and/or other competitors offered similar or better products, we would be forced to record an adjustment to inventory for impairment or obsolescence to reflect inventory at net realizable value. The accounting effect of this entry would be a charge to earnings, thereby reducing our net earnings.

#### Income Taxes

We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. We have considered future market growth, forecasted earnings, future taxable income, and the mix of earnings in the jurisdictions in which we operate and prudent and feasible tax planning strategies in determining the need for a valuation allowance. We currently have recorded a full valuation allowance against net deferred tax assets as we currently believe it is more likely than not that the deferred tax assets will not be realized. In the event 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 deferred tax assets would be charged to earnings in the period such determination is made. Likewise, if we later determine that it is more likely than not that the net deferred tax assets would be realized, the previously provided valuation allowance would be reversed.

#### Contingencies

We may be subject to certain asserted and unasserted claims encountered in the normal course of business. It is our belief that the resolution of these matters will not have a material adverse effect on our financial position or results of operations, however, we cannot provide assurance that damages that result in a material adverse effect on our financial position or results of operations will not be imposed in these matters. We account for contingent liabilities when it is probable that future expenditures will be made and such expenditures can be reasonably estimated.

#### Valuation of Long-Lived Assets Including Goodwill and Purchased Intangible Assets

We review property, plant and equipment, goodwill and purchased intangible assets for impairment whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. Our asset impairment review assesses the fair value of the assets based on the future cash flows the assets are expected to generate. An impairment loss is recognized when estimated undiscounted future cash flows expected to result from the use of the asset plus net proceeds expected from disposition of the asset (if any) are less than the carrying value of the asset. This approach uses our estimates of future market growth, forecasted revenue and costs, expected periods the assets will be utilized and appropriate discount rates. Such evaluations of impairment of long-lived assets including goodwill arising on a business combination and purchased intangible assets are an integral part of, but not limited to, our strategic reviews of our business and operations performed in conjunction with restructuring actions. When impairment is identified, the carrying amount of the asset is reduced to its estimated fair value. Deterioration of our business in a

geographic region or within a business segment in the future could also lead to impairment adjustments as such issues are identified. The accounting effect of an impairment loss would be a charge to earnings, thereby reducing our net earnings.

## Convertible debt

In accordance with recent FASB accounting guidance, due to certain factors, including a liquidated damages provision in the registration rights agreement and an indeterminate amount of shares to be issued upon conversion of the debentures, the Company values and accounts for the embedded conversion feature related to the Debentures, the Investors' warrants, and the registration rights as derivative liabilities. Accordingly, these derivative liabilities are measured at fair value with changes in fair value reported in earnings as long as they remain classified as liabilities. The Company reassesses the classification at each balance sheet date. If the classification required under EITF No. 00-19 changes as a result of events during the period, the contract should be reclassified as of the date of the event that caused the reclassification.

The fair value of these derivative instruments, as determined by applying the Black-Scholes valuation model, is adjusted quarterly. The Black-Scholes valuation model requires the input of highly subjective assumptions, including the expected stock price volatility. Additionally, although the Black-Scholes model meets the requirements of SFAS 133, the fair values generated by the model may not be indicative of the actual fair values as our derivative instruments have characteristics significantly different from traded options. Accordingly, the results obtained could be significantly different if other assumptions were used. The effect of this entry would be a charge to net earnings, thereby either increasing or reducing our net earnings based upon the assumptions used and the results obtained.

## RECENT ACCOUNTING PRONOUNCEMENTS

In March 2007, the Emerging Issues Task Force ("EITF") reached a consensus on issue number 06-10, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements," ("EITF 06-10"). EITF 06-10 provides guidance to help companies determine whether a liability for the postretirement benefit associated with a collateral assignment split-dollar life insurance arrangement should be recorded in accordance with either SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions" (if, in substance, a postretirement benefit plan exists), or Accounting Principles Board Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract). EITF 06-10 also provides guidance on how a company should recognize and measure the asset in a collateral assignment split-dollar life insurance contract. EITF 06-10 is effective for fiscal years beginning after December 15, 2007, though early adoption is permitted. The management is currently evaluating the effect of this pronouncement on financial statements.

In March 19, 2008, FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities. The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. Currently the Company does not carry any derivative instruments and the adoption of this statement may not have any effect on the financial statements.

In December 2007, FASB issued FASB Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51. This Statement applies to all entities that prepare consolidated financial statements, except not-for-profit organizations, but will affect only those entities that have an outstanding non-controlling interest in one or more subsidiaries or that deconsolidate a subsidiary. Not-for-profit organizations should continue to apply the guidance in Accounting Research Bulletin No. 51, Consolidated Financial Statements, before the amendments made by this Statement, and any other applicable standards, until the Board issues interpretative guidance. This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 (that is, January 1, 2009, for entities with calendar year-ends). Earlier adoption is prohibited. The effective date of this Statement is the same as that of the related Statement 141(R). This Statement shall be applied prospectively as of the beginning of the fiscal year in which this Statement is initially applied, except for the presentation and disclosure requirements. The presentation and disclosure requirements shall

be applied retrospectively for all periods presented. Management is currently evaluating the effect of this pronouncement on financial statements.

In December 2007, the FASB issued SFAS No. 141(R), "Business Combinations". This Statement replaces SFAS No. 141, Business Combinations. This Statement retains the fundamental requirements in Statement 141 that the acquisition method of accounting (which Statement 141 called the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. This Statement also establishes principles and requirements for how the acquirer: a) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; b) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase and c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141(R) will apply prospectively to business combinations for which the acquisition date is on or after Company's fiscal year beginning October 1, 2009. While the Company has not yet evaluated this statement for the impact, if any, that SFAS No. 141(R) will have on its consolidated financial statements, the Company will be required to expense costs related to any acquisitions after September 30, 2009.

In February 2007, FASB issued FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. FAS 159 is effective for fiscal years beginning after November 15, 2007. Early adoption is permitted subject to specific requirements outlined in the new Statement. Therefore, calendar-year companies may be able to adopt FAS 159 for their second quarter 2007 financial statements.

The new Statement allows entities to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be measured at fair value. If a company elects the fair value option for an eligible item, changes in that item's fair value in subsequent reporting periods must be recognized in current earnings. FAS 159 also establishes presentation and disclosure requirements designed to draw comparison between entities that elect different measurement attributes for similar assets and liabilities. The management is currently evaluating the effect of this pronouncement on financial statements.

In September 2006, FASB issued SFAS 158 'Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)' This Statement improves financial reporting by requiring an employer to recognize the over funded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. The Company currently does not have any defined benefit plan and so FAS 158 will not affect the financial statements.

In September 2006, FASB issued SFAS 157 'Fair Value Measurements'. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The management is currently evaluating the effect of this pronouncement on financial statements.

## RESULTS OF OPERATIONS

### REVENUES

Revenues for the year ended December 31, 2007 were \$18,994,000, representing a significant year-over-year decline of 35% as compared to \$29,073,000 for the year ended December 31, 2006.

The decrease in revenues was mainly due to a lower contribution of the low-margin mobile phone wholesaling and distribution business in Greater China and the disposal of major legacy CRM and call center unit during 2007. However, the company has great growth in Gaming Products business revenues that increased to \$2,859,000 (2006: \$364,000) due to the emphasis on Gaming technology development through newly acquired gaming subsidiaries during 2007. Segmented financial information of the four business operating groups is set out below followed by a brief discussion of each business group.

### YEAR ENDED DECEMBER 31, 2007 COMPARED TO YEAR ENDED DECEMBER 31, 2006

| For the year ended December 31, 2007 (in | Group 1.<br>Outsourcing<br>Services | Group 2.<br>Telecom<br>Value-Added | Group 3.<br>Products<br>(Telecom & | Group 4.<br>Other<br>Business | Total |
|--|-------------------------------------|------------------------------------|------------------------------------|-------------------------------|-------|
|--|-------------------------------------|------------------------------------|------------------------------------|-------------------------------|-------|

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|   | Services |       | Gaming) |          |          |
|---|----------|-------|---------|----------|----------|
| thousands of US Dollars,<br>except percentages) | (\$)     | (\$)  | (\$)    | (\$)     | (\$)     |
| Revenues  | 2,310    | 1,839 | 14,528  | 317      | 18,994   |
| (% of Total Revenues)                           | 12%      | 10%   | 76%     | 2%       | 100%     |
| Earnings / (Loss) from<br>Operations            | (544)    | 737   | (6,133) | (10,487) | (16,427) |

44

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|   | Group 1.<br>Outsourcing<br>Services | Group 2.<br>Telecom<br>Value-Added<br>Services | Group 3.<br>Products<br>(Telecom &<br>Gaming) | Group 4.<br>Other<br>Business | Total            |
|---|-------------------------------------|--|---|-------------------------------|------------------|
| For the year ended December 31, 2007 (in thousands of US Dollars, except percentages) | Restated<br>(\$)                    | Restated<br>(\$)                               | Restated<br>(\$)                              | Restated<br>(\$)              | Restated<br>(\$) |
| Revenues  | 1,813                               | 2,784  | 23,385  | 1,091                         | 29,073           |
| (% of Total Revenues)   | 6%                                  | 5%   | 77%   | 12%                           | 100%             |
| Earnings / (Loss) from Operations   | (67)                                | (1,054)  | (1,345)                                       | (4,969)                       | (7,435)          |

(1) OUTSOURCING SERVICES

Revenues for the year ended December 31, 2007 were \$2,310,000, a significant year-over-year increase of 28% as compared to \$1,813,000 for the year ended December 31, 2006. Outsourcing services revenues made up 13% of the Company's total revenues for the FY 2007 which was mainly derived from software development, R&D, and project management services.

(2) TELECOM VALUE-ADDED SERVICES (VAS)

Revenues for the year ended December 31, 2007 were \$1,839,000, a year-over-year increase of 34% as compared to \$2,784,000 for the same period last year. The increase was mainly due to the sales revenues from WAP-based mobile phone games and traditional SP businesses, from which revenues accounted for 90% of the Company's total VAS revenues for FY2007.

(3) PRODUCTS (TELECOM & GAMING)

Revenues for the year ended December 31, 2007 were \$14,528,000, a year-over-year decrease of 38% from \$23,385,000 for the year ended December 31, 2006. Decrease in Products revenues, which accounted for 77% of the Company's total revenues for FY2007, is largely due to contraction of the Company's mobile phone wholesaling and distribution businesses in Greater China.

Gaming technology revenues derived from selling Multi-player Electronic Gaming Machine to casino operators amounted to \$2,311,000 and accounted for 16% of total revenues for FY2007.

As planned, the company continues to scale down its low-margin mobile phone wholesaling business and distribution business in Greater China. Revenues from sales and distribution of mobile communication products, accessories, phone cards and mobile SIM cards, and telecom related services in Hong Kong and Greater China amounted to \$11,669,000, a significant year-over-year decline of 33% as compared to \$17,268,000 for the same periods in 2006.

(4) OTHER BUSINESS

Revenues for other business for the year ended December 31, 2007 was \$317,000, a significant decrease of 71% as compared to \$1,091,000 for the year ended December 31, 2006 due to the disposal of certain subsidiaries during 2007.

COST OF REVENUES

Cost of revenues for the year ended December 31, 2007 were \$15,292,000, representing a year-over-year decrease of 40% as compared to \$25,529,000 for the same period of prior year. Cost of revenues as a percentage of the corresponding revenues was approximately 81% for FY2007 as compared to 88% for the same period of prior year.

**(1) OUTSOURCING SERVICES**

Cost of revenues from outsourcing services for FY2007 amounted to \$2,199,000, a year-over-year increase of 55% as compared with 2006. Increase in cost of revenues was largely due to headcount increase at service staff level.

**(2) TELECOM VALUE-ADDED SERVICES (VAS)**

Cost of revenues from VAS for FY2007 was \$508,000, a decrease of 75% as compared with 2006 due to the sale of a major telecom CRM unit during 2007.

**(3) PRODUCTS (TELECOM & GAMING)**

Cost of revenues derived from Products for FY2007 amounted to \$12,538,000, a reduction of 43% as compared with the same periods in 2006. Approximately 87% of the cost of revenues related to Products for the third quarter of FY2007 was derived from the sales of mobile phones and 13% was derived from the sales of electronic gaming machines.

**GROSS PROFIT**

Gross profit for FY2007 was \$3,702,000 (2006: \$3,544,000). Gross margin was 20% for FY2007 as compared to 13% for the same period of prior year. Improvement in gross margin was attributed to higher margin for Multiplayer Gaming Machines (39%) and Electronic Slot Machines (60%).

**SELLING, GENERAL AND ADMINISTRATIVE EXPENSES**

Selling, general and administrative expenses (SG&A) totaled \$13,480,000 for FY2007, a year-over-year increase of 69% as compared to \$7,968,000 for the same periods of prior year. The increased SG&A was mainly due to the provision for captioned USD5 million against 3G receivables during 2007. SG&A consists primarily of indirect staff salaries, office rental, insurance, advertising expenditures and traveling costs.

| SELLING, GENERAL AND ADMINISTRATIVE EXPENSES<br>(in thousands of US Dollars, except percentages) | For the year ended<br>December 31, 2007<br>Audited | For the year ended<br>December 31, 2006<br>Restated | Percentage<br>Change |
|--|--|---|----------------------|
| Remuneration and related expenses  | \$ 4,498   | \$ 2,293  | % 96                 |
| Office (majority is rental and utilities)  | 821  | 599   | 37                   |
| Travel   | 440  | 302   | 46                   |
| Entertainment  | 158  | 103   | 54                   |
| Professional (legal and consultant)  | 600  | 357   | 68                   |
| Audit  | 697  | 156   | 346                  |
| Selling  | 470  | 215   | 118                  |
| Bad Debts  | 5,319  | 4,537   | 17                   |
| Other  | 475  | (595)   | % (180)              |
| Total  | \$ 13,480  | \$ 7,968  | 69                   |

**(1) OUTSOURCING SERVICES**

Selling, General and Administrative expenses for outsourcing services were \$757,000 for the year ended December 31, 2007, an increase of 67% from \$453,000 for the year ended December 31, 2006.



SELLING, GENERAL AND ADMINISTRATIVE  
EXPENSES

| (in thousands of US Dollars, except percentages) | Group 1. Outsourcing Services |                                  |                      | Percentage<br>Change |
|--|-------------------------------|----------------------------------|----------------------|----------------------|
|  | For the year ended            | For the year ended               | For the year ended   |                      |
|  | December 31, 2007<br>Audited  | December 31,<br>2006<br>Restated | December 31,<br>2006 |                      |
| Remuneration and related expenses                | \$ 463                        | \$ 317                           | %                    | 46                   |
| Office (majority is rental and utilities)        | 65                            | 35                               |                      | 83                   |
| Travel   | 87                            | 12                               |                      | 653                  |
| Entertainment                                    | 13                            | 5                                |                      | 191                  |
| Professional (legal and consultant)              | 7                             | 9                                |                      | (28)                 |
| Audit  | 4                             | 3                                |                      | 44                   |
| Selling  | 11                            | 0                                |                      | 2,225                |
| Bad Debts  | 100                           | 49                               |                      | 103                  |
| Other  | 7                             | 23                               | %                    | (70)                 |
| Total  | \$ 757                        | \$ 453                           |                      | 67                   |

## (2) TELECOM VALUE-ADDED SERVICES (VAS)

Selling, General and Administrative expenses for VAS were \$471,000 for the year ended December 31, 2007 as compared to \$603,000 in 2006.

SELLING, GENERAL AND ADMINISTRATIVE  
EXPENSES

| (in thousands of US Dollars, except percentages) | Group 2. Telecom Value-Added Services |                                  |                      | Percentage<br>Change |
|--|---------------------------------------|----------------------------------|----------------------|----------------------|
|  | For the year ended                    | For the year ended               | For the year ended   |                      |
|  | December 31, 2007<br>Audited          | December 31,<br>2006<br>Restated | December 31,<br>2006 |                      |
| Remuneration and related expenses                | \$ 255                                | \$ 337                           | %                    | (24)                 |
| Office (majority is rental and utilities)        | 66                                    | 122                              |                      | (46)                 |
| Travel   | 42                                    | 72                               |                      | (41)                 |
| Entertainment                                    | 26                                    | 38                               |                      | (32)                 |
| Professional (legal and consultant)              |                                       |                                  |                      | n/a                  |
| Audit  | 3                                     |                                  |                      | n/a                  |
| Selling  | 11                                    | 10                               |                      | 12                   |
| Bad Debts  | 46                                    | 3                                |                      | 1,693                |
| Other  | 23                                    | 23                               |                      | 1                    |
| Total  | \$ 471                                | \$ 603                           | %                    | (22)                 |

## (3) PRODUCTS (TELECOM &amp; GAMING)

Selling, General and Administrative expenses for products (telecom & gaming) were \$2,548,000 for the year ended December 31, 2007, a year-over-year increase of 7% as compared to \$2,370,000 for the year ended December 31, 2006.

SELLING, GENERAL AND ADMINISTRATIVE  
EXPENSES

| (in thousands of US Dollars, except percentages) | Group 3. Products (Telecom & Gaming) |              |            |
|--|--------------------------------------|--------------|------------|
|  | For the year                         | For the year | Percentage |

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|   | ended<br>December 31, 2007 | ended<br>December 31,<br>2006 | Change |
|---|----------------------------|-------------------------------|--------|
|   | Audited                    | Restated                      |        |
| Remuneration and related expenses         | \$ 1,227                   | \$ 315                        | % 289  |
| Office (majority is rental and utilities) | 455                        | 158                           | 189    |
| Travel                                    | 146                        | 47                            | 208    |
| Entertainment                             | 99                         | 40                            | 147    |
| Professional (legal and consultant)       | 104                        | 19                            | 437    |
| Audit                                     | 43                         | 0                             | 25,576 |
| Selling                                   | 344                        | 95                            | 264    |
| Bad Debts                                 | (126)                      | 1,627                         | (108)  |
| Other                                     | 256                        | 69                            | % 272  |
| Total                                     | \$ 2,548                   | \$ 2,370                      | 7      |

47

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(4) OTHER BUSINESS

Selling, General and Administrative expenses were \$9,703,000 for the year ended December 31, 2007, a substantial increase of 114% as compared to \$4,542,000 for 2006. The substantial increase was mainly due to the provision for bad debts for USD\$5 million from the sale and disposal of Gz3G during 2007.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

| (in thousands of US Dollars, except percentages) | Group 4. Other Business                      |   | Percentage Change |
|--|--|---|-------------------|
|  | For the year ended December 31, 2007 Audited | For the year ended December 31, 2006 Restated |                   |
| Remuneration and related expenses                | \$ 2,554                                     | \$ 1,325                                      | % 99              |
| Office (majority is rental and utilities)        | 235  | 284   | (17)              |
| Travel   | 165  | 172   | (4)               |
| Entertainment                                    | 20   | 21  | (4)               |
| Professional (legal and consultant)              | 489  | 328   | 49                |
| Audit  | 648  | 153   | 322               |
| Selling  | 104  | 110   | (6)               |
| Bad Debts  | 5,299  | 2,858   | 85                |
| Other  | 189  | (709)   | % (127)           |
| Total  | \$ 9,703                                     | \$ 4,542                                      | 114               |

DEPRECIATION AND AMORTIZATION EXPENSES

Depreciation and amortization expenses were \$752,000 for the year ended December 31, 2007, representing a year-over-year decrease of 51% as compared \$1,536,000 for the same periods of the prior year. Decrease in depreciation and amortization was mainly due to the amortize issuance cost of \$835,000 carry forward in the 2006 re-audit.

Depreciation

| (in thousands of US Dollars, except percentages) | For the year ended December 31, 2007 Audited | For the year ended December 31, 2006 Restated | Percentage Change |
|--|--|---|-------------------|
|  | Group 1. Outsourcing Services                | \$ (2)  |                   |
| Group 2. Telecom Value-Added Services            | 167  | 268   | (38)              |
| Group 3. Products (Telecom & Gaming)             | 116  | 38  | 205               |
| Group 4. Other Business                          | 159  | 89  | 79                |
| Total  | \$ 440                                       | \$ 401  | % 10              |

Amortization

| (in thousands of US Dollars, except percentages) | For the year ended December 31, 2007 Audited | For the year ended December 31, 2006 Restated | Percentage Change |
|--|--|---|-------------------|
|  | Group 1. Outsourcing Services                | \$  |                   |

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|                                       |        |          |        |
|---------------------------------------|--------|----------|--------|
| Group 2. Telecom Value-Added Services | 1      | -        | n/a    |
| Group 3. Products (Telecom & Gaming)  | 311    | 29       | 972    |
| Group 4. Other Business               |        | 1,106    | (100)  |
| Total                                 | \$ 312 | \$ 1,135 | % (72) |

48

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## LOSS FROM OPERATIONS

On a year-over-year basis, Loss from operations amounted to \$16,427,000 for FY2007, as compared to \$7,434,000 for FY2006. During this year, provision of \$3.5 million against receivable from 3G purchaser and extra goodwill impairment of approximately \$5,461,000 resulted in and reduced the Operating Loss directly for the fiscal year ended December 31, 2007.

| (in thousands of US Dollars,<br>except percentages)            | Group 1.<br>Outsourcing<br>Services<br>(\$) | Group 2.<br>Telecom<br>Value-Added<br>Services<br>(\$) | Group 3.<br>Products<br>(Telecom<br>& Gaming)<br>(\$) | Group 4.<br>Other<br>Business<br>(\$) | For the<br>year<br>ended<br>December<br>31, 2007<br>(\$) | For the<br>year<br>ended<br>December<br>31, 2006<br>(\$) |
|--|---|--|---|---------------------------------------|--|--|
| Operating profits (Loss) before non-cash accounting provisions | 3,520                                       | 783  | (6,408)   | (3,491)                               | (5,596)  | 2,945  |
| Allowance for doubtful accounts (1)                            | (100)                                       | (46)   | 1,772   | (6,945)                               | (5,319)  | (4,537)  |
| Goodwill impairment (2)  | (3,964)                                     |  | (1,497)   |                                       | (5,461)  | (5,601)  |
| Stock-based compensation expenses (3)                          |   |  |   | (51)                                  | (51)   | (242)  |
| Operating profits (Loss)                                       | (544)                                       | 737  | (6,133)   | (10,487)                              | (16,427)   | (7,435)  |

## INTEREST INCOME / (EXPENSES), NET

| (in thousands of US Dollars, except percentages) | For the year<br>ended<br>December 31,<br>2007<br>Audited | For the year<br>ended<br>December 31,<br>2006<br>Restated | Percentage<br>Change |
|--|--|---|----------------------|
| Interest income                                  | \$ 37  | \$ 162  | % (77)               |
| Interest expenses                                | 859  | 1,058   | (19)                 |
| Interest income / (expenses), net                | \$ (822)   | \$ (896)  | % (8)                |

Interest income was \$37,000 for the year ended December 31, 2007, a decrease of 77% as compared to \$162,000 for the year ended December 31, 2006. Interest expenses were \$859,000 for the year ended December 31, 2007, a decrease of 19% as compared to \$1,058,000 for the year ended December 31, 2006. The Decrease in Interest Income (Expenses) was mainly due to the divestiture of telecom CRM units during 2007, and most of the interest expenses of this year were attributed to the interest accrual of \$499,000 for Five Million Convertible Note.

| (in thousands of US Dollars, except percentages) | For the year<br>ended<br>December 31,<br>2007<br>Audited | For the year<br>ended<br>December 31,<br>2006<br>Restated | Percentage<br>Change |
|--|--|---|----------------------|
| Interest Expenses                                |  |   |                      |
| Group 1. Outsourcing Services                    | \$ 6   | \$ 22   | % n/a                |
| Group 2. Telecom Value-Added Services            | 2  |   | n/a                  |
| Group 3. Products (Telecom & Gaming)             | 445  | 56  | 695                  |
| Group 4. Other Business                          | 406  | 980   | (59)                 |
| Total  | \$ 859   | \$ 1,058  | % (19)               |

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| Interest Income<br>(in thousands of US Dollars, except percentages) | For the year<br>ended<br>December 31,<br>2007<br>Audited | For the year<br>ended<br>December 31,<br>2006<br>Restated | Percentage<br>Change |
|---|--|---|----------------------|
| Group 1. Outsourcing Services                                       | \$   | \$ -  | % n/a                |
| Group 2. Telecom Value-Added Services                               | 2  | -   | n/a                  |
| Group 3. Products (Telecom & Gaming)                                | 18   | 140   | (87)                 |
| Group 4. Other Business   | 17   | 22  | (23)                 |
| Total   | \$ 37  | \$ 162  | % (77)               |

49

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## SUNDRY INCOME/EXPENSE

Sundry income known as non-operating income is defined as the external income (miscellaneous income) that results from factors outside of our operating subsidiaries' control and such income does not relate to each subsidiary's core operating business. Income from the sale of various investments is one of the typical examples. (See Note 11 for details)

For the year ended December 31, 2007, the non-operating income or sundry income of \$1,238,000 included in Statement of Operations was mainly derived from the investment income of \$561,000, leasehold income \$65,000, software service income \$78,000 and various other income totaling \$534,000. .

For the year ended December 31, 2006, the non-operating income or sundry income was \$108,000 mainly derived from leasehold income of \$79,000 and various other incomes totaling \$29,000.

| Sundry Income (Net)<br>(in thousands of US Dollars, except percentages) | For the year<br>ended<br>December 31,<br>2007<br>Audited | For the year<br>ended<br>December 31,<br>2006<br>Restated | Percentage<br>Change |       |
|---|--|---|----------------------|-------|
| Group 1. Outsourcing Services   | \$ 1   | \$ -  | %                    | n/a   |
| Group 2. Telecom Value-Added Services                                   | 42   | -   |                      | n/a   |
| Group 3. Products (Telecom & Gaming)                                    | 115  | -   |                      | n/a   |
| Group 4. Other Business   | 1,080  | 108   |                      | 900   |
| Total   | \$ 1,238   | \$ 108  | %                    | 1,046 |

## SHARE OF PROFIT OF ASSOCIATED COMPANIES

An aggregate of \$77,000 in loss from investment has been recognized for the year ended December 31, 2007 as a result of sharing loss of our 40% ownership interest in Bell-Pact Shanghai, acquired in January 2007.

An aggregate of \$17,000 in earnings from investment has been recognized for the year ended December 31, 2006 as a result of sharing profits and loss of our 20% ownership interest in Take1 Technology – (\$295,000), acquired in April 2004; 20% ownership in MOABC – (\$19,000), acquired in October 2006; and, 45% ownership interest in PactGames – \$331,000, acquired in September 2006 (ownership has been increased to 51% interest as of December 31, 2007).

## INCOME TAXES

The income taxes expenses for the Company's subsidiaries were \$7,000 and \$18,000 for the years ended December 31, 2007 and 2006 respectively. The provision of income taxes depends on the tax rate and tax exemption. Pursuant to the PRC Income Tax Laws, the Company's subsidiaries and VIEs are generally subject to Enterprise Income Taxes ("EIT") at a statutory rate of 33%, which comprises 30% national income tax and 3% local income tax. Certain subsidiaries and VIEs are qualified for preferred high technology or software enterprise tax status, and they are subject to preferential tax rate of 15% under PRC Income Tax Rules.

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| (in thousands of US Dollars, except percentages) | For the year ended December 31, 2007<br>Audited | For the year ended December 31, 2006<br>Restated | Percentage Change |
|--|---|--|-------------------|
| Group 1. Outsourcing Services                    | \$  | \$   | % n/a             |
| Group 2. Telecom Value-Added Services            |   | 3  | n/a               |
| Group 3. Products (Telecom & Gaming)             |   | 4  | n/a               |
| Group 4. Other Business                          |   | 18   | (100)             |
| Total  | \$  | 7 \$   | 18 % (61)         |

MINORITY INTERESTS

Minority interests for the year ended December 31, 2007 and 2006 was \$37,000 and \$58,000 respectively. Minority interests represented minority ownership interests in subsidiaries consolidated in the Company's consolidated financial statement.

NET LOSS

On a year-over-year basis, Net Loss amounted to \$14,195,000 for FY2007, a year-over-year decrease of 15% as compared to \$12,415,000 for the same period of prior year. Net Loss incurred in FY 2007 was mainly due the substantial provision \$3.5 million against receivable from 3G purchaser, \$5.5 million of goodwill impairment, and certain write-offs, compensation costs and provisions for bad debt related to our legacy telecom operation. Segmented details are set out below:

| (in thousands of US Dollars, except percentages)                 | Group 1. Outsourcing Services<br>(\$) | Group 2. Telecom Value-Added Services<br>(\$) | Group 3. Products (Telecom & Gaming)<br>(\$) | Group 4. Other Business<br>(\$) | For the year ended December 31, 2007<br>(\$) | For the year ended December 31, 2006<br>(\$) | Percentage Change<br>(%) |
|--|---------------------------------------|---|--|---------------------------------|--|--|--------------------------|
| Operating profits (Loss)   | (544)                                 | 737   | (6,133)                                      | (10,487)                        | (16,427)                                     | (7,435)                                      | 121                      |
| Interest income / (expenses), net                                | (6)                                   | 1   | (430)  | (387)                           | (822)  | (896)  | (8)                      |
| Loss in change in fair value of warrants                         | -                                     | -   | -  | -                               | -  | (214)  | (100)                    |
| Liquidated damages   | -                                     | -   | -  | -                               | -  | (3,817)                                      | (100)                    |
| Sundry income  | 1                                     | 42  | 115  | 1,080                           | 1,238  | 108  | 1,046                    |
| Shares of earning from investment on equity method               |                                       |   | (77)   |                                 | (77)   | 17   | (553)                    |
| Earnings before Income Taxes, Minority Interest and Discontinued | (549)                                 | 780   | (6,525)                                      | (9,794)                         | (16,088)                                     | (12,237)                                     | 31                       |

Operations

CONTRACTUAL OBLIGATIONS

CONTRACTUAL OBLIGATIONS

Cash resources required to satisfy short and long term contractual obligations as of December 31, 2007 are tabulated below:

51

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## Payments Due by Period

| Contractual Obligations (in thousands) | Total    | Less than<br>1 year | 1-5 years | After 5<br>years |
|--|----------|---------------------|-----------|------------------|
| Line of credit                         | \$ 100   | 100                 | -         | -                |
| Bank Loans                             | 1,824    | 80                  | 370       | 1,374            |
| Operating leases                       | 404      | 210                 | 194       | -                |
| Capital leases                         | N/A      | -                   | -         | -                |
| Total cash contractual obligations     | \$ 2,328 | 390                 | 564       | 1,374            |

## OFF-BALANCE SHEET ARRANGEMENTS

There were no off-balance sheet guarantees, interest rate swap transactions, foreign currency forward contracts or long term purchase commitments outstanding as of December 31, 2007. Further, the Company had not engaged in any non-exchange trading activities during 2007.

## LIQUIDITY AND CAPITAL RESOURCES

## OVERVIEW

Net cash and cash equivalents at December 31, 2007 were approximately \$3.75 million, an increase of approximately \$1.97 million compared to December 31, 2006. This change resulted from cash used in operations of \$1.08 million, cash provided by investing activities of \$0.52 million and cash provided by financing activities of \$2.29 million.

Significant components of cash flows from operations are as follows:

| (Amounts in millions<br>of US Dollars)     |             |
|--|-------------|
| Net loss                                   | \$ (14,195) |
| Non-cash and/or<br>nonrecurring items      | 12,008      |
| Other changes in assets<br>and liabilities | 1,108       |
| Net cash used in<br>operations             | \$ (1,079)  |

Other significant sources (uses) of cash during 2007 were mainly attribute to \$3.5 million of provision against receivables from 3G purchaser, \$2.95 million proceeds from issuance of convertible debenture, \$5.5 million of Goodwill impairment and \$1.5 million of accounts receivable and other current assets, ..

## WORKING CAPITAL

The Company's working capital decreased to \$3,205,000 at December 31, 2007, as compared to \$6,925,000 at December 31, 2006. The decreased working capital primarily resulted from the decreased \$6,865,000 in net assets held for dispositions, and the decreased \$2,311,000 in other current assets.

## ISSUANCE OF COMMON STOCK

During the year ended December 31, 2007, the Company had the following equity transactions (i) 199,444 shares of common stock were issued as the monthly principal redemption shares for 8 million convertible debentures from

January to March, such shares are valued at \$1,090,914; (ii) 41,426 treasury shares were sold to the open market with total consideration \$127,000; (iii) 202,000 shares as a results of exercise of stock options with cash consideration of \$406,000. As of December 31, 2007, the Company received \$196,000 from exercise of stock options.

## CAPITAL RESOURCES

As of December 31, 2007, we had approximately \$3,750,000 in cash. We regularly review our cash funding requirements and attempt to meet those requirements through a combination of cash on hand; cash provided by operations, available borrowings under bank lines of credit and possible future public or private equity offerings. We evaluate possible acquisitions of, or investments in, businesses that are complementary to ours, which transactions may require the use of cash. We believe that our cash, other liquid assets, operating cash flows, credit arrangements, access to equity capital markets, taken together, provide adequate resources to fund ongoing operating expenditures. In the event that they do not, we may require additional funds in the future to support our working capital requirements or for other purposes and may seek to raise such additional funds through the sale of public or private equity as well as from other sources.

On February 6, 2007, our subsidiary, PacificNet Games Limited (PactGames) entered into a definitive agreement for a \$5 million financing in the form of secured convertible debt with Pope Asset Management, LLC (Pope), an institutional investor. Proceeds from the financing was be used to provide PactGames with additional working capital in expanding its gaming technology operations, funding for strategic acquisitions in China and funding for general corporate purposes.

The \$5 million convertible debt issued by PactGames to Pope, matures on February 6, 2010, and may be converted into 26% to 32% ownership interest in PactGames based on reaching certain net income milestones during fiscal year 2007. The interest rate on the convertible debt will initially be set at 8%, and shall increase to 15% if the note is not converted prior to maturity.

## ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to various market risks arising from adverse changes in market rates and prices, such as foreign exchange fluctuations and interest rates, which could impact our results of operations and financial position. We do not currently engage in any hedging or other market risk management tools, and we do not enter into derivatives or other financial instruments for trading or speculative purposes.

### Foreign Currency Exchange Rate Risk

All of the Company's revenues are denominated either in U.S. dollars or Hong Kong dollars, while its expenses are denominated primarily in Hong Kong dollars and Chinese Renminbi ("RMB"). The value of the RMB-to-U.S. dollar or Hong Kong dollar-to-United States dollar and other currencies may fluctuate and is affected by, among other things, changes in political and economic conditions. Since 1994, the conversion of Renminbi into foreign currencies, including U.S. dollars, has been based on rates set by the People's Bank of China, which are set daily based on the previous day's inter-bank foreign exchange market rates and current exchange rates on the world financial markets. Since 1994, the official exchange rate for the conversion of Renminbi to U.S. dollars had generally been stable and the Renminbi had appreciated slightly against the U.S. dollar. However, on July 21, 2005, the Chinese government changed its policy of pegging the value of Chinese Renminbi to the U.S. dollar. Under the new policy, Chinese Renminbi may fluctuate within a narrow and managed band against a basket of certain foreign currencies. Recently there has been increased political pressure on the Chinese government to decouple the Renminbi from the United States dollar. At the recent quarterly regular meeting of People's Bank of China, its Currency Policy Committee affirmed the effects of the reform on Chinese Renminbi exchange rate. Since February 2006, the new currency rate system has been operated; the currency rate of Renminbi has become more flexible while basically maintaining stable and the expectation for a larger appreciation range is shrinking. Although a devaluation of the Hong Kong dollar or Renminbi relative to the United States dollar would likely reduce the Company's expenses (as expressed in United States dollars), any material increase in the value of the Hong Kong dollar or Renminbi relative to the United States dollar would increase the Company's expenses, and could have a material adverse effect on the Company's business,

financial condition and results of operations. For fluctuations in period to period exchange rates, the translation adjustment is required to translate from local functional currency to the USD reporting currency (not RMB to HKD to USD). The Company has never engaged in currency hedging operations and has no present intention to do so.

#### Interest Rate Risk

Changes in interest rates may affect the interest paid (or earned) and therefore affect our cash flows and results of operations. We are exposed to interest rate change risk with respect to one of our subsidiaries credit facility with a commercial lender. However, we do not believe that this interest rate change risk is significant.

## Inflation

Inflation has not had a material impact on the Company's business in recent years.

## Concentration of Credit Risk

Credit risk represents the accounting loss that would be recognized at the reporting date if counterparties failed completely to perform as contracted. Concentrations of credit risk (whether on or off balance sheet) that arise from financial instruments exist for groups of customers or counterparties when they have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions as described below:

The Company's business is characterized by rapid technological change, new product and service development, and evolving industry standards and regulations. Inherent in the Company's business are various risks and uncertainties, including the impact from the volatility of the stock market, limited operating history, uncertain profitability and the ability to raise additional capital.

All of the Company's revenue is derived from Asia and Greater China. Changes in laws and regulations, or their interpretation, or the imposition of confiscatory taxation, restrictions on currency conversion, devaluations of currency or the nationalization or other expropriation of private enterprises could have a material adverse effect on our business, results of operations and financial condition.

If the Company is unable to derive any revenues from Greater China, it would have a significant, financially disruptive effect on the normal operations of the Company.

A substantial portion of the operations of business operations depend on mobile telecommunications operators (operators) in China and any loss or deterioration of such relationship may result in severe disruptions to their business operations and the loss of a significant portion of the Company's revenue. The VIEs rely entirely on the networks and gateways of these operators to provide its wireless value-added services. Specifically these operators are the only entities in China that have platforms for wireless value-added services. The Company's agreements with these operators are generally for a period of less than one year and generally do not have automatic renewal provisions. If neither of them is willing to continue to cooperate with the Company, it would severely affect the Company's ability to conduct its existing wireless value-added services business.

## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The consolidated financial statements and the report and notes, are attached hereto following the signature page beginning on Page F-1.

## INDEX TO FINANCIAL STATEMENTS

|  |     |
|--|-----|
| Report of Independent Registered Public Accounting Firm  | F-2 |
| Consolidated Balance Sheets - As of December 31, 2007 and December 31, 2006 (restated)   | F-3 |
| Consolidated Statements of Operations - For the Years Ended December 31, 2007, December 31, 2006 (restated) and December 31, 2005 (restated) | F-4 |
|  | F-5 |

Consolidated Statements of Changes in Stockholders' Equity - For the Years Ended December 31, 2007, December 31, 2006 (restated) and December 31, 2005 (restated)

Consolidated Statements of Cash Flows - For the Years Ended December 31, 2007, December 31, 2006 (restated) and December 31, 2005 (restated)

F-6

Notes to Consolidated Financial Statements

F-7

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

NONE

**ITEM 9A. CONTROLS AND PROCEDURES**

Management is responsible for establishing and maintaining adequate internal control over financial reporting of the Company. Internal control over financial reporting is a process designed by, or under the supervision of, our chief executive and chief financial officers and effected by our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principals.

54

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Management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of our internal control over financial reporting as of December 31, 2007 based on criteria established under the COSO framework, an integrated framework for evaluation of internal controls issued to identify the risks and control objectives related to the evaluation of the control environment by the Committee of Sponsoring Organizations of the Treadway Commission.

Based on our evaluation described above, management has concluded that our internal control over financial reporting was not effective as of December 31, 2007. Management has determined that (i) our inadequate staffing and supervision and (ii) the significant amount of manual intervention required in our accounting and financial reporting process are material weaknesses in our internal control over financial reporting.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation requirements by our registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

#### ITEM 9B. OTHER INFORMATION

None

#### PART III

#### ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

##### COMPLIANCE WITH SECTION 16(A) OF THE EXCHANGE ACT

Set forth below are the names of the directors, executive officers and significant employees of the Company as of June 11, 2008:

| Name                 | Age | Title   |
|----------------------|-----|---|
| Tony Tong            | 40  | Chairman and Chief Executive Officer                  |
| Victor Tong          | 37  | President, Secretary, and Director<br>Chief Financial |
| Phillip Wong         | 57  | Officer (Appointed on April 10, 2008)                 |
| Daniel Lui           | 43  | Former Chief Financial Officer                        |
| ShaoJian (Sean) Wang | 41  | Director  |
| Guo-Jing Su          | 37  | Independent Director (1)(2)(3)                        |
| Jeremy Goodwin       | 33  | Independent Director (1)                              |
| Tao Jin              | 38  | Independent Director (1)(2)                           |
| Stephen Crystal      | 43  | Independent Director                                  |
| Mike Fei             | 38  | Company Secretary and General Counsel                 |

- (1) Member of Audit Committee
- (2) Member of Nominating Committee
- (3) Member of Compensation Committee

Our executive officers are appointed at the discretion of our board of directors with no fixed term. There are no family relationships between or among any of our executive officers or our directors other than the relationship between Mr. Tony Tong and Mr. Victor Tong.

The following is a brief description of each board of director, key positions and brief biography:

MR. TONY TONG, age 40, is the Chairman, CEO, Executive Director, and co-founder of PacificNet. Prior to founding PACT, Mr. Tong worked at Andersen Consulting (now Accenture, NYSE:ACN) and ADC Telecommunications (NASDAQ:ADCT), a global supplier of telecom equipment. Mr. Tong's R&D achievements include being the inventor and patent holder of US Patent Number 6,012,066 (granted by US Patent and Trademark Office) titled "Computerized Work Flow System." Tony is a frequent speaker on Asian gaming technology and was invited to present at the G2E (Las Vegas), G2E Asia (Macau), European iGaming Congress - Barcelona (EiGexpo.com), Casino Affiliate Convention - Macau (CAC2007.com), Asia GEM Gaming Expo – Philippines, and China 3G Summit. Tony is also a frequent speaker on technology investment in China, and was invited to present at the APEC International Finance & Technology Summit, China Venture Capital Forum, and China Hi-Tech Fair, and a Fellow of Hong Kong Institute of Directors. Tony graduated with Bachelor of Mechanical/Industrial Engineering Degree from the University of Minnesota and served on the Computer Engineering Department Advisory Board and was an Adjunct Professor at the University of Minnesota, USA. Mr. Tony Tong was named to the 2008 "25 People to Watch" List compiled by Global Gaming Business Magazine, the leading global gaming magazine which annually honors 25 top individuals with major impact on the gaming industry. At the 3rd Annual Euro-Asian Summit of Leaders at the Asia GEM 2008 in Manila, Philippines, Mr. Tony Tong was elected member of the Euro-Asian Cooperation on Gaming Association Limited (ECG, <http://www.ecglimited.com>), a leading gaming association for gaming operators, suppliers, and regulators which promotes the development and growth of the legitimate gaming industry.

MR. VICTOR TONG, age 37, is the President of PacificNet, and has served on our board as an Executive Director since 2002. Mr. Victor Tong gained his consulting, systems integration, and technical expertise through his experience at Andersen Consulting (now Accenture, NYSE:ACN), American Express Financial Advisors (IDS), 3M, and the Superconductivity Center at the University of Minnesota. In 1994, Mr. Victor co-founded Talent Information Management ("TIM"), a leading internet application development and consulting company in Minnesota. PacificNet.com was originally founded as an operating division of TIM. In 1997, Mr. Tong successfully sold GoWeb, an internet consulting division of TIM to Key Investment, a leading technology and media investment company owned by Vance Opperman, a billionaire in Minnesota who founded West Publishing. Mr. Tong became the President of KeyTech, a leading information technology consulting company based in Minnesota. In 1999, he was recognized in "City Business 40 Under 40" as one of the future business and community leaders in Minnesota. Mr. Tong won the Student Commencement Speaker Award and graduated with honors with a Bachelor of Science in Physics from the University of Minnesota. Mr. Victor Tong was named to the 2008 "25 People to Watch" List compiled by Global Gaming Business Magazine, the leading global gaming magazine which annually honors 25 top individuals with major impact on the gaming industry. Victor Tong is the brother of Tony Tong.

MR. PHILLIP WONG, age 57, has served as Chief Financial Officer since April 10, 2008. Mr. Phillip Wong, age 57, has over 20 years of hands-on China business experience, including financial and lottery gaming experience. Mr. Wong has served as president of Shenzhen G-Lot Technology Limited, a leading provider of lottery technology and systems in China serving the Welfare and Sports Lottery markets. Mr. Wong was formerly the General Manager of a listed company in Hong Kong (Culturecom: HK Stock Code 0343.HK, formerly known as Jademan Holdings). Mr. Wong has a Post Graduate Diploma in General Management from Macquarie University of Australia. He is also a Fellow of the Chartered Institute of Management Accountants of the UK since 1986 as well as a Fellow of the Hong Kong Institute of Certified Public Accountants. Mr. Wong was awarded the Ten Outstanding Young Persons' Award in Hong Kong and was elected Vice-Chairman of the Ten Outstanding Young Persons Association in the late 1980's. Before the transfer of sovereignty of Hong Kong back to China in 1997, Mr. Wong was the Convener of the Economic Sub-group of the Basic Law Drafting Committee of the Hong Kong Management Association. From 1992 to 2002, Mr. Wong was a Committee Member of the Chinese Political Party's Consultative Committee of Zengcheng City, Guangdong. Mr. Wong discontinued with his voluntary services based Hong Kong after he moved to Shanghai in 2002.

MR. DANIEL LUI, age 43, has served as Chief Financial Officer from March 1, 2007, to April 2008. Mr. Lui joined PacificNet with over 17 years of professional and commercial accounting experience, 7 years of which was in Mainland China. He carries the credentials of Chartered Accountant (Alberta, Canada) and CPA-inactive (Washington, USA). Mr. Lui was Vice President of Finance and Company Secretary of Fiberxon Inc., a leading communications subsystem maker, where he was in charge of Fiberxon's Finance, Company Secretarial, and Information Technology departments from 2002 to 2007. Prior to joining Fiberxon, Mr. Lui was Chief Financial Officer of China Motion NetCom Ltd., a wholly owned subsidiary of China Motion Telecom International Limited, a Hong Kong Exchange listed company, engaged in long distance call resale business from 2000 to 2001. Prior to that, Mr. Lui was Financial Advisory Services Manager of PricewaterhouseCoopers and Auditor at KPMG. Mr. Lui received his Bachelors of Business Administration degree from the University of Hawaii at Manoa in 1987 and Master of Business Administration from University of Alberta in Canada in 1994.

MR. SHAOJIAN (SEAN) WANG, age 41, has served on our board as a Director since 2002. From 2002 to May 2006, Mr. Wang also served as Chief Financial Officer of PacificNet. Mr. Wang is now President and Chief Operating Officer of Hurray! Holding Co., Ltd. (NASDAQ:HRAY), a NASDAQ-listed Chinese VAS company. Previously, Mr. Wang was COO and acting Chief Financial Officer (CFO) at GoVideo and Opta Corporation, a public listed consumer Electronics Company in the US controlled by TCL, a leading consumer electronics maker in China. From 1987 to 2002, he served as a country manager at Ecolab, Inc. and as the managing director at Thian Bing Investments PTE, Ltd. From 1993 to 2002, Mr. Wang served as managing director of Thian Bing Investments PTE, Ltd. where he managed the Singapore-based company's multi-million dollar investment operations and identified strategic and

investment opportunities. Mr. Wang attended Peking University and received a BS in Economics from Hamline University and an MBA from Carlson School of Management, University of Minnesota.

MR. GUO-JING SU, age 37, has served on our board as an independent director since February 5, 2008. Mr. Su is currently the Chief Executive Officer of Beijing Lottery International Information Technology Development Ltd., Chairman of the Board of Directors of Vindaway Trading Co., Ltd. and a member of the China IT Channel Committee as well as a member of the 9th Beijing Enterprise Committee of the China National Democratic Construction Association. In 2005, Mr. Su became a shareholder of Beijing Lottery International Information Technology Development Ltd. In the same year, the company cooperated with the China Center for Lottery Studies of Peking University to found the magazine “Gaming Industry and Public Welfare” where Mr. Su served as a Special Advisor. Mr. Su became the second largest shareholder of Hubei Bothwin Investment Ltd. the following year. From 2004 to 2005, Mr. Su was the General Manager of the Paperless Lottery Department at the Beijing Welfare Lottery Center, taking charge of the operations of Happy 8 (a gaming method) and paperless lottery. In 2001, Mr. Su established Vindaway Trading Co., Ltd, which acquired related technology and facilities from Silicon Valley-based Filanet and launched the Interjak hardware series between 2002 and 2004. Prior to that, Mr. Su served as a Project Director at China National Electronics Import and Export Corporation. He is also referred to by industry reporters as “China’s Gaming Expert” because of his insights on gaming in China. Mr. Su graduated from the University of Shanghai where he studied Science and Technology from 1989 to 1992 and studied law at the Party School of the Central Committee of C.P.C. from 1998 to 2000.

MR. JEREMY GOODWIN, age 33, has served on our board as an Independent Director since December 24, 2004. Jeremy Goodwin is the founder of China Diligizer and a Managing Partner with 3G Capital Partners. He began his career in 1995 at Mees Pierson Investment Finance S.A. in Geneva, Switzerland where he supported the fund private placement/private equity finance team. Noteworthy transactions executed by the group included assistance on the placements of the \$1.2 Billion Carlyle Partners II Limited Partnership. In 1997 he went to work for the then parent institution, ABN Amro, in Beijing, China where he established the Global Clients desk representing the bank's multinational clients to sovereign regulatory agencies and local financial institutions while monitoring their working capital needs. During his time there, the office was approved by the Central Bank of China to operate as a fully licensed branch. Noteworthy transactions executed by the group included assistance in the business development and project management for the Royal Dutch Shell Oil project and the Beijing Capital International Airport listing on the Hong Kong Stock Exchange arranged by the Hong Kong office of ABN Amro Rothschild. He also assisted the Singapore Debt Capital Markets team in the business development origination of Sovereign Euro Debt Issuances for the Ministry of Finance and the State Development Bank in Beijing for the People's Republic of China. In 1999, He went to work for ING Barings in London as an International Associate working directly for the business manager to the CEO. One of his primary assignments was in Hong Kong with the ING Beijing Investment arm of Baring Private Equity Partners, a joint venture with the Beijing Municipal Government established in 1994 at the decree of then Chinese Premier Zhu Rong Ji and widely considered the first domestic Chinese Private Equity fund. Mr. Goodwin received his BS from Cornell University in 1996 in conjunction with the Institute of Higher International Studies in Geneva, Switzerland. He later pursued his advanced degree with Princeton University with a concentration in Chinese affairs which he completed at the prestigious Nanjing Chinese Studies Center of the Johns Hopkins School of Advanced International Studies. Jeremy is fluent in written and spoken Mandarin Chinese, French and has working knowledge of Vietnamese.

MR. TAO JIN, age 38, has served on our board as an Independent Director since January 6, 2005. Mr. Jin is a resident partner at Jun He Law Offices ([www.JunHe.com](http://www.JunHe.com)), a leading Chinese law firm specializing in commercial legal practice with over 160 lawyers and offices in Beijing, Shanghai, Shenzhen, Dalian, Haikou and New York. Founded in April 1989, Jun He was one of the first private law firms formed in China, and has been a pioneer in the re-established Chinese legal profession with a focus in representing foreign clients in business activities throughout China. Over the past few years, Jun He has been honored a number of times as one of the best law firms in China by the Ministry of Justice of China. With a team of more than 160 well-trained lawyers, Jun He is one of the largest and most established law firms in China. Prior to joining Jun He, Mr. Jin served as Vice President and Assistant General Counsel of J.P. Morgan Chase Bank, as the head legal counsel for capital markets transactions in Asia, and for JPMorgan's M&A transactions in China. Mr. Jin joined Jun He as a partner in 2005. From 1999 to 2002, Mr. Jin

served as a Senior New York Qualified Lawyer for Sullivan & Cromwell, which represented China Unicom, PetroChina and China Telecom in their IPO's and dual listings in New York and Hong Kong. From 1996 to 1999, Mr. Jin served as Associate Lawyer for Cleary, Gottlieb Steen & Hamilton, which represented various Fortune 500 companies and investment banks in public and private securities offerings and M&A activities. Mr. Jin received his Juris Doctor in 1996 with high honors from Columbia University, and received B.S. in Psychology in 1990 from Beijing University.

MR. STEPHEN CRYSTAL, age 43, has served on the Board of Directors of PacificNet as an Independent Director since March 3, 2008. Mr. Crystal is currently Chief Executive Officer and President of TableMAX Holdings, LLC, a leading provider of electronic table games. Mr. Crystal is also a former board member of Las Vegas Gaming, Inc., a game management system operator as well as founder and managing member of JMC Investments, LLC, an investment company whose portfolio includes gaming real estate and operations, gaming technology, hospitality and entertainment, and franchise assets. Prior to that, Mr. Crystal co-founded Barrick Gaming Corporation, which owned and operated six hotel casinos in Las Vegas. Prior to entering the gaming world, Mr. Crystal practiced law at Armstrong Teasdale, LLP, Gage & Tucker L.C, and Wirken & King, P.C. Mr. Crystal also served as an Equal Opportunity Specialist for the United States Department of Labor from May 1990 to May 1992 and served in the New Hampshire House of Representatives from December 1988 to August 1989. Mr. Crystal received his law degree from the American University, Washington College of Law in 1992 and his Bachelor degree from Dartmouth College in Political Science in 1986.

MR. MIKE FEI, age 38, is the Company Secretary and General Counsel for PacificNet. Mr. Fei joined PacificNet in 2004 as in-house PRC Chief Legal Counsel for PacificNet's China Operations. Mr. Fei is a Member of the All-China Bar Association and holds a Master of Law degree from the University of New South Wales of Australia. Mr. Fei has 8 years of experience in the legal profession and dealt with more than 200 cases of litigation and arbitration which related to the issues of foreign investment, bankruptcy, merging, commercial contract and debt disputes.

## CORPORATE GOVERNANCE

### BOARD OF DIRECTORS

We have seven members serving on our Board of Directors. Three of our current members were appointed by the board of directors in 2008. Each board member is nominated for re-election at our annual meeting to serve until the next annual meeting of stockholders and until their successors are duly elected and qualified. There have been no material changes to the procedures by which security holders may recommend nominees to the company's board of directors.

### AUDIT COMMITTEE OF THE BOARD OF DIRECTORS

The board of directors has established a separately-designated audit committee in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934, as amended. As of March 31, 2008 our Audit Committee consisted of Messrs. Tao Jin (Chairman), Jeremy Goodwin, Mike Poon and Guo-Jing Su, each of whom are considered "independent" under the NASDAQ Stock Market listing standards currently in effect. The board of directors has determined that each of the members of the audit committee qualify as an "audit committee financial expert".

The Audit Committee is responsible for nominating the Company's independent auditors and reviewing any matters that might impact the auditors' independence from the Company; reviewing plans for audits and related services; reviewing audit results and financial statements; reviewing with management the adequacy of the Company's system of internal accounting controls, including obtaining from independent auditors management letters or summaries on such internal accounting controls; determining the necessity and overseeing the effectiveness of the internal audit function; reviewing compliance with the U.S. Foreign Corrupt Practices Act and the Company's internal policy prohibiting insider trading in its Common Stock; reviewing compliance with the SEC requirements for financial reporting and disclosure of auditors' services and audit committee members and activities; reviewing related-party transactions for potential conflicts of interest; and reviewing with corporate management and internal and independent auditors the policies and procedures with respect to corporate officers' expense accounts and perquisites, including their use of corporate assets.

### CODE OF ETHICS

On May 14, 2003, we adopted a code of ethics that applies to our Chief Executive Officer and Chief Financial Officer, and other persons who perform similar functions. A copy of our Code of Ethics was filed as an exhibit to our Annual Report on Form 10-KSB filed on April 2, 2004. Our Code of Ethics is intended to be a codification of the business and ethical principles which guide us, to deter wrongdoing, to promote honest and ethical conduct, to avoid conflicts of interest, and to foster full, fair, accurate, timely and understandable disclosures, compliance with applicable governmental laws, rules and regulations, the prompt internal reporting of violations and accountability for adherence to this Code.

### COMPLIANCE WITH SECTION 16(A) OF EXCHANGE ACT

Section 16(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), requires our executive officers, directors and persons who beneficially own more than 10% of a registered class of our equity securities to file with the

Securities and Exchange Commission initial reports of ownership and reports of changes in ownership of our common stock and other equity securities. Such executive officers, directors, and greater than 10% beneficial owners are required by SEC regulation to furnish us with copies of all Section 16(a) forms filed by such reporting persons.

Based solely on our review of such forms furnished to us and written representations from certain reporting persons, we believe that the following executive officers and directors failed to timely file Form 4's: Tony Tong failed to timely file Form 4's, one Form 4 reporting the exercise of a stock option and three Form 4's each reporting the grant of stock options; Victor Tong failed to timely file Form 4's, one Form 4 reporting the exercise of a stock option and four Form 4's each reporting the grant of stock options; Shaojian Wang failed to timely file Form 4's, two Form 4's each reporting the exercise of stock options and three Form 4's each reporting the grant of stock options; Michael Chun Ha failed to timely file Form 4's, one Form 4 reporting the exercise of an option and three Form 4's each reporting the grant of stock options; Peter Wang failed to timely file three Form 4's each reporting the grant of stock options; Jeremy Goodwin failed to timely file three Form 4's each reporting the grant of stock options and Tao Jin failed to timely file three Form 4's each reporting the grant of stock options.

## ITEM 11. EXECUTIVE COMPENSATION

### Overview

This compensation discussion describes the material elements of compensation awarded to, earned by, and paid to each of our executive officers listed in the Summary Compensation Table below (the "named executive officers") during the last completed fiscal year. This compensation discussion focuses on the information contained in the following tables and related footnotes and narrative primarily for the last completed fiscal year, but we have also described compensation actions taken before or after the last completed fiscal year to the extent it enhances the understanding of our executive compensation disclosure.

The compensation committee currently oversees the design and administration of our executive compensation program.

### Objectives and Philosophy

In General. The objectives of our compensation programs are to:

- Provide our executive officers with both cash and equity incentives to motivate them to further the interests of the company and our stockholders
- Provide employees with long-term incentives to assist in creating a culture of corporate ownership, which we believe will assist in retaining these employees
- Provide stability during our growth stage

Generally, the compensation of our executive officers is composed of an annual base salary annual incentive compensation and equity awards in the form of stock options, other benefits and perquisites, post-termination severance and acceleration of stock option vesting for certain named executive officers upon termination and/or a change in control. Our other benefits and perquisites consist of life and health insurance benefits. In setting base salaries, the compensation committee generally reviews the individual contributions of the particular executive. In addition, stock options are granted to provide the opportunity for long-term compensation based upon the performance of our common stock over time. Our philosophy is to aggregate these elements so that they reach at a level that is commensurate with our size and sustained performance.

### Elements of Compensation

Compensation consists of following elements:

**Base Salary.** Base salaries for our executive officers are established based on the scope of their responsibilities, taking into account competitive market compensation paid by other companies in our industry for similar positions, and the

other elements of the executive officer's compensation, including stock-based compensation. Our intent is to target executive base salaries near the median of the range of salaries for executives in similar positions with similar responsibilities at comparable companies, in line with our compensation philosophy. Base salaries are reviewed annually, and may be increased annually to realign salaries with market levels after taking into account individual responsibilities, performance and experience. Based on publicly available information, we believe that the base salaries established for our executive officers are comparable to those paid by similar companies in our industry.

**Annual Bonuses.** Our executive officers and certain other employees are eligible for annual cash bonuses, which are paid at the discretion of our compensation committee. The employment agreement with our executive officers do not provide for minimum bonuses. The determination of the amount of annual bonuses paid to our executive officers generally reflects a number of subjective considerations, including the performance of our company overall and the contributions of the executive officer during the relevant period.

**Incentive Compensation.** We believe that long-term performance is achieved through an ownership culture that encourages long-term performance by our executive officers through the use of stock-based awards. Our 2006 Stock Option Plan permits the grant of stock options, restricted stock, stock appreciation rights, and performance-based stock awards. Under power delegated by our Board, the Compensation Committee of the Board has the authority to award incentive compensation to our executive officers, employees, consultants and directors in such amounts and on such terms as the committee determines in its sole discretion.

Currently, we do not maintain any incentive compensation plans based on pre-defined performance criteria. Incentive compensation is intended to compensate executive officers, employees, consultants and directors for achieving financial and operational goals and for achieving individual annual performance objectives. These objectives are expected to vary depending on the individual executive, but are expected to relate generally to strategic factors such as expansion of our services and to financial factors such as improving our results of operations. The actual amount of incentive compensation for the prior year will be determined following a review of each executive's individual performance and contribution to our strategic goals conducted during the first quarter of each year. Specific performance targets used to determine incentive compensation for each of our executive officers for 2007 have not yet been determined.

**Other Compensation.** Each employment agreement provides the executive with certain other benefits, including reimbursement of business and entertainment expenses and housing allowance. Each executive is eligible to participate in all benefit plans and programs that are or in the future may be available to other executive employees of our company, including any profit-sharing plan, thrift plan, health insurance or health care plan, disability insurance, pension plan, supplemental retirement plan, vacation and sick leave plan, and other similar plans. The compensation committee in its discretion may revise, amend or add to the officer's executive benefits and perquisites as it deems advisable. We believe that these benefits and perquisites are typically provided to senior executives of similar companies.

#### Compensation Committee Interlocks and Insider Participation

As of March 31, 2008 our Compensation Committee consisted of Messrs. Guo-Jing Su (Chairman), Tao Jin, Mike Poon. No member of our Compensation Committee was, or has been, an officer or employee of the Company or any of our subsidiaries. No member of the Compensation Committee has a relationship that would constitute an interlocking relationship with executive officers or directors of the Company or another entity.

#### Compensation Committee Report on Executive Compensation

The compensation committee has reviewed and discussed with management the disclosures contained in the Compensation Discussion and Analysis of this Annual Report on Form 10-K. Based upon this review and discussion, the compensation committee recommended to our Board of Directors that the Compensation Discussion and Analysis be included in our Annual Report on Form 10-K to be filed with the SEC.

Compensation Committee of the Board of Directors: Guo-Jing Su (Chairman), Tao Jin, Mike Poon.

This report shall not constitute soliciting material or otherwise be considered filed under the Securities Act or the Securities Exchange Act.

#### Summary Compensation Table

| Name and Principal Position                               | Year | Salary (\$) | Option Awards (\$)(1) | All Other Compensation | Total (\$) |
|---|------|-------------|-----------------------|------------------------|------------|
| Tony Tong, Chairman, Chief Executive Officer and Director | 2007 | \$ 100,000  | \$ 27,453             | \$ 200,000             | \$ 327,543 |
|   | 2006 | \$ 100,000  | \$ 21,552             |                        | \$ 121,552 |
| Daniel Lui, Chief Financial Officer(2)                    | 2007 | \$ 100,000  |                       |                        | \$ 40,000  |
|   | 2006 | \$ 40,000   |                       |                        |            |
| Victor Tong, President and Director                       | 2007 | \$ 100,000  | \$ 27,453             | \$ 200,000             | \$ 327,543 |
|   | 2006 | \$ 48,000   | \$ 21,552             |                        | \$ 121,552 |

- 1) Valuation based on the dollar amount of option grants recognized for financial statement reporting purposes pursuant to FAS 123R with respect to 2006. On December 15, 2006, the board of directors cancelled all options granted in 2005 and 2006.
- 2) Mr. Daniel Lui resigned as our Chief Financial Officer in April, 2008.

#### Employment Agreements

On March 17, 2008, the Company renewed an Executive Employment Contract with Tony Tong for a period of three years. Mr. Tong currently serves as our Chairman and Chief Executive Officer. The employment agreement provides for Mr. Tong to earn an annual base salary of \$50,000 in cash and \$300,000 in stock compensation annually until March 17, 2011. Mr. Tong is also eligible for an annual bonus for each fiscal year during the term of his contract based on performance standards as the compensation committee may deem appropriate. Mr. Tong is entitled to receive a monthly housing allowance of \$5,000 and a monthly automobile allowance of \$500.

On March 17, 2008, the Company renewed an Executive Employment Contract with Victor Tong for a period of three years. Mr. Tong currently serves as our President. The employment agreement provides for Mr. Tong to earn an annual base salary of \$50,000 in cash and \$250,000 stock compensation annually until March 17, 2011. Mr. Tong is also eligible for an annual bonus for each fiscal year during the term of his contract based on performance standards as the compensation committee may deem appropriate. Mr. Tong is entitled to receive a monthly housing allowance of \$5,000 and a monthly automobile allowance of \$500. Mr. Tong's employment contract was renewed for a period of three years through March 17, 2011, starting from March 17, 2008.

#### Grants of Plan-Based Awards

During the fiscal year ended December 31, 2007, options were issued to the named executive officers to purchase 10,000 shares of common stock in the aggregate.

#### 2005 Equity Incentive Plan

Awards

The 2005 Equity Incentive Plan (the "2005 Plan") provides for the grant of options and stock appreciation rights ("SARs") of up to an aggregate of 2,000,000 shares of Common Stock to directors, officers, employees and independent contractors of the Company or its affiliates. If any award expires, is cancelled, or terminates unexercised or is forfeited, the number of shares subject thereto is again available for grant under the 2005 Plan.

61

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#### Administration of the 2005 Plan

The 2005 Plan is administered by the Board of Directors or a committee of the Board of Directors consisting of not less than two members of the Board, each of whom is a “non-employee director” within the meaning of Rule 16b-3 promulgated under the Exchange Act and an “outside director” within the meaning of Code Section 162(m) (in either case, the “Committee”). Among other things, the Committee has complete discretion, subject to the express limits of the 2005 Plan, to determine the persons to be granted an award, the type of award to be granted, the number of shares of Common Stock subject to each award, the exercise price of each option, the term of each award, the vesting schedule for an award, whether to accelerate vesting, the value of the stock, and the required withholding. The Committee may amend, modify or terminate any outstanding award, provided that the participant’s consent to such action is required if the action would materially and adversely affect the participant. The Committee is also authorized to construe the award agreements, and may prescribe rules relating to the 2005 Plan. Notwithstanding the foregoing, the Committee does not have any authority to grant or modify an award under the 2005 Plan with terms or conditions that would cause the grant, vesting or exercise to be considered nonqualified “deferred compensation” subject to Code Section 409A.

#### Limitation on number of Awards

Among other things, in order for the grant of stock options and SARs to qualify as performance-based compensation and be excluded from the Company’s corporate income tax deduction cap of \$1,000,000 per year for its Named Executive Officers, as set forth in Section 162(m) of the Code, the stockholders must approve the maximum number of shares of common stock that can be issued to any one person under the Plan in any calendar year. The number of shares of Common Stock for which stock options or SARs may be granted to a participant under the 2005 Plan in any calendar year cannot exceed 500,000.

#### Options

Options granted under the 2005 Plan may be either “incentive stock options” (“ISOs”), which are intended to meet the requirements for special federal income tax treatment under the Code, or “nonqualified stock options” (“NQSOs”). Options may be granted on such terms and conditions as the Committee may determine; provided, however, that the exercise price of an option may not be less than the fair market value of the underlying stock on the date of grant and the term of the option may not exceed 10 years (110% of such value and 5 years in the case of an ISO granted to an employee who owns (or is deemed to own) more than 10% of the total combined voting power of all classes of capital stock of the Company or a parent or subsidiary of the Company). ISOs may only be granted to employees. In addition, the aggregate fair market value of Common Stock covered by ISOs (determined at the time of grant) which are exercisable for the first time by an employee during any calendar year may not exceed \$100,000. Any excess is treated as a NQSO.

#### Stock Appreciation Rights

Stock appreciation rights may be granted under our 2005 Plan. Stock appreciation rights allow the recipient to receive the appreciation in the fair market value of our common stock between the exercise date and the date of grant. The Committee determines the terms of stock appreciation rights, including when such rights become exercisable and whether to pay the increased appreciation in cash or with shares of our common stock, or a combination thereof. Stock appreciation rights expire under the same terms that apply to stock options.

#### Additional Terms

Except as provided in the 2005 Plan, awards granted under the 2005 Plan are not transferable and may be exercised only by the respective grantees during their lifetime or by their guardian or legal representative. Each award

agreement will specify, among other things, the effect on an award of the disability, death, retirement, authorized leave of absence or other termination of employment. The Company may require a participant to pay the Company the amount of any required withholding in connection with the grant, vesting, exercise or disposition of an award. A participant is not considered a stockholder with respect to the shares underlying an award until the shares are issued to the participant.

Term; Amendments

The 2005 Plan is effective for 10 years, unless it is sooner terminated or suspended. The Committee may at any time amend, alter, suspend or terminate the 2005 Plan; provided that no amendment requiring stockholder approval will be effective unless such approval has been obtained. No termination or suspension of the 2005 Plan will affect an award which is outstanding at the time of the termination or suspension.

Certain Federal Income Tax Consequences

The following is a general summary of the federal income tax consequences under current tax law of options and stock appreciation rights. It does not purport to cover all of the special rules, including special rules relating to participants subject to Section 16(b) of the Exchange Act and the exercise of an option with previously-acquired shares, or the state or local income or other tax consequences inherent in the ownership and exercise of stock options and the ownership and disposition of the underlying shares or the ownership and disposition of restricted stock.

**Options.** A participant does not recognize taxable income upon the grant of NQSO or an ISO. Upon the exercise of a NQSO, the participant recognizes ordinary income in an amount equal to the excess, if any, of the fair market value of the shares acquired on the date of exercise over the exercise price thereof, and the Company will generally be entitled to a deduction for such amount at that time. If the participant later sells shares acquired pursuant to the exercise of a NQSO, the participant recognizes long-term or short-term capital gain or loss, depending on the period for which the shares were held. Long-term capital gain is generally subject to more favorable tax treatment than ordinary income or short-term capital gain.

Upon the exercise of an ISO, the participant does not recognize taxable income. If the participant disposes of the shares acquired pursuant to the exercise of an ISO more than two years after the date of grant and more than one year after the transfer of the shares to the participant, the participant recognizes long-term capital gain or loss and the Company is not be entitled to a deduction. However, if the participant disposes of such shares within the required holding period, all or a portion of the gain is treated as ordinary income and the Company is generally entitled to deduct such amount.

**Stock Appreciation Rights.** Generally, no taxable income is realized upon the grant of an SAR. Upon exercise, the holder of the SAR is taxed at ordinary income tax rates on the amount of any cash and the fair market value of any stock received.

In addition to the tax consequences described above, a participant may be subject to the alternative minimum tax, which is payable to the extent it exceeds the participant's regular tax. For this purpose, upon the exercise of an ISO, the excess of the fair market value of the shares over the exercise price therefore is an adjustment which increases alternative minimum taxable income. In addition, the participant's basis in such shares is increased by such excess for purposes of computing the gain or loss on the disposition of the shares for alternative minimum tax purposes. If a participant is required to pay an alternative minimum tax, the amount of such tax which is attributable to deferral preferences (including the incentive option adjustment) is allowed as a credit against the participant's regular tax liability in subsequent years. To the extent the credit is not used, it is carried forward.

Outstanding Equity Awards at Fiscal Year End

The following table summarizes the unexercised options and equity incentive plan awards for each name executive officer outstanding as of December 31, 2007. There were no stock awards outstanding as of December 31, 2007.

| Name | Number of Securities | Number of Securities | Equity Incentive | Option Exercise | Option Expiration |
|------|----------------------|----------------------|------------------|-----------------|-------------------|
|------|----------------------|----------------------|------------------|-----------------|-------------------|

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|                | Underlying<br>Unexercised<br>Options (#)<br>Exercisable | Underlying<br>Unexercised<br>Options (#)<br>Unexercisable | Plan<br>Awards:<br>Number of<br>Securities<br>Underlying<br>Unexercised<br>Unearned<br>Options (#) | Price (\$) | Date     |
|----------------|---|---|--|------------|----------|
| Tony Tong, CEO | 0   | 10,000  |  | \$ 4.31    | 2013-8-8 |

Option Exercises and Stock Vested

The following table summarizes stock option exercises by our named executive officers in 2007. There were no stock awards granted or vested during 2007.

| Name/ Principal<br>Position | Option Awards                                      |  |
|-----------------------------|--|--|
|                             | Number of<br>Shares<br>Acquired on<br>Exercise (#) | Value<br>Realized<br>on Exercise<br>(\$) |
| Tony Tong, CEO              | 90,000   | \$ 193,500                               |
| Victor Tong, President      | 90,000   | \$ 198,000                               |

#### Pension Benefits

We do not sponsor any qualified or non-qualified defined benefit plans.

#### Nonqualified Deferred Compensation

We do not maintain any non-qualified defined contribution or deferred compensation plans. The compensation committee may elect to provide our officers and other employees with non-qualified defined contribution or deferred compensation benefits if the compensation committee determines that doing so is in our best interests.

#### Director Compensation

| Name of Director | Fees Earned<br>or Paid in<br>Cash | Option<br>Awards (\$)<br>(1) | All other<br>compensation<br>(\$) | Total(\$) |
|------------------|-----------------------------------|------------------------------|-----------------------------------|-----------|
| WANG SHAO JIAN   | -                                 |                              | 40,000                            | 40,000    |
| TONY I TONY      |                                   | 27,543-                      | 40,000                            | 67,543    |
| VICTOR TONG      | -                                 |                              | 40,000                            | 40,000    |
| JIN TAO          | -                                 |                              | 40,000                            | 40,000    |
| JEREMY GOODWIN   |                                   | -                            | 40,000                            | 40,000    |
| POO HO-MAN       |                                   |                              | 40,000                            | 40,000    |
| SU GUO JING      |                                   |                              | 20,000                            | 20,000    |
| STEPHEN CRYSTAL  |                                   |                              | 40,000                            | 40,000    |

(1) The aggregate number of option awards outstanding at fiscal year end is 10,000.

#### DIRECTORS' FEES

All of the Company's directors are reimbursed for out-of-pocket expenses relating to attendance at meetings. Each director is paid a sign-on bonus of 10,000 stock options of common stock of the Company. Each director is also entitled to US\$500 for each board meeting that such director attends in person, by conference call, or by committee action and US\$200 for each committee meeting, payable by cash, common stock or stock options of the Company, at the option of the Company.

#### ANNUAL RETAINER FEE

Each director is paid an annual retainer fee of US\$10,000 in the form of common stock or stock options of the Company. Such retainer fee is paid semi-annually in arrears. The number of shares of common stock issued is based on the average closing market price over the ten trading days prior to the end of the six month period that the retainer fee is due.



ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table sets forth as of December 31, 2007, the number of shares of our Common Stock beneficially owned by (i) each person who is known by us to be the beneficial owner of more than five percent of the Company's Common Stock; (ii) each director; (iii) each of the named executive officers in the Summary Compensation Table; and (iv) all directors and executive officers as a group. Unless otherwise indicated, the stockholders listed in the table have sole voting and investment power with respect to the shares indicated.

| NAME AND ADDRESS OF BENEFICIAL OWNER   | NUMBER OF SHARES<br>STOCK<br>BENEFICIALLY OWNED<br>(1) | % OF<br>COMMON<br>STOCK<br>BENEFICIALLY<br>OWNED |
|--|--|--|
| Sino Mart Management Ltd. (2)<br>c/o ChoSam Tong<br>16E, Mei On Industrial Bldg.17 Kung Yip Street, Kwai<br>Chung, NT, Hong Kong | 1,851,160  | 15.45%   |
| ChoSam Tong (3)<br>16E, Mei On Industrial Bldg. 17 Kung Yip Street, Kwai<br>Chung, NT, Hong Kong                                 | 1,861,160  | 15.45%   |
| Kin Shing Li (4)<br>Rm. 3813, Hong Kong Plaza 188 Connaught Road West,<br>Hong Kong  | 1,150,000  | 9.60%  |
| Tony Tong  | 296,000  | 2.47%  |
| Victor Tong  | 96,000   | *  |
| ShaoJian (Sean) Wang   | 16,000   | *  |
| Tao Jin  | 10,000   | *  |
| Jeremy Goodwin   | -  | *  |
| Ho-Man (Mike) Poon   | -  | *  |
| All directors and officers as a group (8 persons)  | 418,000  | 3.49%  |

\* Less than one percent.

\*\* The address for each beneficial owner not otherwise specified is: c/o PacificNet Inc., 23/F, Building A, TimeCourt, No.6 Shuguang Xili, Chaoyang District, Beijing, China,100028

(1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to the shares shown. Except as indicated by footnote and subject to community property laws where applicable, to our knowledge, the stockholders named in the table have sole voting and investment power with respect to all common stock shares shown as beneficially owned by them. A person is deemed to be the beneficial owner of securities that can be acquired by such person within 60 days upon the exercise of options, warrants or convertible securities (in any case, the "Currently Exercisable Options"). Each beneficial owner's percentage ownership is determined by assuming that the Currently Exercisable Options that are held by such person (but not those held by any other person) have been exercised and converted.

(2)

Sino Mart Management Ltd. is owned by Mr. ChoSam Tong, the father of Messrs. Tony Tong and Victor Tong.

- (3) Includes shares of common stock of Sino Mart Management Ltd., which is owned by Mr. ChoSam Tong.
- (4) Information obtained from the Schedule 13D/A filed by Mr. Kin Shing Li on October 14, 2003.

#### EQUITY COMPENSATION PLAN INFORMATION

The following table sets forth aggregate information regarding the Company's equity compensation plans in effect as of December 31, 2007:

|  | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights (\$) | Remaining available for further issuance under equity compensation plans |
|--|---|--|--|
| Equity compensation plans approved by security holders (under 2005 Stock Option Plan)<br>(1) | 33,000  | \$4.31   | 2,000,000  |
| Equity compensation plans not approved by security holders                                   | N/A   | N/A  | N/A  |

(1) Reflects options granted and available for issuance under the 2005 Stock Option Plan.

#### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

There were no transactions, or currently proposed transactions in an amount exceeding \$120,000, since the beginning of the Company's last fiscal year in which the Company was or is to be a participant and in which any related person had or will have a direct or indirect material interest.

We will reimburse our officers and directors for any reasonable out-of-pocket business expenses incurred by them in connection with certain activities on our behalf such as identifying and investigating possible target businesses and business combinations. There is no limit on the amount of accountable out-of-pocket expenses reimbursable by us, which will be reviewed only by our board or a court of competent jurisdiction if such reimbursement is challenged.

All ongoing and future transactions between us and any of our officers and directors or their respective affiliates, including loans by our officers and directors, will be on terms believed by us to be no less favorable than are available from unaffiliated third parties and such transactions or loans, including any forgiveness of loans, will require prior approval in each instance by a majority of our uninterested "independent" directors (to the extent we have any) or the members of our board who do not have an interest in the transaction, in either case, who had access, at our expense, to our attorneys or independent legal counsel.

#### ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

During fiscal year ended December 31, 2007, our principal independent auditors were Kabani & Company, Inc. ("Kabani"). Our former independent auditors, Clancy and Co., P.L.L.C., resigned as our independent auditor on January 19, 2007. The following is a summary of the services provided and fees billed to us by Kabani during 2007 and by Clancy during 2006.

##### AUDIT FEES

An aggregate of \$365,000 and \$160,000 has been paid for professional services rendered by Kabani for the audit of the financial statements for the years ended December 31, 2007 and 2006, respectively. Further, an aggregate of \$500,000 has been accrued in 2007 for professional services rendered by Kabani & Company, Inc for the restatement of the Company's financial statements for the fiscal years ended December 31, 2006 and 2005.

##### AUDIT RELATED FEES

NONE

##### TAX FEES

NONE

##### ALL OTHER FEES

NONE

##### PRE-APPROVAL OF SERVICES

The Audit Committee pre-approves all services, including both audit and non-audit services, provided by our independent accountants. For audit services, each year the independent auditor provides the Audit Committee with an engagement letter outlining the scope of the audit services proposed to be performed during the year, which must be formally accepted by the audit commences. The independent auditor also submits an audit services fee proposal,

which also must be approved by the audit commences.

66

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

EXHIBITS

The following exhibits are filed as part of this report:

EXHIBIT

NUMBER DESCRIPTION

- 3.1 Certificate of Incorporation, as amended. (1)
- 3.2 Form of Amended By Laws of the Company.(1)
- 4.0 Specimen Stock Certificate of the Company (3)
- 4.1 Securities Purchase Agreement, dated as of January 15, 2004, among PacificNet Inc. and the purchasers identified therein (2)
- 4.2 Form of Common Stock Warrant issued to each of the purchasers (2)
- 4.3 Form of Common Stock Warrant issued to each of the purchasers, dated December 9, 2004 (3)
- 4.4 Form of Common Stock Warrant issued to each of the purchasers, dated November 17, 2004 (3)
- 4.5 Securities Purchase Agreement, dated February 28, 2006, among PacificNet Inc. and the Holders identified therein (4)
- 4.6 Form of Variable Rate Convertible Debenture due March 2009 issued to each of the Holders (4)
- 4.6(a) Form of Amended and Restated Variable Rate Convertible Debenture due March 2009 issued to each of the Holders
- 4.7 Form of Common Stock Purchase Warrant issued to each of the holders (4)
- 4.8 Form of Registration Rights Agreement, dated February 28, 2006(5)
- 4.9 Form of Variable Rate Convertible Debenture due February 2009
- 10.1 Form of Indemnification Agreement with officers and directors. (6)
- 10.2 Amendment to 1998 Stock Option Plan. (7)
- 10.3 Agreement dated on December 1, 2003 for the Sale and Purchase and Subscription of Shares in Epro Telecom Holdings Limited (8)
- 10.4 Agreement dated on December 15, 2003 for the Sale and Purchase of Shares in Beijing Linkhead Technologies Co., Ltd. (8)
- 10.5 Securities Purchase Agreement, dated as of December 9, 2004, among PacificNet Inc. and the purchasers identified therein (3)
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- 10.7 Agreement for the Sale and Purchase of Shares in Shanghai Classic Group Limited (4)
- 10.8 Agreement for the Sale and Purchase of Shares of Cheer Era Limited (9)
- 10.9 Agreement for the Sale and Purchase of Shares in Pacific Smartime Solutions Limited
- 10.10 Agreement for the Sale and Purchase of Shares in Guangzhou Clickcom Digit-net Science and Technology Ltd. (11)
- 10.11 PacificNet Inc. Amended and Restated 2005 Stock Option Plan (10)
- 10.12 Agreement for the Sale and Purchase of Shares in GuangZhou 3G Information Technology Co., Ltd. (11)
- 10.13

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Agreements of Consulting, Pledge, and Power of Attorney of Clickcom and Sunroom (11)

10.14 Agreement for the Sale and Purchase of Shares in Lion Zone Holdings (12)

10.15 Form of Lock-Up Agreement, dated March 13, 2006(5)

10.16 Form of Voting Agreement, dated March 13, 2006(5)

10.17 Agreement among PacificNet Strategic Investment Holdings Limited, Shenzhen GuHaiGuanChao Investment Consultant Co., Ltd., Lion Zone Holdings Limited and Mr. Wang Wenming for the termination of “the Agreement for the Sale and Purchase 51% Shares of Lion Zone Holdings Limited” (13)

10.18+ Tony Tong Employment Agreement

10.19+ Victor Tong Employment Agreement

10.20 Consulting Service Agreement with Daniel Howing Lui (14)

14 Code of Ethics (8)

21 List of Subsidiaries (Included in Exhibit 99.1)

99.1+ Corporate structure chart of our corporate and share ownership structure

+ Filed herewith.

(1) Incorporated by reference to the Amendment to Registration Statement on Form S-3 on Form SB-2/A (Registration No. 333-113209) filed on April 21, 2004.

(2) Incorporated by reference to the Registration Statement on Form S-3 filed on March 2, 2004

(3) Incorporated by reference to the Form SB-2 Registration Statement filed on December 31, 2004.

(4) Incorporated by reference to the Company's Form 8-K filed on March 6, 2006

(5) Incorporated by reference to the Company's Form 10-KSB/A filed on November 3, 2006.

(6) Incorporated by reference to the Company's Form SB-2 filed on October 21, 1998.

(7) Incorporated by reference to the Company's 10-KSB filed on March 31, 2003.

(8) Incorporated by referenced to the Company's Form 10-KSB filed on April 2, 2004.

(9) Incorporated by reference to the Company's Form 8-K filed on April 19, 2004.

(10) Incorporated by reference to the Company's Definitive Proxy Statement filed on October 26, 2006.

(11) Incorporated by reference to the Company's Form 10-KSB filed on April 19, 2005.

(12) Incorporated by reference to the Company's Form 8-K filed on December 20, 2005.

(13) Incorporated by reference to the Company's Form 8-K filed on November 27, 2006.

(14) Incorporated by reference to the Company's Form 8-K filed on February 23, 2007.

SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, as amended, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PACIFICNET INC.

Date: June 12, 2008 BY: /S/ TONY TONG  
 Tony Tong  
 Chief Executive Officer  
 (Principal Executive Officer)

Date: June 12, 2008 BY: /S/ PHILLIP WONG  
 Phillip Wong  
 Chief Financial Officer  
 (Principal Financial Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| NAME                             | TITLE                      | DATE          |
|----------------------------------|----------------------------|---------------|
| /s/ TONY TONG<br>Tony Tong       | Director, Chairman and CEO | June 12, 2008 |
| /s/ VICTOR TONG<br>Victor Tong   | Director, President        | June 12, 2008 |
| /s/ PHILLIP WONG<br>Phillip Wong | Chief Financial Officer    | June 12, 2008 |

INDEX TO EXHIBITS

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INDEX TO FINANCIAL STATEMENTS

|   |     |
|---|-----|
| Report of Independent Registered Public Accounting Firm   | F-2 |
| Consolidated Balance Sheets - As of December 31, 2007 and 2006<br>(restated)  | F-3 |
| Consolidated Statements of Operations - For the Years Ended<br>December 31, 2007, December 31, 2006 (restated) and December 31,<br>2005 (restated)                      | F-4 |
| Consolidated Statements of Changes in Stockholders' Equity - For the<br>Years Ended December 31, 2007, December 31, 2006 (restated) and<br>December 31, 2005 (restated) | F-5 |
| Consolidated Statements of Cash Flows - For the Years Ended<br>December 31, 2007, December 31, 2006 (restated) and December 31,<br>2005 (restated)                      | F-6 |
| Notes to Consolidated Financial Statements  | F-7 |

F-1

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Pacific Net Inc.

We have audited the accompanying consolidated balance sheets of PacificNet Inc. (a Delaware Corporation) and Subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2007. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards established by the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of PacificNet Inc. and Subsidiaries as of December 31, 2007 and 2006, and the results of their consolidated operations and cash flows for each of the three years in the period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. During the year ended December 31, 2007, the Company incurred net losses of \$14,195,000. In addition, the Company had a negative cash flow in operating activities amounting to negative \$1,079,000 in the year ended December 31, 2007, and the Company's accumulated deficit was \$65,070,000 as of December 31, 2007. In addition, the Company is in default on its convertible debenture obligation and three holders of Convertible Subordinated Debentures filed an involuntary petition for Chapter 11 relief in federal bankruptcy court on Saturday, March 22, 2008 in Wilmington, DE. These factors, among others, as discussed in Note 1 to the consolidated financial statements, raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ KABANI & COMPANY, INC.

LOS ANGELES, CA  
April 28, 2007

F-2

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## PACIFICNET INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

AS AT DECEMBER 31, 2007 AND 2006

(In thousands of United States dollars, except par values and share numbers)

|  | As at December 31, |                    |
|--|--------------------|--------------------|
|  | 2007               | 2006<br>(Restated) |
| <b>ASSETS</b>  |                    |                    |
| Current Assets:  |                    |                    |
| Cash and cash equivalents  | \$ 3,750           | \$ 1,778           |
| Accounts receivables, net  | 5,241              | 4,774              |
| Inventories, net   | 693                | 188                |
| Loan receivable from related parties                             | 2,273              | 2,991              |
| Loan receivable from third parties                               | 815                | 128                |
| Marketable equity securities - available for sale                | 547                | 18                 |
| Net assets held for disposition                                  | 2,692              | 9,557              |
| Other current assets   | 408                | 2,719              |
| Total Current Assets   | 16,419             | 22,153             |
| Property and equipment, net                                      | 5,285              | 4,008              |
| Intangible assets, net   | 343                | 323                |
| Investments - cost basis   | 120                | 15                 |
| Investment - equity method                                       | 13                 | 100                |
| Goodwill   | 870                | 5,601              |
| Other receivables  | 1,670              | 471                |
| TOTAL ASSETS   | \$ 24,720          | \$ 32,671          |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                      |                    |                    |
| Current Liabilities:   |                    |                    |
| Bank line of Credit  | \$ 100             | \$ 111             |
| Bank loans-current portion                                       | 80                 | 411                |
| Accounts payable   | 414                | 225                |
| Accrued expenses   | 3,500              | 1,270              |
| Customer deposits  | 514                | 243                |
| Convertible debenture  | 5,809              | 8,945              |
| Warrant liability  |                    | 904                |
| Liquidated damages liability                                     | 2,697              | 2,837              |
| Loan payable to related party                                    | -                  | 282                |
| Shares to be issued  | 127                | -                  |
| Total Current Liabilities  | 13,241             | 15,228             |
| Bank loans - non current portion                                 | 1,743              | 637                |
| Convertible debenture-non current portion                        | 5,224              | -                  |
| Total long-term liabilities                                      | 6,967              | 637                |
| Total liabilities  | 20,208             | 15,865             |
| Minority interest  | 1,720              | 2,829              |
| Commitments and contingencies                                    |                    |                    |
| Stockholders' Equity:  |                    |                    |
| Preferred stock, par value \$0.0001, Authorized 5,000,000 shares |                    |                    |

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|  |           |           |
|--|-----------|-----------|
| Issued and outstanding - none  | -         | -         |
| Common stock, par value \$0.0001, Authorized 125,000,000 shares          |           |           |
| Issued and outstanding:  |           |           |
| December 31, 2007: 16,887,041 issued, 14,314,072 outstanding             |           |           |
| December 31, 2006: 14,155,597 issued, 11,541,202 outstanding             | 1         | 1         |
| Treasury stock, at cost (2007: 2,572,969 shares ;2006: 2,614,395 shares) | (145)     | (272)     |
| Additional paid-in capital   | 79,125    | 65,757    |
| Shares issued as deposit   | (10,974)  | -         |
| Cumulative other comprehensive income                                    | 200       | (42)      |
| Accumulated deficit  | (65,070)  | (51,090)  |
| Stock subscription receivable  | (345)     | (377)     |
| Total Stockholders' Equity   | 2,792     | 13,977    |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY                               | \$ 24,720 | \$ 32,671 |

The accompanying notes form an integral part of these consolidated financial statements

F-3

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PACIFICNET INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005  
(In thousands of United States dollars, except loss per share and share amounts)

|   | For The Years Ended December 31, |                  |                  |
|---|----------------------------------|------------------|------------------|
|   | 2007                             | 2006<br>Restated | 2005<br>Restated |
| Net Revenues  |                                  |                  |                  |
| Services  | \$ 4,466                         | \$ 5,720         | \$ 4,242         |
| Product sales   | 14,528                           | 23,353           | 2,839            |
| Total net revenue   | 18,994                           | 29,073           | 7,081            |
| Cost of Revenues  |                                  |                  |                  |
| Services  | 2,754                            | 3,562            | 3,160            |
| Product sales   | 12,538                           | 21,967           | 2,562            |
| Total cost of revenue   | 15,292                           | 25,529           | 5,722            |
| Gross Profit  | 3,702                            | 3,544            | 1,359            |
| Operating expenses:   |                                  |                  |                  |
| Selling, General and Administrative expenses                              | 13,480                           | 7,968            | 3,576            |
| Stock-based compensation expenses   | 51                               | 242              | 282              |
| Depreciation and amortization   | 752                              | 1,536            | 31               |
| Impairment of Goodwill  | 5,461                            | -                | 3,689            |
| Impairment of Investment  | 385                              | 1,233            | -                |
| Total Operating expenses  | 20,129                           | 10,979           | 7,578            |
| Loss from continued operations  | (16,427)                         | (7,435)          | (6,219)          |
| Other income (expenses):  |                                  |                  |                  |
| Interest income /(expense), net   | (822)                            | (896)            | 194              |
| Gain / (Loss) in change in fair value of derivatives                      | -                                | (214)            | -                |
| Liquidated damages expense  | -                                | (3,817)          | -                |
| Share of earnings from investment on equity method                        | (77)                             | 17               | 855              |
| Sundry income, net  | 1,238                            | 108              | 266              |
| Total other income (expense)  | 339                              | (4,803)          | 1,315            |
| Loss from continued operations before Income Taxes and Minority Interests | (16,058)                         | (12,238)         | (4,904)          |
| Provision for income taxes  | (7)                              | (18)             | (28)             |
| Minority Interests  | 37                               | (58)             | (1,203)          |
| Loss from continued operations  | (16,058)                         | (12,314)         | (6,135)          |
| Income / (Loss) from discontinued operations:                             |                                  |                  |                  |
| Net gain on disposal  | 2,181                            | -                | -                |
| Net loss on disposal  | -                                | 26               | -                |

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|   |             |             |            |
|---|-------------|-------------|------------|
| Income / (Loss) from discontinued operations        | (318)       | (127)       | 989        |
| Total income / (Loss) from discontinued operations  | 1,863       | (101)       | 989        |
| NET LOSS  | (14,195)    | (12,415)    | (5,145)    |
| Other comprehensive income (loss):                  |             |             |            |
| Foreign exchange gain (loss)                        | 242         | (27)        | 7          |
| Net comprehensive loss                              | \$ (13,953) | \$ (12,442) | \$ (5,138) |
| BASIC & DILUTED LOSS PER COMMON SHARE:              |             |             |            |
| Loss per share-Continued Operations                 | \$ (1.35)   | \$ (1.07)   | \$ (0.28)  |
| Loss per share-Discontinued Operations              | \$ 0.16     | \$ (0.01)   | \$ 0.07    |
| Basic & Diluted Loss Per Share                      | \$ (1.19)   | \$ (1.08)   | \$ (0.21)  |
| * Weighted average number of shares-Basic & Diluted | 11,895,525  | 11,538,664  | 21,695,473 |

\* Basic and diluted weighted average number of shares are considered equivalent as the effect of dilutive securities is anti-dilution.

The accompanying notes form an integral part of these consolidated financial statements

F-4

PACIFICNET INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(In thousands of United States dollars, except number of shares)

|  | Common Stock | Additional Paid-in Capital | Issuance of shares as Deposit | Stock Subscriptions Receivable | Cumulative Other Comprehensive Income (Loss) | Accumulated Deficit (Restated) | Treasury Stock | Total Stockholders' Equity |
|--|--------------|----------------------------|-------------------------------|--------------------------------|--|--------------------------------|----------------|----------------------------|
|  | Shares       | Amount                     | Amount                        | Amount                         | Amount                                       | Amount                         | Shares         | Amount                     |
| BALANCE AT DECEMBER 31, 2004 - Restated  | 9,794,121    | 1 \$ 57,729                | \$ -                          | \$ -                           | \$ (22)                                      | \$ (33,482)                    | 833,616        | (119) \$ 24,107            |
| Issuance of common stock for acquisition of subsidiaries                           | 515,900      | - 3,971                    | -                             | -                              | -  | -                              | -              | - 3,971                    |
| Stock Issued for services  | 20,000       | - 63                       | -                             | -                              | -  | -                              | -              | - 63                       |
| Repurchase of common shares for acquisition of Cheer Era                           | (149,459)    | - (1,547)                  | -                             | -                              | -  | -                              | 149,459        | - (1,547)                  |
| Cancellation of common shares  | (45,000)     | - -                        | -                             | -                              | -  | -                              | 45,000         | - -                        |
| Repurchase of common shares  | (2,000)      | - -                        | -                             | -                              | -  | -                              | 2,000          | (15) (15)                  |
| Options granted  | -            | - 282                      | -                             | -                              | -  | -                              | -              | - 282                      |
| Exercise of stock options and warrants for cash                                    | 676,000      | - 966                      | -                             | -                              | -  | -                              | -              | - 966                      |
| Holdback shares as contingent consideration due to performance targets not yet met | -            | - -                        | -                             | -                              | -  | -                              | 298,550        | - -                        |
| Share consideration for acquisition of ChinaGoHi deemed issued under S&P           | -            | - -                        | -                             | -                              | -  | -                              | (137,500)      | - -                        |
| To record the correction for the excess finders fee adjusted to Apic               | -            | - 455                      | -                             | -                              | -  | -                              | -              | - 455                      |
| To correctly record the option exercise price                                      | -            | - 60                       | -                             | -                              | -  | -                              | -              | - 60                       |
| Foreign currency translation gain/(loss)   | -            | - -                        | -                             | -                              | 7  | -                              | -              | - 7                        |
| Net loss   | -            | - -                        | -                             | -                              | -  | (5,145)                        | -              | - (5,145)                  |

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|  |            |      |            |          |       |      |          |           |       |            |
|--|------------|------|------------|----------|-------|------|----------|-----------|-------|------------|
| BALANCE AT<br>DECEMBER 31,<br>2005 - Restated                                      | 10,809,562 | 1    | 61,980     | -        | -     | (15) | (38,627) | 1,191,125 | (134) | \$ 23,205  |
| Exercise of stock<br>options for cash and<br>receivable                            | 418,000    | -    | 834        | -        | -     | -    | -        | -         | -     | 834        |
| Issuance of common<br>stock for acquisition<br>of subsidiaries                     | 618,112    | -    | 4,346      | -        | -     | -    | -        | 1,142,798 | -     | 4,346      |
| Cancellation of<br>common stock for<br>acquisition of<br>subsidiaries              | (275,000)  | \$ - | \$ (1,672) | \$ -     | \$ -  | \$ - | \$ -     | 275,000   | \$ -  | \$ (1,672) |
| Repurchase of<br>common shares -<br>Treasury shares                                | (29,472)   | -    | -          | -        | -     | -    | -        | 29,472    | (138) | (138)      |
| Foreign<br>currency translation<br>gain/(loss)                                     | -          | -    | -          | -        | -     | (27) | -        | -         | -     | (27)       |
| Issuance of stock<br>options   | -          | -    | 242        | -        | -     | -    | -        | -         | -     | 242        |
| Issuance of warrants<br>for issuing fee of<br>convertible debts                    | -          | -    | 28         | -        | -     | -    | -        | -         | -     | 28         |
| Stock subscription<br>receivable   | -          | -    | -          | -        | (377) | -    | -        | -         | -     | (377)      |
| Goodwill opening<br>balance adjust   | -          | -    | -          | -        | -     | -    | (48)     | -         | -     | (48)       |
| Net income/(loss)  | -          | -    | -          | -        | -     | -    | (12,415) | -         | -     | (12,415)   |
| BALANCE AT<br>DECEMBER 31,<br>2006 - Restated                                      | 11,541,202 | 1    | 65,758     | -        | (377) | (42) | (51,090) | 2,614,395 | (272) | 13,978     |
| Reclassification of<br>warrant liability to<br>equity                              | -          | -    | 690        | -        | -     | -    | 213      | -         | -     | 903        |
| Issuance of common<br>stock for repayment<br>of convertible<br>debenture (199,444) | 199,444    | -    | 1,091      | -        | -     | -    | -        | -         | -     | 1,091      |
| Sale of treasury<br>shares   | 41,426     | -    | 155        | -        | -     | -    | -        | (41,426)  | 127   | 282        |
| Issuance of common<br>stock in escrow -<br>restricted                              | 2,330,000  | -    | 10,974     | (10,974) | -     | -    | -        | -         | -     | -          |
| Exercise of stock<br>options for cash<br>(202,000 shares)                          | 202,000    | -    | 406        | -        | -     | -    | -        | -         | -     | 406        |
| Stock option expense   | -          | -    | 51         | -        | -     | -    | -        | -         | -     | 51         |
| Foreign<br>currency translation<br>gain/(loss)                                     | -          | -    | -          | -        | -     | 242  | -        | -         | -     | 242        |

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|                          |            |      |           |             |       |        |             |           |          |          |
|--------------------------|------------|------|-----------|-------------|-------|--------|-------------|-----------|----------|----------|
| Stock subscription       |            |      |           |             |       |        |             |           |          |          |
| receivable               | -          | -    | -         | -           | 32    | -      | -           | -         | -        | 32       |
| Net loss                 | -          | -    | -         | -           | -     | -      | (14,195)    | -         | -        | (14,195) |
| <b>B A L A N C E A T</b> |            |      |           |             |       |        |             |           |          |          |
| December 31, 2007        | 14,314,072 | \$ 1 | \$ 79,125 | \$ (10,974) | (345) | \$ 200 | \$ (65,070) | 2,572,969 | \$ (145) | \$ 2,792 |

The accompanying notes form an integral part of these consolidated financial statements

F-5

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PACIFICNET INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In thousands of United States dollars)

|  | For The Years Ended December 31, |                  |                  |
|--|----------------------------------|------------------|------------------|
|  | 2007                             | 2006<br>Restated | 2005<br>Restated |
| Cash Flows from operating activities   |                                  |                  |                  |
| Net Loss   | \$ (14,195)                      | \$ (12,415)      | \$ (5,145)       |
| Adjustment to reconcile net loss to net cash provided by (used in) operating activities: |                                  |                  |                  |
| Provision for allowance for doubtful accounts  | 5,319                            | 4,537            | 2,739            |
| Minority Interest  | (37)                             | 58               | 1,203            |
| Depreciation and amortization  | 752                              | 1,536            | 31               |
| Share of earnings from investment on equity method                                       | 77                               | (17)             | (855)            |
| Goodwill impairment  | 5,461                            | -                | 3,689            |
| Investment impairment  | 385                              | 1,233            | -                |
| Stock-based compensation   | 51                               | 242              | 282              |
| Issuance of shares for services  | -                                | -                | 63               |
| Change in fair value of derivatives  | -                                | 214              | -                |
| Amortization of interest discount  | -                                | 690              | -                |
| Liquidated damages expense   | -                                | 3,817            | -                |
| Changes in current assets & liabilities net of effects from purchase of subsidiaries:    |                                  |                  |                  |
| Accounts receivable and other current assets   | 1,544                            | (7,098)          | (297)            |
| Inventories  | (505)                            | 2                | (55)             |
| Accounts payable and other accrued expenses  | 1,244                            | (2,202)          | 3,526            |
| Net cash provided by (used in) operating activities of continued operations              | 96                               | (9,403)          | 5,182            |
| Net cash provided by (used in) operating activities of discontinued operations           | (1,175)                          | 28               | (988)            |
| Net cash provided by (used in) operating activities                                      | (1,079)                          | (9,375)          | 4,193            |
| Cash flows from investing activities:  |                                  |                  |                  |
| Increase in restricted cash  | -                                | (71)             | -                |
| Increase in purchase of marketable securities  | (529)                            | (19)             | 11               |
| Acquisition of property and equipment  | (1,033)                          | (2,608)          | (2,966)          |
| Acquisition of subsidiaries and affiliated companies                                     | -                                | (667)            | (3,958)          |
| Repurchase of treasury shares  | 282                              | (138)            | (15)             |
| Net cash used in investing activities of continued operations                            | (1,280)                          | (3,503)          | (6,928)          |
| Net cash provided by (used in) investing activities of discontinued operations           | \$ 1,801                         | \$ 1,408         | \$ (2,678)       |
| Net cash provided by (used in) investing activities                                      | \$ 521                           | \$ (2,095)       | \$ (9,606)       |
| Cash flows from financing activities:  |                                  |                  |                  |

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|  |                 |                 |                 |
|--|-----------------|-----------------|-----------------|
| Loans receivable from third parties  | (237)           | 934             | (1,024)         |
| Loans receivable from related parties  | (564)           | 622             | (868)           |
| Loan payable to related party  | (282)           | (121)           | 575             |
| Advances (repayments) under bank line of credit                                | (11)            | (204)           | 1,113           |
| Repayments of amount borrowed under capital lease obligations                  | -               | 41              | (5)             |
| Proceeds from exercise of stock options and subscription                       | 438             | 237             | 966             |
| Advances under bank loans  | (10)            | 935             | (1,453)         |
| Net proceeds from issuance of convertible debenture                            | 2,954           | 7,500           | -               |
| Net cash provided by (used in) financing activities of continued operations    | 2,288           | 9,944           | (696)           |
| Net cash provided by (used in) financing activities of discontinued operations | -               | -               | -               |
| Net cash provided by (used in) financing activities                            | 2,288           | 9,944           | (696)           |
| Effect of exchange rate change on cash and cash equivalents                    | 242             | (27)            | 7               |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>                    | <b>1,972</b>    | <b>(1,553)</b>  | <b>(6,102)</b>  |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>                          | <b>1,778</b>    | <b>3,331</b>    | <b>9,433</b>    |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>                                | <b>\$ 3,750</b> | <b>\$ 1,778</b> | <b>\$ 3,331</b> |
| <b>SUPPLEMENTAL CASH FLOW INFORMATION:</b>                                     |                 |                 |                 |
| Interest paid  | \$ (822)        | \$ 664          | \$ 229          |
| Income taxes paid  | \$ (7)          | \$ 5            | \$ (53)         |
| <b>NON-CASH INVESTING AND FINANCING ACTIVITIES:</b>                            |                 |                 |                 |
| Property & Equipment acquired under bank loans                                 | \$ 785          | \$ 1,082        | \$ -            |
| Investments in subsidiaries and affiliate through issuance of common stock     | \$ -            | \$ 4,346        | \$ 3,971        |
| Issuance of common stock for payment of convertible debenture                  | \$ 1,091        | \$ -            | \$ -            |
| Cumulative effect of change in accounting principle (note 10)                  | \$ 213          | \$ -            | \$ -            |

The accompanying notes form an integral part of these consolidated financial statements

PACIFICNET INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – RESTATED  
(Amounts expressed in United States dollars unless otherwise stated)

1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

NATURE OF OPERATIONS

PacificNet Inc. (referred to herein as “PacificNet” or the “Company”) was originally incorporated in the State of Delaware on April 8, 1987. PacificNet (PACT) is a leading provider of gaming and mobile game technology worldwide with a focus on emerging markets in Asia. PacificNet's gaming products are localized to their specific markets creating an enhanced user experience for players and larger profits for operators. PacificNet's gaming clients include the leading hotels, casinos, and gaming operators in Macau, Europe and elsewhere around the world. PacificNet also maintains legacy subsidiaries in the call center and ecommerce business in China. PacificNet employs about 500 staff in its various subsidiaries with offices in the US, Hong Kong, Macau, China. Through our subsidiaries we provide outsourcing services, value-added telecom services (VAS) and products (telecom and gaming) services. Our business process outsourcing (BPO) services include call centers, providing customer relationship management (CRM), and telemarketing services, and our information technology outsourcing (ITO) includes software programming and development. Our products (telecom and gaming) include gaming technology and communication products distribution. The Company's operations are primarily targeted in Greater China and certain Asian country markets.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION AND BASIS OF PRESENTATION

The consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States of America and present the financial statements of the Company and its wholly owned and majority-owned subsidiaries including variable interest entities (“VIEs”) for which the Company is the primary beneficiary. All significant inter-company accounts and transactions have been eliminated. Investments in entities in which the Company can exercise significant influence, but which are less than majority owned and not otherwise controlled by the Company, are accounted for under the equity method.

The Company has adopted FASB Interpretation No. 46R “Consolidation of Variable Interest Entities” (“FIN 46R”), an Interpretation of Accounting Research Bulletin No. 51. FIN 46R requires a Variable Interest Entity (VIE) to be consolidated by a company if that company is subject to a majority of the risk of loss for the VIE or is entitled to receive a majority of the VIE's residual returns. VIEs are those entities in which the Company, through contractual arrangements, bears the risks of, and enjoys the rewards normally associated with ownership of the entities, and therefore the company is the primary beneficiary of these entities. Acquisitions of subsidiaries or variable interest entities are accounted for using the purchase method of accounting. The results of subsidiaries or variable interest entities acquired during the year are included in the consolidated income statements from the effective date of acquisition.

**INITIAL MEASUREMENT OF VIE-** The Company initially measures the assets, liabilities, and non-controlling interests of the VIEs at their fair values at the date of the acquisitions. Goodwill is recorded for the excess of the fair value of the newly consolidated assets and the reported amount of assets transferred by the primary beneficiary to the VIE over the sum of the fair value of the consideration paid, the reported amount of any previously held interests, and the fair value of the newly consolidated liabilities and non-controlling interests are allocated and reported as a pro rata adjustment of the amounts that would have been assigned to all of the newly consolidated assets as if the initial consolidation had resulted from a business combination.



ACCOUNTING AFTER INITIAL MEASUREMENT OF VIE – Subsequent accounting for the assets, liabilities, and non-controlling interest of a consolidated variable interest entity are accounted for as if the entity were consolidated based on voting interests and the usual accounting rules for which the VIE operates are applied as they would to a consolidated subsidiary as follows:

Carrying amounts of the VIE are consolidated into the financial statements of PacificNet as the primary beneficiary (referred as “Primary Beneficiary” or “PB”)

Inter-company transactions and balances, such as revenues and costs, receivables and payables between or among the Primary Beneficiary and the VIE(s) are eliminated in their entirety

There is no direct ownership interest by the Primary Beneficiary in the VIE, equity of the VIE is eliminated with an offsetting credit to minority interest

PRC laws and regulations restrict us, as a foreign entity, from having a direct controlling interest in entities such as Beijing Xing Chang Xin Sci-tech Development Co. Ltd (IMOBILE-DE) that hold operating licenses to engage in domestic online ecommerce and telecom value-added services in China. As a result, we conduct substantially all of our operations through Beijing PacificNet IMOBILE Technology Co., Ltd (WOFE). We own 51% of the shares in each of the WOFEs and each WOFE signed Consulting and Services Agreements with IMOBILE-DE (the entities that actually carry out the operating activities). These agreements provide that all of the DE profits will flow through to the respective WOFEs. Pursuant to these agreements, the Company guarantees any obligations undertaken by these companies under their contractual agreements with third parties, and the Company is entitled to receive service fees based on the contractual arrangements from these companies. Accordingly, we bear the risks of and enjoy the rewards associated with the investments in the WOFEs.

The operations of DE are managed by their original management teams, however, the Company has the power to appoint or change directors and senior management because it indirectly ultimately controls the voting power of the shareholders of each DE through the Power of Attorney given to PacificNet’s President according to the operating agreements between the DE and WOFE. Pursuant to the Consulting and Service Agreements signed between each WOFE and their respective DE, the WOFE (“Party A”) agrees to be the exclusive provider of telecom consulting services to the DE (“Party B”). During the term of the agreement, Party B shall not accept technical and consulting services provided by any third party. Party B agrees to pay a fee to Party A based on the contractual arrangements and on management’s decision for the services provided. Payment of the service fees has been secured through a share pledge agreement with the shareholders of each of the DEs, whereby they pledged all of their shares to the respective WOFE.

(1) Each of the DEs, by design, is thinly capitalized because a substantial portion of PacificNet’s invested amounts or consideration were paid or payable directly to previous owners of DE for entering into the acquisition transactions while none of the investment consideration was injected into the DEs. Therefore, additional funding from PacificNet is needed to support the DEs’ business development and working capital.

(2) Fees from Service Contracts are substantial, but are not commensurate with the level of service provided by the WOFEs to the DEs. The contractual and funding arrangements with the DEs evidence that PacificNet has closely participated in the majority of the DEs’ economics. PacificNet is the primary beneficiary through its WOFE subsidiaries since PacificNet is the only enterprise with a sufficiently large interest in the VIEs. In compliance with PRC’s foreign investment restrictions on Internet Content Provider and Value Added Telecom Services Provider’s laws and regulations, the Company conducts all of its value-added services for telecom in China via the following significant domestic VIEs below. The respective management agreements between the VIE’s and WOFE’s create a variable interest and accordingly, these Vies are consolidated as VIE through their respective WOFEs from the date of

acquisition.

The following is a summary of all the VIEs of the Company:

Beijing Xing Chang Xin Sci-tech Development Co. Ltd (the “iMobile-VIE”), is a China company controlled through business agreement. Through iMobile -VIE, a variable interest entity, PacificNet is able to engage in the business of ICP, and operates mobile distribution and value-added service in the PRC. The business of the VIE is managed by their original management teams. iMobile -VIE is owned by Gao Chunhui, CEO 51% and Liu Lei, COO 49%, of the Company. The registered capital of the VIE is RMB 2,000,000. The VIE’s board of directors has the power to appoint the General Manager of the VIE who in turn has the power to appoint other members of the management. PacificNet does not directly participate in the daily operation of the VIE ,however, it does have the power to change the management, if needed, because PacificNet is directly or indirectly controlling the board of this VIE.

F-8

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Under various contractual agreements, employee shareholders of the VIEs are required to transfer their ownership in these entities to our subsidiaries in China when permitted by PRC laws and regulations or to our designees at any time for the amount of the outstanding loans. All voting rights of the VIEs are then assigned to us. We have the power to appoint all directors and senior management personnel of the VIEs. Through our wholly owned subsidiaries in China, we have also entered into exclusive technical agreements and other service agreements with the VIEs, under which these subsidiaries provide technical services.

## BUSINESS COMBINATIONS

The Company accounts for its business combinations using the purchase method of accounting. This method requires that the acquisition cost to be allocated to the assets and liabilities of the Company acquired based on their fair values. The Company makes estimates and judgments in determining the fair value of the acquired assets and liabilities, based on valuations using management's estimates and assumptions including its experience with similar assets and liabilities in similar industries. If different judgments or assumptions were used, the amounts assigned to the individual acquired assets or liabilities could be materially different.

## GOODWILL AND PURCHASED INTANGIBLE ASSETS

Goodwill represents the excess of the purchase price over the fair value of the identifiable assets and liabilities acquired as a result of the Company's acquisitions of interests in its subsidiaries and VIEs. Fair market value of the identifiable assets and liabilities, including tangible and intangible, is primarily ascertained with the replacement cost method. At time of acquisition, based on market research and discussion with management, a benchmark is established with reference to comparable replacement cost in the open market. Occasionally, net book value is used as a fair market value equivalent if the assets and liabilities of the newly acquired subsidiaries and/or VIEs were either current in nature or newly established.

Under Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets ("SFAS 142")," goodwill is no longer amortized, but tested for impairment upon first adoption and annually, thereafter, or more frequently if events or changes in circumstances indicate that it might be impaired. The Company assesses goodwill for impairment annually in accordance with SFAS 142. The assessment includes first comparing implied P/E valuation of the goodwill carrying subsidiaries (adjusted by R&D expenses written off) to benchmarks as found in comparable publicly traded companies. If a comfortable buffer over the public benchmark does not exist, more sophisticated DCF analysis, based on 5 year cash flows forecasts, will follow to ascertain if goodwill impairment is warranted.

The Company applies the criteria specified in SFAS No. 141, "Business Combinations" to determine whether an intangible asset should be recognized separately from goodwill. Intangible assets acquired through business acquisitions are recognized as assets separate from goodwill if they satisfy either the "contractual-legal" or "separability" criterion. Per SFAS 142, intangible assets with definite lives are amortized over their estimated useful life and reviewed for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets." Intangible assets, such as purchased technology, trademark, customer list, user base and non-compete agreements, arising from the acquisitions of subsidiaries and variable interest entities are recognized and measured at fair value upon acquisition. Intangible assets are amortized over their estimated useful lives from one to ten years. The Company reviews the amortization methods and estimated useful lives of intangible assets at least annually or when events or changes in circumstances indicate that it might be impaired. The recoverability of an intangible asset to be held and used is evaluated by comparing the carrying amount of the intangible asset to its future net undiscounted cash flows. If the intangible asset is considered to be impaired, the impairment loss is measured as the amount by which the carrying amount of the intangible asset exceeds the fair value of the intangible asset, calculated using a discounted future cash flow analysis. The Company uses estimates and judgments in its impairment tests, and if different estimates or judgments had been utilized, the timing or the amount of the impairment charges could be different.

We currently have six reporting units: EPRO (assets held for disposition), Smartime/Soluteck, iMobile-WOFE, Wanrong, PacificNet Games, and Take 1, but those that are marked either assets held for disposition or discontinued are excluded for the purposes of goodwill assessment. We determined our reporting units if the entity constituted a business, financial information was available, and segment management can regularly review the operating results of that component. Excluding investment holding vehicles and self-developed units, reporting units only include those operating units that PacificNet holds 50% or more through acquisition and maintain effective control. Units such as PacificNet Solution, PacificNet Limited, and PacificNet Communication are 100% owned by PacificNet through self-development and not through acquisition. Therefore, there is no goodwill allocation to these self-developed units.

F-9

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We allocated goodwill amongst the reporting units based on the consideration paid in shares and cash minus the proportional share of the fair value of net assets and liabilities at the time of acquisition specific to each reporting unit. The fair value of each reporting unit represents the amount at which the unit as a whole could be bought or sold in a current transaction between willing parties in an open marketplace. At the time of acquisition, the fair value of assets and liabilities was determined based on book value minus any potential write-down, if any, to reflect the fair value of the assets and liabilities acquired in the transaction. The Company has one class of goodwill arising from business combination resulting from the acquisitions of our subsidiaries. Goodwill has been revised to reflect certain expenses that should have been written off prior to certain acquisitions, not subsequent to the acquisitions, to better reflect the assets acquired and liabilities assumed in certain business combinations during 2003 in accordance with SFAS No. 141, "Business Combinations". Originally, the Company had acquired certain intangible assets such as research and development costs and related party receivables that were considered as part of the purchase price allocation, then subsequently expensed them at year end.

The total carrying amount of goodwill recorded on the balance sheets at December 31, 2007 is \$870,000 and the changes in the carrying amount of goodwill for the following reporting periods are summarized below:

|   | Group 1.<br>Outsourcing<br>Services | Group 2.<br>Telecom<br>Value-Added<br>Services | Group 3.<br>Products<br>(Telecom &<br>Gaming) | Total goodwill<br>on the<br>restated<br>balance sheet |
|---|-------------------------------------|--|---|---|
| Balance as of December 31,<br>2004-Restated                 | \$ 3,964                            | \$ -   | \$ -  | \$ 3,964  |
| Goodwill acquired during the year                           | -                                   | 5,183  | -   | 5,183   |
| Goodwill reclassified to net assets held<br>for disposition | -                                   | (1,494)  | -   | (1,494)   |
| Goodwill impaired during the year                           | -                                   | (3,689)  | -   | (3,689)   |
| Balance as of December 31,<br>2005-Restated                 | 3,964                               | -  | -   | 3,964   |
| Goodwill acquired during the year                           | -                                   | 461  | 1,176   | 1,637   |
| Balance as of December 31,<br>2006-Restated                 | 3,964                               | 461  | 1,176   | 5,601   |
| Goodwill acquired during the year                           | -                                   | -  | 730   | 730   |
| Goodwill impaired during the year                           | (3,964)                             | -  | (1,497)                                       | (5,461)   |
| Balance as of December 31, 2007                             | -                                   | \$ 461   | \$ 409  | \$ 870  |

The Company assesses the need to record impairment losses on our goodwill assets at least annually or when an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The assessment includes using a combination of qualitative and quantitative analyses such as DCF/PE multiples based on 5 year profit forecasts, and published comparables, where applicable. The Company concluded that there have been no material adverse changes on the operating environments during the reporting periods that would have otherwise affected the carrying value of the goodwill. In addition, there has been no disposal of any reporting subsidiaries and, as a result, no gain or loss is recognized during those reporting periods.

The following table summarizes goodwill from the Company's acquisitions during 2007 and 2006:

| (US\$'000s) | For the Years ended December<br>31, |                  |
|-------------|-------------------------------------|------------------|
|             | 2007                                | 2006<br>Restated |
| Epro        | \$ -                                | \$ 3,949         |

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|                     |        |          |
|---------------------|--------|----------|
| Smartime (Soluteck) | -      | 15       |
| iMobile             | -      | 430      |
| Wanrong             | 461    | 461      |
| Take 1              | 141    | -        |
| PacificNet Games    | 268    | 746      |
| Total               | \$ 870 | \$ 5,601 |

IMPAIRMENT OF LONG-LIVED ASSETS

The Company periodically assesses the need to record impairment losses on long-lived assets, such as property, plant and equipment, and purchased intangible assets, used in operations and its investments when indicators of impairment are present indicating the carrying value may not be recoverable. An impairment loss is recognized when estimated undiscounted future cash flows expected to result from the use of the asset plus net proceeds expected from disposition of the asset (if any) are less than the carrying value of the asset. When impairment is identified, the carrying amount of the asset is reduced to its estimated fair value. All goodwill will no longer be amortized and potential impairment of goodwill and purchased intangible assets with indefinite useful lives will be evaluated using the specific guidance provided by SFAS No. 142 and SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets."

F-10

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This impairment analysis is performed at least annually. For investments in affiliated companies that are not majority-owned or controlled, indicators or value generally include revenue growth, operating results, cash flows and other measures. Management then determines whether there has been a permanent impairment of value based upon events and circumstances that have occurred since acquisition. It is reasonably possible that the impairment factors evaluated by management will change in subsequent periods, given that the Company operates in a volatile environment. This could result in material impairment charges in future periods.

There was \$5,461,000 impairment of goodwill in the year ended December 31, 2007.

| (US\$'000s)                | 2007     | 2006     |
|----------------------------|----------|----------|
|                            |          | Restated |
| Epro                       | \$ 3,949 | \$ -     |
| Smartime (Soluteck PactSo) | 15       | -        |
| iMobile                    | 430      | -        |
| PacificNet Games           | 478      | -        |
| Take 1                     | 589      | -        |
| Total                      | \$ 5,461 | \$ N/A-  |

#### INVESTMENTS IN AFFILIATED COMPANIES

The Company's investments in affiliated companies for which its ownership exceeds 20%, but is not majority-owned or controlled, are accounted for using the equity method. The Company's investments in affiliated companies for which its ownership is less than 20% are accounted for using the cost method.

Following is the summary of the entities accounted under the equity method:

|                              | 2007        | 2006        |
|------------------------------|-------------|-------------|
| Total assets                 | \$131,210   | \$1,987,498 |
| Total liabilities            | 14,393      | 1,312,445   |
| Net assets                   | 116,817     | 675,053     |
| Income (loss) from operation | (180,083)   | 292,598     |
| Net income (loss)            | \$(191,558) | \$292,463   |

#### COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) consists of net earnings and other gains (losses) affecting stockholders' equity that, under generally accepted accounting principles are excluded from net earnings in accordance with Statement of Financial Accounting Standards ("SFAS") 130, Reporting Comprehensive Income.

#### REVENUE RECOGNITION

Revenues are derived from the following categories as classified by our operating segments (see Note 15): (1) outsourcing services including Business Process Outsourcing (BPO), call center, IT Outsourcing (ITO) and software development services; (2) Telecom Value-Added Telecom Services (VAS) including Content Providing (CP), Interactive Voice Response (IVR), Platform Providing (PP) and Service Providing (SP); and (3) Products (telecom & gaming) Services, including calling cards, GSM/ CDMA/ XiaoLingTong products, and multimedia self-service kiosks.

Revenues from outsourcing services are recognized when the services are rendered. Revenues from license agreements are recognized when a signed non-cancelable software license exists, delivery has occurred, the Company's fee is fixed or determinable, and collectability is probable at the date of sale. Revenues from software development services are recognized when the customer accepts the installation and no significant modification or customization work is involved, in accordance with SOP 97-2 "Software Revenue Recognition." Revenues from support services such as consulting, implementation and training services are recognized when the services are performed, collectability is probable and such revenues are contractually nonrefundable.

F-11

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Revenues from value-added telecom services are derived principally from providing mobile phone users with short messaging service ("SMS"), multimedia messaging service ("MMS"), color ring back tone ("CRBT"), wireless application protocol ("WAP") and interactive voice response system ("IVR"). These services include news and other content subscriptions, mobile dating service, picture and logo download, ring tones, ring back tones, mobile games, chat rooms and access to music files. These revenues are charged on a monthly or per-usage basis and are recognized in the period in which the service is performed, provided that no significant Company obligations remain, collection of the receivables is reasonably assured and the amounts can be accurately estimated. In accordance with EITF No. 99-19, "Reporting Revenues Gross as a Principal Versus Net as an Agent," revenues are recorded on a gross basis when the Company is considered the primary obligor to the VAS users. Under the gross method, the amounts billed to VAS users are recognized as revenues and the fees charged or retained by the third-party operators are recognized as cost of revenues.

Revenues from the sale of products and systems are recognized when the product and system is completed, shipped, and the risks and rewards of ownership have transferred.

Revenues from the distribution of all types of calling cards and product sales is recognized in accordance with EITF No. 99-19, "Reporting Gross Revenues as a Principal Versus Net as an Agent," where revenues are recorded on a gross basis when the Company is considered the primary obligor to the users, maintains an inventory of products before the products are ordered by customers, has latitude in establishing the pricing power of products, is subject to physical inventory loss risk, and has credit risk as it is responsible for collecting the sales price from the customer and is responsible for paying the supplier regardless of whether or not the sales price is fully collectible.

The effect of post-shipment/delivery obligations, such as customer acceptance, product returns, etc. on our revenue recognition policy is as follows: (a) there is no effect on outsourcing services as revenue is recognized as the services are performed; however product sale revenue is recognized when contracts are approximately 80% completed for revenue recognition and fully when the customer signs the UAT, (i.e., "User Acceptance Form"); (b) there is no effect on telecom value-added services revenue as the product sales mainly involve IVR hardware that are from mature and stable products of multi-national vendors and there have been minimal returns historically; and (c) there is no effect on product (telecom & gaming) since the transactions are conducted on cash basis and revenue is recognized at the time the sale is transacted.

#### ALLOWANCE FOR DOUBTFUL ACCOUNTS

The Company presents accounts receivable, net of allowances for doubtful accounts and returns. The allowances are calculated based on a detailed review of certain individual customer accounts, historical rates and an estimate of the overall economic conditions affecting the Company's customer base. The Company frequently monitors its customers' financial condition and credit worthiness and only sells products, licenses or services to customers where, at the time of the sale, collection is reasonably assured. If the financial condition of its customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. The Company also records reserves for doubtful accounts for all other customers based on a variety of factors including the length of time the receivables are past due, the financial health of the customer, macroeconomic considerations and historical experience. If circumstances related to specific customers change, the Company's estimates of the recoverability of receivables could be further adjusted. Allowance for doubtful accounts at December 31, 2007 was approximately \$5,365,000 (2006: \$4,536,000).

#### PROPERTY AND EQUIPMENT

Property and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated useful life of the asset or the lease term, ranging from three to five years. Significant improvements and betterments are capitalized. Routine repairs and maintenance are expensed when incurred. When property and

equipment is sold or otherwise disposed of, the asset account and related accumulated depreciation account are relieved, and any gain or loss is included in operations.

#### INVENTORIES

Inventories consist of finished goods and are stated at the lower of cost or market value. Cost is computed using the first-in, first-out method and includes all costs of purchase and other costs incurred in bringing the inventories to their present location and condition. Market value is determined by reference to the sales proceeds of items sold in the ordinary course of business after the balance sheet date or management estimates based on prevailing market conditions. The inventories consist of finished goods and represent gaming and telecommunication products such as electronic gaming machines, gaming systems, AWP, VLT, slot and bingo machines, mobile phone, rechargeable phone cards, smart chip, and interactive voice response cards.

F-12

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## INCOME TAXES

Income taxes are accounted for using an asset and liability approach, which requires the recognition of income taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in the Company's consolidated financial statements or tax returns. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax laws; the effects of future changes in tax laws or rates are not anticipated. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence assessed using the criteria in SFAS No. 109, "Accounting for Income Taxes," will not more-likely-than-not be realized.

The Company records a valuation allowance for deferred tax assets, if any, based on estimates of its future taxable income as well as its tax planning strategies when it is more likely than not that a portion or all of its deferred tax assets will not be realized. If the Company is able to utilize more of its deferred tax assets than the net amount previously recorded when unanticipated events occur, an adjustment to deferred tax assets would be reflected in income when those events occur.

## RESEARCH AND DEVELOPMENT COSTS AND CAPITALIZED SOFTWARE COSTS

Expenditures related to the research and development of new products and processes, including significant improvements and refinements to existing products are expensed as incurred, unless they are required to be capitalized.

Software development costs are required to be capitalized when a product's technological feasibility has been established by completion of a detailed program design or working model of the product, and ending when a product is available for release to customers. For the years ended December 31, 2007 and 2006, the Company did not capitalize any costs related to the purchase of software and related technologies and content.

## STOCK-BASED COMPENSATION PLANS

Prior to January 1, 2006, PacificNet accounted for awards granted under stock-based compensation plans following the recognition and measurement principles of APB 25, Accounting for Stock Issued to Employees, and related interpretations. Compensation expense, if any, is recognized for awards granted at an exercise price less than fair market value of the underlying common stock on the date of grant.

Effective January 1, 2006, PacificNet adopted the fair value recognition provisions of SFAS 123(R). See Item 6 for a description of the Company's adoption of SFAS 123R. The fair value of stock options is determined using the Black-Scholes option pricing model, which is consistent with the valuation techniques previously utilized for options in footnote disclosures required under SFAS 123, as amended by FASB Statement No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure." The determination of the fair value of stock-based compensation awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables, including the expected volatility of the Company's stock price over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rate and expected dividends.

On July 3, 2007 the board extended the grant of previously expired options. Total options for which the grant was extended were 15,000 and 3,000 on two different grants. The Company recorded \$51,400 as stock based compensation expense utilizing Black Scholes Options Pricing Model by using the following assumptions: exercise price of \$2.20 and \$1.75, risk free interest rate of 4.76%, volatility of 70.88% and dividend yield of 0%.

As of December 31, 2007 we had no stock options exercisable, 202,000 options were exercised during FY2007.



Additional information on options outstanding as of December 31, 2007 is as follows:

|                     | WEIGHTED<br>AVERAGE<br>EXERCISE<br>PRICE | OPTIONS | WEIGHTED<br>AVERAGE<br>REMAINING<br>CONTRACTUAL<br>LIFE |     |
|---------------------|--|---------|---|-----|
| Options outstanding | \$ 4.31                                  | 33,000  | 5.62years   |     |
| Options exercisable | N/A                                      | N/A     |   | N/A |

On April 28, 2008 the Company's Board of Directors approved the grant of up to 2,000,000 in bonus shares to the directors, employees and consultants of the Company as compensation. The Company issued 1,086,000 shares against 2007 compensation and accrued \$1,086,000 in expenses at the fair market value at the approval date.

#### ADVERTISING EXPENSES

Advertising expenses consist primarily of costs of promotion for corporate image and product marketing and costs of direct advertising. The Company expenses all advertising costs as incurred and classify these costs under selling, general and administrative expenses, which amounted to \$23,341 in 2007 (2006: \$31,052).

#### CASH EQUIVALENTS

Cash and cash equivalents comprise cash at bank and on hand, demand deposits with banks and other financial institutions, and short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Bank overdrafts that are repayable on demand and form an integral part of the PacificNet's cash management are also included as a component of cash and cash equivalents for the purpose of the cash flow statement. Highly liquid investments with original maturities of three months or less are considered cash equivalents.

#### RELATED PARTY TRANSACTIONS

A related party is generally defined as (i) any person that holds 10% or more of the Company's securities including such person's immediate families, (ii) the Company's management, (iii) someone that directly or indirectly controls, is controlled by or is under common control with the Company, or (iv) anyone who can significantly influence the financial and operating decisions of the Company. A transaction is considered to be a related party transaction when there is a transfer of resources or obligations between related parties. (See Note 14)

#### RECLASSIFICATION

Certain prior period amounts have been reclassified to conform to the current year presentation. These changes had no effect on previously reported results of operations or total stockholders' equity.

#### FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value is described as the amount at which the instrument could be exchanged in a current transaction between informed willing parties, other than a forced liquidation. Cash and cash equivalents, accounts receivable and payable, accrued expenses and other current liabilities are reported on the consolidated balance sheets at carrying value which approximates fair value due to the short-term maturities of these instruments. The Company does not have any off balance sheet financial instruments.

CONCENTRATION OF CREDIT RISK

**CASH HELD IN BANKS.** For those financial institutions that the Company maintains cash balances in the United States, the amounts are insured by the Federal Deposit Insurance Corporation up to \$3,750,000 in 2007.

**GEOGRAPHIC RISK.** All of the Company's revenues are derived in Asia and Greater China and its operations are governed by Chinese laws and regulations. The operations in China are carried out by the subsidiaries and Variable Interest Entities (VIEs). If the Company was unable to derive any revenue from Asia and Greater China, it would have a significant, financially disruptive effect on the normal operations of the Company.

F-14

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## SIGNIFICANT RELATIONSHIPS

A substantial portion of the operations of the Company's VIEs (Dianxun-DE and Sunroom-DE) business operations depend on mobile telecommunications operators (operators) in China and any loss or deterioration of such relationship may result in severe disruptions to their business operations and the loss of a significant portion of the Company's revenue. The VIEs rely entirely on the networks and gateways of these operators to provide its wireless value-added services. Specifically these operators are the only entities in China that have platforms for wireless value-added services. The Company's agreements with these operators are generally for a period of less than one year and generally do not have automatic renewal provisions. If neither of them is willing to continue to cooperate with the Company, it would severely affect the Company's ability to conduct its existing wireless value-added services business.

## MARKETABLE EQUITY SECURITIES

Marketable equity securities are classified as available-for-sale and are recorded at fair value in other assets on the balance sheet, with the change in fair value during the period excluded from earnings and recorded net of tax as a component of other comprehensive income. Realized gains or losses are charged to the income statement during the period in which the gain or loss is realized. Investments classified as available-for-sale securities include marketable equity securities of Unit Trust Funds and are based primarily on quoted market prices at December 31, 2007.

|                   | Cost      | Market Value | Unrealized Gain/(Loss) |
|-------------------|-----------|--------------|------------------------|
| December 31, 2007 | \$369,000 | \$547,000    | \$178,000              |
| December 31, 2006 | \$19,000  | \$18,000     | \$(1,000)              |

## FOREIGN CURRENCY

The Company's reporting currency is the U.S. dollar. The Company's operations in China and Hong Kong use their respective currencies as their functional currencies. The financial statements of these subsidiaries are translated into U.S. dollars using period-end rates of exchange for assets and liabilities and average rates of exchange in the period for revenue and expenses. Translation gains and losses are recorded in accumulated other comprehensive income or loss as a component of shareholders' equity. During the year ended December 31, 2007, the foreign currency translation adjustments to the Company's comprehensive income was \$242,000 and the currency translation gain was approximately \$118,000, primarily as a result of the Hong Kong dollars appreciating against the U.S. dollar.

## SEGMENT INFORMATION

The Company determines and classified its operating segments in accordance with SFAS No. 131 "DISCLOSURES ABOUT SEGMENTS OF AN ENTERPRISE AND RELATED INFORMATION" based on the following considerations: (a) each of the Company's operating segments is a discrete business unit that earns revenues and incurs expenses; (b) the operating results are regularly reviewed by PacificNet's chief operating decision makers for the purposes of fine-tuning its strategies going forward, making resource allocation decisions such as whether further working capital advances are required and assessing individual performance; and (c) discrete financial information for each subsidiary within each operating segment is available. The chief operating decision makers are the Company's President and CEO and its Chairman, and their decisions are based on discussions with each segment's senior management and financial controllers regarding non-financial indicators such as customer satisfaction, loyalty and new marketplace competition as well as financial indicators such as internally generated financial statements, to assess overall financial performance.

## GOING CONCERN

As shown in the accompanying consolidated financial statements, the Company incurred accumulated losses of \$65 million and \$51 million as of December 31, 2007 and 2006 respectively. Negative cash flows from the operations was \$1.1 million for the year ended December 31, 2007. These matters raise substantial doubt about the Company's ability to continue as a going concern.

F-15

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In view of the matters described in the preceding paragraph, recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheet is dependent upon continued operations of the Company, which in turn is dependent upon the Company's ability to raise additional capital, obtain financing and to succeed in its future operations. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern.

The Company has taken certain restructuring steps to provide the necessary capital to continue its operations. These steps included, but not limited to: 1) accelerate disposal and spin-off of unprofitable or unfavorable return-on-investment non-gaming operations; 2) focus on execution of the new high potential gaming business initiatives; 3) acquisition of profitable and/or strategic operations through issuance of equity instruments; 4) formation of strategic relationship with key gaming operators in Asia; 5) issuance and/or restructure of new long-term convertible debentures.

On April 30, 2007, the Company entered into a sale and purchase agreement to dispose of its interest in Guangzhou3G for a consideration of US\$6 million. The deal was subsequently reopened for renegotiation in November 2007 (See note 14).

On May 15 & 20, 2007, the Company entered into various definitive agreements to divest and reduce its equity interests in certain unprofitable subsidiaries to below 20% equity interest, namely: Linkhead, Clickcom, PacTelso, PacSo and PacPower (See note 14).

On March 27, 2008, three holders of PACT's Convertible Subordinated Debentures filed an involuntary petition for Chapter 11 relief in federal bankruptcy court late Saturday, March 22, 2008 in Wilmington, DE. The Company has retained counsel to oppose the filing because the petition fails to meet the standard for invoking an involuntary bankruptcy and fails to take into consideration other agreements between the Company and the petitioning creditors. The Company intends to vigorously oppose the petition and move for dismissal of the filing, and if successful will seek damages and attorney fees. Subsequently, PACT also received default notice from all but one of the debenture holders including Iroquois Master Fund Ltd., Alpha Capital AG, Whalehaven Capital Fund Limited, DKR Soundshore Oasis Holding Fund Ltd., Basso Fund Ltd., Basso Multi-Strategy Holding Fund Ltd., and Basso Private Opportunities Holding Fund Ltd. from the same Convertible Subordinated Debentures related to the private offering of \$8,000,000 principal amount variable debentures consummated on March 13, 2006, and due March 2009.

PACT has retained counsel to oppose the above petition. The amount of the debt in question is as follows: Iroquois Master Fund Ltd. \$2.5 million, Whalehaven Capital Fund Limited \$958,000, Alpha Capital AG \$685,000 DKR Soundshore Oasis Holding Fund Ltd \$960,000, and Basso Fund Ltd., Basso Multi- Strategy Holding Fund Ltd., and Basso Private Opportunities Holding Fund Ltd., a combined amount of \$500,000.

## RECENT PRONOUNCEMENTS

In March 19, 2008, FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities. The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. Currently the Company does not carry any derivative instruments and the adoption of this statement may not have any effect on the financial statements.

In December 2007, FASB issued FASB Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51. This Statement applies to all entities that prepare consolidated financial statements, except not-for-profit organizations, but will affect only those entities that have an outstanding

non-controlling interest in one or more subsidiaries or that deconsolidate a subsidiary. Not-for-profit organizations should continue to apply the guidance in Accounting Research Bulletin No. 51, Consolidated Financial Statements, before the amendments made by this Statement, and any other applicable standards, until the Board issues interpretative guidance. This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 (that is, January 1, 2009, for entities with calendar year-ends). Earlier adoption is prohibited. The effective date of this Statement is the same as that of the related Statement 141(R). This Statement shall be applied prospectively as of the beginning of the fiscal year in which this Statement is initially applied, except for the presentation and disclosure requirements. The presentation and disclosure requirements shall be applied retrospectively for all periods presented. Management is currently evaluating the effect of this pronouncement on financial statements.

In December 2007, the FASB issued SFAS No. 141(R), "Business Combinations". This Statement replaces SFAS No. 141, Business Combinations. This Statement retains the fundamental requirements in Statement 141 that the acquisition method of accounting (which Statement 141 called the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. This Statement also establishes principles and requirements for how the acquirer: a) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; b) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase and c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141(R) will apply prospectively to business combinations for which the acquisition date is on or after Company's fiscal year beginning October 1, 2009. While the Company has not yet evaluated this statement for the impact, if any, that SFAS No. 141(R) will have on its consolidated financial statements, the Company will be required to expense costs related to any acquisitions after September 30, 2009.

In February 2007, FASB issued FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. FAS 159 is effective for fiscal years beginning after November 15, 2007. Early adoption is permitted subject to specific requirements outlined in the new Statement. Therefore, calendar-year companies may be able to adopt FAS 159 for their first quarter 2007 financial statements.

The new Statement allows entities to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be measured at fair value. If a company elects the fair value option for an eligible item, changes in that item's fair value in subsequent reporting periods must be recognized in current earnings. FAS 159 also establishes presentation and disclosure requirements designed to draw comparison between entities that elect different measurement attributes for similar assets and liabilities. The management is currently evaluating the effect of this pronouncement on financial statements.

In September 2006, FASB issued SFAS 158 'Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)' This Statement improves financial reporting by requiring an employer to recognize the over funded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. The Company currently does not have any defined benefit plan and so FAS 158 will not affect the financial statements.

In September 2006, FASB issued SFAS 157 'Fair Value Measurements'. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The management is currently evaluating the effect of this pronouncement on financial statements.

## 2. BUSINESS ACQUISITIONS

### TAKE 1 TECHNOLOGIES GROUP LIMITED

On January 05, 2007, we entered into an agreement for PacificNet to exercise the option to acquire an additional 31% interest in Take 1. The completion date for the new Securities Subscription Agreement was January 05, 2007, with a contingent consideration to be paid entirely with shares of PacificNet: 149,459 PACT Shares. As a result, PacificNet has become the majority and controlling shareholder of Take1 with our ownership percentage increasing from 20% to 51%.

An initial equity investment of 30% in Take 1 was made in April 2004 by the Company, through its subsidiary PacificNet Strategic Investment Holdings Limited, for a consideration of 149,459 PacificNet shares. PacificNet's interest in Take 1 was reduced to 20% in the year 2005 from 30% as a result of PacificNet repurchasing an aggregate of 149,459 at nominal value.

Summarized below were the assets acquired and liabilities assumed for Take 1 in the acquisition: (In thousands of US Dollars)

|                        |         |
|------------------------|---------|
| Estimated fair values: |         |
| Current assets         | 106,422 |

|                                     |           |
|-------------------------------------|-----------|
| Current liabilities                 | (728,156) |
| Net assets (liabilities) acquired   | (621,734) |
| Total Consideration Paid            | 217,247   |
| Goodwill and Identified Intangibles | 838,981   |
| Allocation:                         |           |
| Customer Relations                  | 88,805    |
| Product Design                      | 7,990     |
| Proprietary Technology              | 11,325    |
| Goodwill                            | 730,860   |

In accordance with SFAS 142, goodwill is not amortized but is tested for impairment at least annually. The purchase price allocation for Take 1 acquisition is based on a management's estimates and overall industry experience. During the year ended December 31, 2007 the Company impaired goodwill amounting to \$590,000.

UNAUDITED PRO FORMA CONSOLIDATED FINANCIAL INFORMATION DISCLOSURE FOR THE YEAR ENDED December 31, 2007 AND 2006

The following is an un-audited pro forma consolidated financial information for the year ended December 31, 2006 and 2007, as presented below, reflects the results of operations of the Company assuming the acquisition occurred on January 1, 2006 and 2007, respectively, and after giving effect to the purchase accounting adjustments. These pro forma results have been prepared for information purposes only and do not purport to be indicative of what operating results would have been had the acquisitions actually taken place on January 1, 2006 and 2007, respectively, and may not be indicative of future operating results.

| Take 1<br><br>(In thousands of<br>U.S Dollars,<br>except for loss<br>per share) | Years ended December<br>31. |             |
|---|-----------------------------|-------------|
|   | 2007                        | 2006        |
| Revenue   | \$ 18,994                   | \$ 30,412   |
| Operating<br>income   | (16,427)                    | (7,144)     |
| Net Loss  | \$ (14,195)                 | \$ (12,325) |
| Basic & Diluted<br>Loss Per Share   | \$ (1.19)                   | \$ (1.07)   |

Accordingly, PacificNet included the financial results of Take 1 in its consolidated 2007 financial results from January 5, 2007 to December 31, 2007.

### 3. EARNINGS PER SHARE (EPS)

Basic and diluted earnings or loss per share (EPS) amounts in the financial statements are computed in accordance with SFAS No. 128, "Earnings Per Share." Basic EPS is based on the weighted average number of common shares outstanding. Diluted EPS is based on the weighted average number of common shares outstanding plus dilutive common stock equivalents. Basic EPS is computed by dividing net income/loss available to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) during the period. Diluted EPS is calculated by dividing net earnings by the weighted average number of common shares outstanding and other dilutive securities. Dilutive earnings per share for the period ended December 31, 2007 exclude the potential dilutive effect of 889,456 warrants because their impact would be anti-dilutive based on current market prices. 445,455 convertible debentures are tested by using if-converted method. The result shows when convertible debentures are included in the computation, diluted EPS increases. According to SFAS No.128, those convertible debentures are ignored in the computation of diluted EPS. All per share and per share information are adjusted retroactively to reflect stock splits and changes in par value.

The reconciliation of the numerators and denominators of the basic and diluted EPS calculations was as follows:

|   | FY 2007     | FY 2006     |
|---|-------------|-------------|
| (In thousands of US Dollars, except weighted shares and per share amounts.) |             | Restated    |
| Numerator: Net Loss   | \$ (14,195) | \$ (12,415) |
| Denominator:  |             |             |
| Weighted average number of shares-Basic & Diluted                           | 11,895,525  | 11,538,664  |

|                                |    |        |    |        |
|--------------------------------|----|--------|----|--------|
| Basic & Diluted Loss Per Share | \$ | (1.19) | \$ | (1.08) |
|--------------------------------|----|--------|----|--------|

#### 4. INVESTMENT IN AFFILIATED COMPANIES

##### Investments

Investments that are recorded at cost are evaluated for any impairments that are not temporary in nature and adjusted for the impairment.

F-18

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Investments in affiliated companies consist of the following as of December 31, 2007 and 2006:

Under Cost Method:

| (USD ' 000s)    | 2007   | 2006<br>(Restated) | DESCRIPTION            |
|-----------------|--------|--------------------|------------------------|
| Glad Smart      | \$ 30  | \$ 30              | 15% ownership interest |
| Linkhead        | \$ 65  | -                  | 15% ownership interest |
| Clickcom        | \$ 25  | -                  | 15% ownership interest |
| Community Media | -      | \$ 4               | 5% ownership interest  |
| MOABC           | -      | \$ (19)            | 15% ownership interest |
| Total           | \$ 120 | \$ 15              |                        |

Under Equity Method:

Investments accounted for under the equity method are carried at cost and adjusted for the Company's proportionate share of undistributed earnings and losses.

| (USD ' 000s)          | 2007  | 2006 (Restated) | DESCRIPTION            |
|-----------------------|-------|-----------------|------------------------|
| Take 1                |       | \$ 100          | 20% ownership interest |
| Bell-Pact Shanghai JV | \$ 13 | -               | 40% ownership interest |
| Total                 | \$ 13 | \$ 100          |                        |

## 5. PROPERTY AND EQUIPMENT, NET

Property and equipment consists of the following as of December 31 (in thousands of US Dollars):

| (In thousands of US Dollars)                          | FY2007   | FY2006<br>Restated |
|---|----------|--------------------|
| Office furniture, fixtures and leasehold improvements | \$ 548   | \$ 505             |
| Computers and office equipment                        | 1,875    | 1,212              |
| Motor Vehicles  | 132      | 56                 |
| Software  | 21       | 27                 |
| Electronic Equipment                                  | 854      | 19                 |
| Land and buildings                                    | 2,896    | 2,805              |
| Less: Accumulated depreciation                        | 1,040    | 615                |
| Net Property and Equipment, Net                       | \$ 5,285 | \$ 4,008           |

For the years ended December 31, 2007 and 2006, the total depreciation and amortization expenses were \$752,000 and \$1,536,000 respectively.

The significant increase of the office furniture, fixtures and leasehold improvements was mainly due to the computers, office, software and electronic equipment in 2007 as the expansion of our business including Games (\$820,000) and Wanrong (\$532,000). Additionally, Shenzhen office purchased through Inc (\$1,301,000) during 2007.

**OPERATING LEASES** - The Company leases warehouse and office space under operating leases with fixed monthly rentals. None of the leases included contingent rentals. Lease expense charged to operations for 2007 amounted to \$466,000 (2006: \$571,000). Future minimum lease payments under non-cancelable operating leases are \$210,000 for 2008, \$194,000 for 2009 to 2012.

**BANK LINE OF CREDIT (2007):** As of December 31, 2007, Smartime has an overdraft banking facility with a large Hong Kong bank in the aggregate amount of \$100,000. This overdraft facility is personally pledged by the deposit account of a director of Smartime.

**BANK LINE OF CREDIT (2006):** As of December 31, 2006, Smartime has an overdraft banking facility of up to \$111,000 with a Hong Kong banking institution. This overdraft facility is secured by a personal deposit account of a director of Smartime.

F-19

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CONTINGENT CONSIDERATION: Warrants have not been included as part of the acquisition price of various S&P Agreements (Note 2) and are no longer considered as part of the purchase consideration due to (i) the ambiguity of the S&P Agreements with respect to the issuance of the warrants and (ii) the lack of actual instruments to transfer the warrants, such as a warrant agreement that is signed and sealed by the Company and property registered at the Company Registrar of securities in Hong Kong, and accordingly, there is no irrevocable obligation by the Company to issue the warrants. Furthermore, the net income milestones were not achieved as required under the S&P Agreements according to Hong Kong law. Based on the opinion of the Company's legal counsel in Hong Kong, the Company does not have an irrevocable obligation to issue the warrants and therefore the warrants are not considered issued and outstanding. The offer to issue the warrants is no longer part of the purchase price in the S&P Agreements due to the failure by the Sellers to satisfy their warranties in the S&P Agreements. Accordingly, the warrants have not been valued.

## 6. OTHER CURRENT ASSETS

Other current assets comprises of the following as at December 31 (in thousands of US Dollars):

| (USD ' 000s)                           | 2007    | 2006<br>Restated |
|--|---------|------------------|
| Prepayment to suppliers                | \$ 346  | \$ 886           |
| Deposit                                | 237     | -                |
| Receivable from Lion Zone Holdings Ltd | -       | 485              |
| Loans to employees                     | 273     | 412              |
| Prepaid expenses                       | 129     | 347              |
| loan to Golden Charpel                 | 517     | -                |
| Others receivable                      | 525     | 404              |
| WeiDa for disposal Linkhead            | 150     | -                |
| Loan to Webplus                        | 237     | -                |
| loan to Mou Yi Liang                   | 244     | -                |
| loan to Bell-Pact Shanghai JV          | 102     | -                |
| loan to UASIT                          | 96      | -                |
| Advances to sales reps                 | -       | 228              |
| Provision for doubtful account         | (2,448) | -                |
| Total                                  | \$ 408  | \$ 2,762         |

## 7. BANK LOANS

Bank loans represent the following at December 31 (in thousands):

|                       | 2007     | 2006   |
|-----------------------|----------|--------|
| Unsecured             | 1,823    | 1,048  |
| Less: current portion | 80       | 411    |
| Non current portion   | \$ 1,743 | \$ 637 |

Aggregate future maturities of borrowing for the next five years are as follows:

(As at December 31, 2007, the aggregate future maturities of borrowing for the next five years were as follows: 2008: \$80,000, 2009: \$85,000, 2010: \$88,000, 2011: \$95,000, 2012: \$101,000 thereafter: \$1,374,000)

| (US\$000s) | January<br>2008 to | January<br>2009 to | January<br>2010 to | January<br>2011to | January<br>2012 to | Thereafter | TOTAL |
|------------|--------------------|--------------------|--------------------|-------------------|--------------------|------------|-------|
|------------|--------------------|--------------------|--------------------|-------------------|--------------------|------------|-------|

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|   | December<br>2008 | December<br>2009 | December<br>2010 | December<br>2011 | December<br>2012 |       |       |
|---|------------------|------------------|------------------|------------------|------------------|-------|-------|
| Beijing PACT<br>office mortgage<br>(1)  | 56               | 59               | 61               | 66               | 70               | 755   | 1,067 |
| Shenzhen PACT<br>office mortgage<br>(2) | 24               | 26               | 27               | 29               | 31               | 619   | 756   |
| TOTAL                                   | 80               | 85               | 88               | 95               | 101              | 1,374 | 1,823 |

(1) Fixed mortgages expiring in 2012 at interest rate of 5.5% per annum.

(2) Fixed mortgage expiring in 2012 at interest rate of 6.2% per annum.

F-20

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## 8. ACCRUED EXPENSES

Accrued expenses consist of the following at December 31 (in thousands of US Dollars):

|                              | 2007     | 2006<br>(Restated) |
|------------------------------|----------|--------------------|
| Professional fee             | \$ 480   | \$ 221             |
| Director fee                 | 111      | 100                |
| Salaries and benefit payable | 1,042    | 535                |
| Marketing expense            | 973      | 341                |
| Income tax payable           | 7        | (53)               |
| Others                       | 887      | 126                |
| Total                        | \$ 3,500 | \$ 1,270           |

## 9. STOCKHOLDERS' EQUITY

## a) COMMON STOCK

During the year ended December 31, 2007, the Company had the following equity transactions (i) 199,444 shares of common stock were issued as the monthly principal redemption shares for 8 million convertible debentures from January to March, such shares are valued at \$1,090,914; (ii) 41,426 treasury shares were sold to the open market with total consideration \$127,000; (iii) 202,000 shares as a results of exercise of stock options with cash consideration of \$406,000; (iv) 2,330,000 shares issued for the purpose of acquisition of Octavian International Ltd recorded as a deposit amounting to \$10,974,300 (note 17). As of December 31, 2007, the Company received \$196,000 from exercise of stock options.

During the year ended December 31, 2006, the Company had the following equity transactions (i) 394,000 shares as a result of exercise of stock options with cash consideration of \$237,000; (ii) 618,112 shares for acquisition of subsidiaries valued at \$4,346,000; and (iii) 275,000 shares returned by ChinaGoHi valued at \$1,672,000, due to a termination agreement signed with ChinaGoHi in November 2006 (as filed in an 8K dated Nov 28, 2006); (iv) repurchase of 24,200 shares from Yueshen with a market value of \$124,223.

## b) STOCK OPTION PLAN

Prior to January 1, 2006, PacificNet accounted for awards granted under stock-based compensation plans following the recognition and measurement principles of APB 25, Accounting for Stock Issued to Employees, and related interpretations. Accordingly, compensation expense was recognized for awards granted at an exercise price less than fair market value of the underlying common stock on the date of grant. Effective January 1, 2006, PacificNet adopted the fair value recognition provisions of SFAS 123(R). See Note 2 for a description of the Company's adoption of SFAS 123R. The fair value of stock options is determined using the Black-Scholes option pricing model, which is consistent with the valuation techniques previously utilized for options in footnote disclosures required under SFAS 123, as amended by FASB Statement No.148, "Accounting for Stock-Based Compensation - Transition and Disclosure." The determination of the fair value of stock-based compensation awards on the date of grant using an option-pricing model is affected by the Company's stock prices as well as assumptions regarding a number of complex and subjective variables, including the expected volatility of the Company's stock price over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rate and expected dividends. The valuation provisions of SFAS 123(R) apply to new grants and unvested grants that were outstanding as of the effective date. For the year ended December 31, 2007, 33,000 new options were granted and no options were vested, thus the option-related compensation cost is zero. PacificNet elected the modified prospective method and therefore has not restated results for prior periods due to 123R.

The status of the Stock Option Plan as of December 31, 2007, is as follows:

|                                | Options<br>outstanding | WEIGHTED<br>AVERAGE<br>EXERCISE<br>PRICE |
|--------------------------------|------------------------|--|
| OUTSTANDING, DECEMBER 31, 2005 | 756,100                | \$ 3.99                                  |
| Granted                        | 500,000                | \$ 4.75                                  |
| Cancelled                      | (491,600)              | \$ 4.75                                  |
| Exercised                      | (394,000)              | \$ 2.12                                  |
| OUTSTANDING, DECEMBER 31, 2006 | 370,500                | \$ 2.00                                  |
| *Granted                       | 806,000                | 4.26                                     |
| Cancelled                      | (941,500)              | 2.00                                     |
| Exercised                      | (202,000)              | 2.00                                     |
| OUTSTANDING, DECEMBER 31, 2007 | 33,000                 | 4.31                                     |

\*This includes 18,000 options expired in 2006 and extended in 2007.

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Following is a summary of the status of options outstanding at December 31, 2007:

| Grant Date | Total<br>Options<br>Outstanding | Aggregate<br>Intrinsic<br>Value | Weighted<br>Average<br>Remaining<br>Life (Years) | Total<br>Weighted<br>Average<br>Exercise<br>Price | Option<br>Exercisable | Weighted<br>Average<br>Exercise<br>Price |
|------------|---------------------------------|---------------------------------|--|---|-----------------------|--|
| 2007-8-13  | 33,000                          | \$0                             | 5.62   | \$4.31  | -                     | \$4.31                                   |

PacificNet originally granted 788,000 options on August 11, 2007; however, as the optionees did not sign the option agreements before December 31, 2007, most of the options have been forfeited except for 33,000 options. These options will be vested commencing August 8, 2008 with a 5% per quarter vesting schedule, and the corresponding compensation costs will be recorded within the vesting period. The weighted-average fair value of such options was \$2.75. The assumptions used in calculating the fair value of options granted using the Black-Scholes option-pricing model are as follows:

|                              |            |
|------------------------------|------------|
| Risk-free interest rate      | 4.51%      |
| Expected life of the options | 5.86 years |
| Expected volatility          | 67.44%     |
| Expected dividend yield      | 0%         |

33,000 options were granted and 202,000 were exercised during the fiscal year ended December 31, 2007.

Among the 202,000 options exercised, 184,000 were included in the ending balance of 370,500 options per the 2006 annual report; these 184,000 options were exercised on July 26, 2007. The other 18,000 were exercised on July 5, 2007.

On July 3, 2007 the board extended the grant of previously expired options to a former director as a result of legal settlement. Total options for which the grant was extended were 15,000 and 3,000 on two different grants. The Company recorded \$51,400 as stock based compensation expense utilizing Black Scholes Options Pricing Model by using the following assumptions: exercise price of \$2.20 and \$1.75, risk free interest rate of 4.76%, volatility of 70.88% and dividend yield of 0%.

The information is as below:

| Option Certificate Number | Grant Date according to (d) | Options Approved | Option Price(A) | Option Shares Exercised(B) | Date Exercised |
|---------------------------|-----------------------------|------------------|-----------------|----------------------------|----------------|
| 2104                      | 12-30-2002                  | 3,000            | \$1.75          | 3,000                      | 7-5-2007       |
| 2300                      | 6-23-2003                   | 15,000           | \$2.20          | 15,000                     | 7-5-2007       |

No other options were vested during the fiscal year ended December 31, 2007.

#### c) WARRANTS

At December 31, 2007, the Company had outstanding and exercisable warrants to purchase an aggregate of 1,007,138 shares of common stock. The weighted average remaining life is 2.34 years and the weighted average price per share is \$10.61 per share.



Following is a summary of the warrant activity:

|                                | Warrants<br>outstanding |    | WEIGHTED<br>AVERAGE<br>EXERCISE<br>PRICE | Aggregate<br>Intrinsic<br>Value |
|--------------------------------|-------------------------|----|--|---------------------------------|
| OUTSTANDING, DECEMBER 31, 2005 | 591,138                 | \$ | 9.50                                     | \$                              |
| Granted                        | 416,000                 |    |  |                                 |
| Expired                        |                         |    |  |                                 |
| Exercised                      |                         |    |  |                                 |
| OUTSTANDING, DECEMBER 31, 2006 | 1,007,138               | \$ | 10.61                                    | \$                              |
| Granted                        |                         |    |  |                                 |
| Expired                        |                         |    |  |                                 |
| Exercised                      |                         |    |  |                                 |
| OUTSTANDING, DECEMBER 31, 2007 | 1,007,138               | \$ | 10.61                                    | \$                              |

Following is a summary of the status of warrants outstanding at December 31, 2007:

| Grant Date | Total warrants<br>Outstanding | Weighted<br>Average<br>Remaining<br>Life<br>(Years) | Total<br>Weighted<br>Average<br>Exercise Price | Warrants<br>Exercisable | Weighted<br>Average<br>Exercise Price |
|------------|-------------------------------|---|--|-------------------------|---------------------------------------|
| 2004-1-15  | 123,456                       | 1.04  | \$7.15   | 123,456                 | \$7.15                                |
| 2004-11-15 | 117,682                       | 1.88  | \$3.89   | 117,682                 | \$3.89                                |
| 2004-12-9  | 350,000                       | 1.94  | \$12.21  | 350,000                 | \$12.21                               |
| 2006-3-13  | 416,000                       | 3.20  | \$12.20  | 416,000                 | \$12.20                               |

On March 13, 2006, we issued 400,000 warrants to several institutional investors in connection with a private placement of \$8 million in convertible debentures. On the same day we issued another 16,000 warrants to our placement agent for the transaction. Those warrants have a term of 5 years and immediately vesting. The assumptions used in calculating the fair value of such warrants granted using the Black-Scholes option- pricing model are as follows:

|                              |               |
|------------------------------|---------------|
| Risk-free interest rate      | 4.78%         |
| Expected life of the options | 5.00<br>years |
| Expected volatility          | 37.08%        |
| Expected dividend yield      | 0%            |

No warrants were granted, cancelled and exercised during the years ended December 31, 2007.

#### d) TREASURY STOCK

The following is a summary of the movement of the Company's shares held as treasury stock for the years ended December 31, 2007.

|                                       | Number of<br>shares | Note |
|---------------------------------------|---------------------|------|
| Escrow shares returned to treasury on | 800,000             |      |
| Repurchase in the open market         | 40,888              |      |

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|  |            |     |
|--|------------|-----|
| Repurchase of shares from Take1  | 149,459    |     |
| Cancellation of former employee shares   | 45,000     |     |
| Holdback shares as contingent consideration due to performance targets not yet met | 529,848    | (1) |
| Termination with ChinaGoHi   | 825,000    |     |
| Incomplete acquisition of Allink   | 200,000    |     |
| Repurchase of shares from Yueshen  | 24,200     |     |
| Shares sold to the open market   | (41,426)   |     |
| Balance, December 31, 2007   | 2,572,969  |     |
| Shares outstanding at December 31, 2007  | 14,314,072 |     |
| Shares issued at December 31, 2007   | 16,887,041 |     |

(1) Includes shares related to Clickcom acquisition: 78,000 PACT shares; Guangzhou Wanrong acquisition: 138,348 PACT shares; iMobile acquisition: 153,500 PACT Shares; and Pacificnet Games: 160,000 PACT shares.

F-23

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## 10. CONVERTIBLE DEBENTURES

### 10.1 Eight Million Convertible Debentures

On March 13, 2006, we completed a private placement in which we sold \$8,000,000 in convertible debentures and issued warrants to purchase up to an aggregate of 400,000 shares of common stock. The debentures are convertible at any time into shares of our common stock at an initial fixed conversion price of \$10.00 per share, subject to adjustments for certain dilutive events. The debentures are due March 13, 2009. The warrants are exercisable for a period of five years at an exercise price of \$12.20 per share. At the closing of the private placement, we prepaid the first year's interest on debentures equal to 5% of the aggregate principal amount of debentures. We will pay interest in cash or shares, provided that certain conditions are met, at the rate of 6% for the second year the debentures are outstanding and then 7% for the third. Beginning January 1, 2007, we are obligated to redeem up to \$320,000 every month, plus accrued, but unpaid interest, liquidated damages and penalties. We also have the option to prepay the debentures at any time, provided that certain conditions have been met, after the 12 month anniversary of the effective date of the registration statement that has been filed with the Securities and Exchange Commission with respect to the common stock issuable upon conversion of the debentures, some or all of the outstanding debentures for cash in an amount equal to 120% of the principal amount outstanding, plus accrued, but unpaid interest, liquidated damages and penalties outstanding. At any time after the nine months anniversary of the effective date of the registration statement, we may force the holders to convert up to 50% of the then outstanding principal amount of the debentures, subject to certain trading conditions being met. If any event of default occurs under the debentures or other related documents, the holders may elect to accelerate the payment of the outstanding principal amount of the debenture, plus accrued, but unpaid interest, liquidated damages and penalties, which shall become immediately due and payable.

Under the terms of a registration rights agreement entered into at the time of the private placement, the Company was obligated to file a registration statement with respect to the shares issuable under the debenture and the warrants by April 30, 2006, and have the registration statement declared effective by the SEC no later than June 28, 2006. Due to various factors, the Company did not file the registration statement until May 15, 2006, and it was not declared effective until December 8, 2006. Therefore, under the terms of the registration rights agreement, the Company was obligated to pay liquidated damages to the investors at the rate of 2% of the principal amount of the debenture each month beginning on June 28, 2006 until the effectiveness of the registration statement, which was equal to \$1,120,000, in the aggregate.

In February 2007, upon reaching an agreement on the amount and payment of accrued liquidated damages, the Company signed a Settlement and Release Agreement with each of the investors. Under the terms of the Settlement and Release Agreements, the Company paid an aggregate \$140,000 in cash as satisfaction in full of liquidated damages owed to Basso Fund Ltd., Basso Multi-Strategy Holding Fund Ltd., and Basso Private Opportunities Holding Fund Ltd. Partial liquidated damages owed to Whalehaven Capital Fund Ltd. were paid in the amount of \$35,000 in cash, with the remaining liquidated damages in the amount of \$105,000 paid in the form of a new convertible debenture due February 2009, on substantially the same terms as the original debentures, except that interest only is paid on the new debentures until October 2008 and beginning in November 2008 until February 2009, when the new debentures are due, the monthly redemption amount under the new debentures shall be equal to \$315,000. The remaining investors also agreed to accept the aggregate \$840,000 in liquidated damages owed to them in the form of the new convertible debentures for the amount of their respective portion of the liquidated damages. The Company also agreed to amend the original debentures to shorten the term for payment of the original principal amount to a 22 month term. As a result the monthly redemption amount for the original debenture increased from \$320,000 to \$363,638. All other terms and conditions of the original debenture remain in full force and effect.

C.E. Unterberg, Towbin L.L.C. acted as placement agent and received a negotiated cash fee in the amount of \$449,500 and a warrant to purchase up to 16,000 shares at an exercise price of \$12.20 per share, which expire five years from the date of issuance. The fair value of these warrants totaled \$28,141. Such amount was charged to other

assets, net, and credited to additional paid-in capital and will be amortized over the life of the debentures. Maxim Group also acted as Placement Agent and received a cash fee in the amount of \$50,000.

F-24

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In connection with the issuance of the debentures, the Company incurred \$1,106,135 of issuance costs, which primarily consisted of investment banker fees, legal and other professional fees. These costs have been recorded as additional expense during year 2006.

**CHANGE IN ACCOUNTING PRINCIPLE:** On January 1, 2007, the Company adopted FSP EITF 00-19-2 and reclassified warranty liability to equity thru cumulative – effect adjustment to the opening balance of retained earnings/loss by \$213,000.

The FSP states that for registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to the issuance of the FSP and that continue to be outstanding at the beginning of the period of adoption, transition shall be achieved by reporting a change in accounting principle through a cumulative effect adjustment to the opening balance of retained earnings, or other appropriate component of equity or net assets in the statement of financial position, in the first interim period of the fiscal year in which this FSP is initially applied. No prior period information is retrospectively adjusted following the transition provisions of FSP.

#### EVENT OF DEFAULT

On March 16, 2007 our predecessor auditor withdrew their opinion on our previously filed financial statements for the years ended December 31, 2005, December 31, 2004 and December 31, 2003. As a result, on March 27, 2007, we notified the holders of the outstanding convertible debenture that we suspended use of the prospectus contained in our Registration Statement on Form S-1 (File No. 333-134127) that was declared effective on December 8, 2006, due to the lack of fiscal year end 2005 and 2004 audited financial statements and that they must cease selling under the prospectus. The suspension of the use of the prospectus after April 17, 2007, triggered an event of default under the registration rights agreement and the convertible debentures, and if any of the holders so elect, they could accelerate and demand payment under the debentures, in accordance with the registration rights agreement based on the following provisions.

- a) "If, during the Effectiveness Period, either the effectiveness of the Registration Statement lapses for any reason or the Holder shall not be permitted to resell Registerable Securities under the Registration Statement for a period of more than 20 consecutive Trading Days or 60 non-consecutive Trading Days during any 12 month period, the Company has to pay 'Mandatory Default Amount' as the sum of (i) the greater of (A) 130% of the outstanding principal amount of this Debenture, plus all accrued and unpaid interest hereon, or (B) the outstanding principal amount of this Debenture, plus all accrued and unpaid interest hereon, divided by the Conversion Price on the date the Mandatory Default Amount is either (a) demanded (if demand or notice is required to create an Event of Default) or otherwise due or (b) paid in full, whichever has a lower Conversion Price, multiplied by the VWAP on the date the Mandatory Default Amount is either (x) demanded or otherwise due or (y) paid in full, whichever has a higher VWAP, and (ii) all other amounts, costs, expenses and liquidated damages due in respect of this Debenture."
- b) "If any Event of Default occurs, the outstanding principal amount of this Debenture plus accrued but unpaid interest, liquidated damages and other amounts owing in respect thereof through the date of acceleration, shall become, at the Holder's selection, immediately due and payable in cash at the Mandatory Default Amount. Commencing 5 days after the occurrence of any Event of Default that results in the eventual acceleration of this Debenture, the interest rate on this Debenture shall accrue at an interest rate equal to the lesser of 18% per annum or the maximum rate permitted under applicable law."

Due to the provisions mentioned above and as per the terms of the Debenture, the Company has reclassified the principal amount of the Debenture of \$8,000,000 (remaining balance: \$4,864,000) and the principal amount of the new Debenture of \$945,000 and the interest accrued thereon to current liabilities.

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The Company accrued 2% as liquidated damages and 30% as mandatory default amount from the date of ineffectiveness of registration statement as follows:

| (\$,000)           | December 31, 2007 |          |
|--------------------|-------------------|----------|
| Liquidated damages | 2%                | \$ 450   |
| Mandatory default  | 30%               | 2,247    |
| Total              |                   | \$ 2,697 |

Such amounts have been recorded as liquidated damages liability as of December 31, 2007.

Following is the summary of convertible debenture:

| (\$,000)                  | \$8 Million<br>convertible<br>debenture | \$945,000<br>convertible<br>debenture | Total    |
|---------------------------|---|---------------------------------------|----------|
| Balance December 31, 2006 | \$ 8,000                                | \$ 945                                | \$ 8,945 |
| Principal payment:        |   |                                       |          |
| Redemption through shares | (1,091)                                 | -                                     | (1,091)  |
| Cash payment              | (2,045)                                 |                                       | (2,045)  |
| Balance December 31, 2007 | \$ 4,864                                | \$ 945                                | \$ 5,809 |

The Company issued 199,444 shares to redeem \$1,090,909 of convertible note as of December 31, 2007.

F-25

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## 10.2 Five Million Convertible Note

On February 7, 2007, PacificNet Games Limited (PactGames), a 51% owned subsidiary of the Company, entered into a definitive \$5 million convertible secured note financing agreement with Pope Asset Management, LLC (Pope), an institutional investor. Proceeds of the financing are to provide PactGames with additional working capital to expand its gaming technology operations, to make further synergistic acquisitions in China and for general corporate purposes.

The \$5 million convertible secured note issued to Pope matures on February 6, 2010. Subject to reaching certain net income milestones during fiscal year 2007, the note is convertible into an equity interest of PactGames ranging between 26% and 32%. The interest rate of the convertible note has initially been set at 8%, and shall increase to 15% if the note is not converted prior to maturity.

In connection with the issuance of the note, PactGames incurred issuance costs of \$274,667, which primarily consisted of investment banker fees, legal and other professional fees. These costs have been capitalized and will be amortized over three years, the life of the note. Interest accrual as of December 31, 2007 amounted to \$498,288.

Following is the summary of convertible debenture:

|                            |          |
|----------------------------|----------|
|                            | December |
|                            | 31, 2007 |
| (\$,000)                   |          |
| Convertible debenture      | \$ 5,000 |
| Accrued interest           | 499      |
| Unamortized financing cost | (275)    |
| Balance December 31, 2007  | \$ 5,224 |

## 11. INCOME TAXES

The Company is registered in the State of Delaware and has operations in primarily three tax jurisdictions - the PRC, Hong Kong and the United States.

The components of income before income taxes are as follows:

|  |             |             |            |
|--|-------------|-------------|------------|
|  | 2007        | 2006        | 2005       |
| Income subject to PRC                              | \$ (353)    | \$ 1,620    | \$ 1,308   |
| Income (Loss) subject to Hong Kong                 | (8,743)     | (8,098)     | (4,451)    |
| Income (Loss) subject to United States             | (5,092)     | (5,961)     | (1,947)    |
| Income (Loss) before taxesx                        | (14,188)    | (12,439)    | (5,090)    |
| Less: income taxes                                 | (7)         | (18)        | (55)       |
| Net Income (Loss) available to common stockholders | \$ (14,195) | \$ (12,457) | \$ (5,145) |

### United States of America

For operations in the USA, the Company is subject to United States federal income tax at a rate of 34%. The Company has incurred net accumulated operating losses for income tax purposes and there is no provision for U.S. federal income tax for 2007, 2006 and 2005 due to the Company's loss position. The Company believes that it is more likely than not that these net accumulated operating losses will not be utilized in the future because the Parent company is a holding company with foreign subsidiaries and does not generate income. Therefore, the Company has provided full valuation allowance for the deferred tax assets arising from the losses as of December 31, 2007, 2006 and 2005.



The following table sets forth the significant components of the deferred tax assets for operation in the United States of America as of December 31, 2007, 2006 and 2005.

|                            | 2007  | 2006  | 2005  |
|----------------------------|-------|-------|-------|
| Deferred tax asset credit: |       |       |       |
| Federal                    | 34%   | 34%   | 34%   |
| State                      | 6%    | 6%    | 6%    |
| Valuation allowance        | (40)% | (40)% | (40)% |
|                            | 0%    | 0%    | 0%    |

#### Hong Kong

Hong Kong profits tax has been provided at a rate of 17.5% on the estimated assessable profits arising in Hong Kong for each of the years ended December 31, 2007, 2006 and 2005. Provision for Hong Kong profits tax for 2007, 2006 and 2005 was approximately \$4,000, \$18,000 and \$0 respectively.

#### PEOPLE'S REPUBLIC OF CHINA (PRC)

Pursuant to the PRC Income Tax Laws, the Company's subsidiaries and VIEs are generally subject to Enterprise Income Taxes ("EIT") at a statutory rate of 33%, which comprises 30% national income tax and 3% local income tax. Some of these subsidiaries and VIEs are qualified new technology enterprises and under PRC Income Tax Laws, they are subject to a preferential tax rate of 15%. In addition, some of the Company's subsidiaries are Foreign Investment Enterprises and under PRC Income Tax Laws, they are entitled to either a three-year tax exemption followed by three years with a 50% reduction in the tax rate, commencing the first operating year, or a two-year tax exemption followed by three years with a 50% reduction in the tax rate, commencing the first profitable year. Provision for PRC business tax expense for 2007 was \$3,000, 2006 was zero (reclassified to discontinued operations) and 2005 was \$28,000.

No provision for deferred tax liabilities has been made, since the Company had no material temporary differences between the tax bases of assets and liabilities and their carrying amounts.

## 12. RELATED PARTY TRANSACTIONS

### LOAN DUE TO AND FROM RELATED PARTIES

As at the years ended December 31, 2007 and 2006, there was a total loan receivable of approximately \$2,273,000 and \$2,991,000 respectively due from related parties while the loan due to related party was \$0 and \$282,000.

As of December 31, 2006, the related party loan receivables included \$1,026,000 due from Take 1, \$196,000 due from MOABC, \$1,101,000 due from PACT Power, \$159,000 due from PactSo-HK, \$25,000 due from PACT AD, and \$484,000 due from shareholders and directors of certain of the Company's subsidiaries in connection with the acquisition of these subsidiaries. The loans receivable from shareholders and directors of these subsidiaries is comprised of \$356,000 due from a shareholder of Yueshen and \$128,000 due from a director of Soluteck.

As of December 31, 2007 the related party loans receivable included \$781,000 due from PACT Power, \$523,000 due from MOABC, \$625,000 due from PACT Linkhead, \$15,000 due from PACT AD, \$150,000 due from PACT Solution, and \$179,000 due from shareholders and directors of certain of the Company's subsidiaries in connection with the acquisition of these subsidiaries. The loans receivable from shareholders and directors of these subsidiaries are comprised of \$115,000 due from a shareholder of Victor Choi and \$64,000 due from a director of Soluteck.

The terms of these related parties loan receivables and payables are summarized below:



#### LOAN TO POWER

PactPower is an affiliated company, 15% owned by PacificNet, as of December 31, 2007. A convertible loan of \$781,000 is outstanding from PactPower. The maturity date of loan was September 9, 2007. Within ninety (90) days overdue, an additional interest charge of 5% per annum will be levied as a penalty. The loan is received approximately \$128,000 on January 2008.

#### LOAN TO MOABC

MOABC is an affiliated company and is 15% owned by PacificNet as of December 31, 2007. A convertible loan of \$523,000 is outstanding from MOABC as of December 31, 2007. The maturity date of loan is January 1, 2009.

#### LOAN TO LINKHEAD

Linkhead is an affiliated company, 15% owned by PacificNet, as of December 31, 2007. A convertible loan of \$625,000 is outstanding from Linkhead. The maturity date of loan is January 1, 2008.

#### LOAN TO PACIFICNET AD

PACIFICNET AD is an affiliated company, 19% owned by PacificNet as of December 31, 2007. A convertible loan of \$15,000 is outstanding from AD and is received on March 2008.

#### LOAN TO PACIFICNET SOLUTION LIMITED (PacSo-HK)

PacSo-HK is an affiliated company, 15% owned by PacificNet, as of December 31, 2007. A convertible loan of \$150,000 is outstanding from PactSo-HK. The maturity date of loan was January 6 2007. The loan is currently due on demand, non-interest bearing and unsecured.

#### LOAN TO VICTOR CHOI SHAREHOLDER

As of December 31, 2007, there was a loan outstanding of \$115,000 receivable from the shareholder of Victor Choi. This loan is secured by 30,000 PacificNet shares. The maturity date of loan was August 31, 2007. The loan is currently due on demand and non-interest bearing.

#### LOAN TO SOLUTECK'S DIRECTOR

As of December 31, 2007, there was a loan outstanding of \$64,000 receivable from a director of Soluteck, due on January 17 for three consecutive years ending 2008. The interest rate for the loan is 8% per annum plus 5% penalty interest in case it has not been timely paid. The loan is collateralized with 100,000 PacificNet's shares owned by the borrowing director and Ms Iris Lo, and the remaining assets of Smartime Holding Ltd.

## LOAN PAYABLE TO RELATED PARTY

As of December 31, 2007, there was no outstanding loan payable to related parties.

As of December 31, 2006, a loan of \$282,000 was payable to a shareholder of Smartime. The loan was advanced to Smartime for working capital purposes.

## 13. SEGMENT INFORMATION

SFAS No. 131, DISCLOSURE ABOUT SEGMENTS OF AN ENTERPRISE AND RELATED INFORMATION ("SFAS 131"), establishes standards for reporting information about operating segments and for related disclosures about products, services and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision-maker, or decision-making group, in making decisions regarding allocation of resources and assessing performance. PacificNet's chief decision-makers, as defined under SFAS 131, are the Chief Executive Officer and Chairman. During 2007 and 2006, PacificNet had four operating segments.

The Company's reportable segments are operating units, which represent the operations of the Company's significant business operations. Summarized financial information concerning the Company's reportable segments is shown in the following table. The "Other" column includes the Company's other insignificant services and corporate related items, and, as it relates to segment profit (loss), income and expense not allocated to reportable segments.

| For the year ended<br>December 31, 2007<br>(in thousands of US<br>Dollars, except<br>percentages) | Group 1.<br>Outsourcing<br>Services | Group 2.<br>Telecom<br>Value-Added<br>Services | Group 3.<br>Products<br>(Telecom &<br>Gaming) | Group 4.<br>Other<br>Business | Total            |
|---|-------------------------------------|--|---|-------------------------------|------------------|
|   | (\$)                                | (\$)   | (\$)  | (\$)                          | (\$)             |
| Revenues  | 2,310                               | 1,839  | 14,528  | 317                           | 18,994           |
| (% of Total Revenues)   | 12%                                 | 10%  | 76%   | 2%                            | 100%             |
| Earnings / (Loss) from<br>Operations  | (544)                               | 737  | (6,133)                                       | (10,487)                      | (16,427)         |
| (% of Total Profit)   | 3%                                  | (4)%   | 37%   | 64%                           | 100%             |
| Total Assets  | 1,490                               | 2,516  | 16,512  | 4,202                         | 24,720           |
| (% of Total Assets)   | 6%                                  | 10%  | 67%   | 17%                           | 100%             |
| Goodwill  | -                                   | 461  | 409   | -                             | 870              |
| Geographic Area   | HK,PRC                              | HK, PRC  | HK,PRC,Macau                                  | HK,PRC                        |                  |
| For the year ended<br>December 31, 2006<br>(in thousands of US<br>Dollars, except<br>percentages) | Group 1.<br>Outsourcing<br>Services | Group 2.<br>Telecom<br>Value-Added<br>Services | Group 3.<br>Products<br>(Telecom &<br>Gaming) | Group 4.<br>Other<br>Business | Total            |
|   | Restated<br>(\$)                    | Restated<br>(\$)                               | Restated<br>(\$)                              | Restated<br>(\$)              | Restated<br>(\$) |
| Revenues  | 1,813                               | 2,784  | 23,385  | 1,091                         | 29,073           |
| (% of Total Revenues)   | 6%                                  | 10%  | 80%   | 4%                            | 100%             |
|   | (67)                                | (1,054)  | (1,345)                                       | (4,969)                       | (7,435)          |

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|                                   |        |         |              |        |        |
|-----------------------------------|--------|---------|--------------|--------|--------|
| Earnings / (Loss) from Operations |        |         |              |        |        |
| (% of Total Profit)               | 1%     | 14%     | 18%          | 67%    | 100%   |
| Total Assets                      | 3,413  | 12,673  | (1,570)      | 18,155 | 32,671 |
| (% of Total Assets)               | 10%    | 39%     | (5)%         | 56%    | 100%   |
| Goodwill                          | 3,964  | 461     | 1,176        | -      | 5,601  |
| Geographic Area                   | HK,PRC | HK, PRC | HK,PRC,Macau | HK,PRC |        |

F-29

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The Company identifies and classifies its operating segments based on reporting entities that exhibit similar long-term financial performance based on the nature of the products and services with similar economic characteristics such as margins, business practices and target market. The operating segments are classified into four major segments which are summarized as follows:

(1) Outsourcing Services - involves human voice services such as Business Process Outsourcing, CRM, call center, IT Outsourcing and software development services. These types of services are conducted through our subsidiaries Smartime/Soluteck-PactSo.

(2) Telecom Value-Added Services (VAS) - Our subsidiary, Guangzhou Wanrong Information Technology Co., Ltd. ("Guangzhou Wanrong"), is one of the leading value-added telecom service providers in China. Since its inception in 2003, Guangzhou Wanrong has achieved strong growth in its VAS including SMS, WAP, JAVA, MMS, IVR, multimedia entertainment download services, media interactive products, mobile email services, life, sports, entertainment, and business information services.

(3) Product (Telecom & Gaming) Services Group - involves communication and gaming products, GSM/CDMA/3G Products, Multimedia Communication Kiosks. This Group includes the following subsidiaries: PacificNet Communications Limited, iMobile, Take1 and PacificNet Games. PacificNet Games Limited (PactGames) is a leading developer of Asian electronic gaming machines, multi-player electronic gaming technology solutions and gaming related maintenance, IT, and distribution services for the leading hotel and casino operators based in the Macau and other Asian gaming markets. Take1 Technologies (Take 1), is in the business of designing and manufacturing electronic multimedia entertainment kiosks, coin-op kiosks and machines, Electronic Gaming Machines (EGM), bingo and slot machines, AWP (Amusements With Prizes) games, server-based downloadable games systems, and Video Lottery Terminals (VLT) such as Keno and Bingo machines, including hardware, software, and cabinets.

(4) Other Business - other administrative, financial and investment services and non-core businesses.

Product and service revenues classified by major geographic areas are as follows (in thousands of US Dollars):

|                                      | Hong Kong | PRC      | Macau    | United States | Total     |
|--------------------------------------|-----------|----------|----------|---------------|-----------|
| For the year ended December 31, 2007 |           |          |          |               |           |
| Product revenues                     | \$ 5,447  | \$ 6,770 | \$ 2,311 | \$ -          | \$ 14,528 |
| Service revenues                     | \$ 261    | \$ 4,205 | \$ -     | \$ -          | \$ 4,466  |

|                                      | Hong Kong | PRC      | Macau  | United States | Total     |
|--------------------------------------|-----------|----------|--------|---------------|-----------|
| For the year ended December 31, 2006 |           |          |        |               |           |
| Product revenues                     | \$ 17,071 | \$ 7,147 | \$ 364 | \$ -          | \$ 24,582 |
| Service revenues                     | \$ 1,228  | \$ 3,263 | \$ -   | \$ -          | \$ 4,491  |

#### 14. NET ASSETS HELD FOR DISPOSITION

Sale of Interest in Linkhead Technology Beijing Limited. ("Linkhead") and PacificNet Telecom Solutions Inc. ("PactTelso")

On May 20, 2007, the Company entered into a definitive agreement to sell its 36% equity interest in Linkhead, a PRC limited liability corporation engaged in the business of resale of VAS, IVR, NMS hardware and software platforms in China, to Mr. Mu Yingliang, a resident of People's Republic of China.

On May 20, 2007, the Company entered into a definitive agreement to sell its 36% equity interest in PactTelso, an intermediate holding company registered under the laws of British Virgin Islands, to Mr. Mu Yingliang, a resident of

People's Republic of China.

Consideration for the 36% interest of Linkhead and PactTelso was US\$500,000, to be paid in three installments. The Company's interest in Linkhead and PactTelso was decreased from 51% to 15% after the transaction. Absent any explicit closing conditions contained in the said agreement, the disposal was completed upon title transfer during the third quarter of 2007.

F-30

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Sale of Interest in PacificNet Solutions Limited ("PacSo-HK")

On May 18, 2007, the Company entered into a definitive agreement to sell its 45% equity interest in PacSo-HK, a company registered under the laws of Hong Kong SAR, China and engaged in systems integration, software application, and e-business solutions services, to Mr. Alex Au, a resident of Hong Kong SAR, China. Consideration for the 45% interest of PacSo-HK was HK\$4,500 (or US\$577), to be paid within 90 days after signing of the agreement. The Company's interest in PacSo-HK decreased from 60% to 15% after the transaction. Absent any explicit closing conditions contained in the said agreement, the disposal was completed upon title transfer during the third quarter of 2007.

Sale of Interest in PacificNet Power Limited ("PactPower")

On May 18, 2007, the Company entered into a definitive agreement to sell its 36% equity interest in PactPower, a company registered under the laws of Hong Kong SAR, China and engaged in power and energy saving contracting and consulting businesses, to Mr. Alex Au, a resident of Hong Kong SAR, China. Consideration for the 36% interest of PactPower was HK\$3,600 (or US\$462), to be paid within 90 days after signing of the agreement. The Company's interest in PactPower decreased from 51% to 15% after the transaction. Absent any explicit closing conditions contained in the said agreement, the disposal was completed upon title transfer during the third quarter of 2007.

Sale of Interest in MOABC.com ("MOABC")

On May 20, 2007, the Company entered into a definitive agreement to sell its 5% equity interest in MOABC, a PRC limited liability corporation engaged in the business of value-added services platform providing, to Mr. Jack Ou, a resident of People's Republic of China. Consideration for the 5% interest of MOABC was RMB5,000 (or US\$647), to be paid within 90 days after signing of the agreement. The Company's interest in MOABC decreased from 20% to 15% after the transaction.

Sale of Interest in PacificNet Clickcom Limited ("Clickcom")

On December 18, 2007, the Company entered into a definitive agreement to sell its 36% entire interest in PacificNet Clickcom Limited. ("Clickcom"), a leading Value-Added Services (VAS) company in China, to Mr. Ou Zhenbin, a Chinese resident. Consideration for the 36% interest of Clickcom was RMB10,000 (or US\$1,314), to be paid in cash within 90 days after the agreement signing. The Company's interest in Clickcom decreased from 51% to 15% after the transaction.

Sale of Interest in Guangzhou 3G Information Technology Co., Ltd. ("Guangzhou 3G")

On April 30, 2007, through our wholly-owned subsidiary, PacificNet Strategic Investment Holdings Limited ("PSI Holdings"), we entered into a stock purchase and sale agreement with Heyspace International Limited to sell PSI Holdings' 51% interest in Guangzhou 3G's parent company, Pacific 3G Information & Technology Co. Limited. The purchase price is \$6,000,000 payable in installments over a six month period or earlier if Heyspace completes its initial public offering prior to October 31, 2007. Heyspace paid an initial purchase price of \$1,000,000 and the remaining balance to be paid by October 2007. Due to non payment of the remaining balance by Heyspace as per the agreement, the Company on November 25, 2007 entered into a memorandum of understanding ("MOU") with Heyspace. Pursuant to the MOU, we agreed with Heyspace that for a period commencing on November 25, 2007 through March 31, 2008, we are free to seek new buyers to purchase PSI Holdings' share ownership in Guangzhou 3G at a consideration and term which at a minimum will not cause any disposal loss to us. As at December 31, 2007, Heyspace owns Pacific 3G.



## Sale of Interest in PacificNet Epro Holdings Limited ("Epro")

On April 18, 2008, PacificNet, consummated the sale of the Company's subsidiary, PacificNet Epro Holdings Limited, a company incorporated in the Hong Kong Special Administrative Region of the PRC ("Epro"), which is primarily engaged in the business of providing call center telecom and customer relationship management services as well as other business outsourcing services in China. Pursuant to the terms of the Sales and Purchase Agreement (the "Agreement") entered into between the Company and Epro Group International Limited (the "Epro Group International"), PacificNet sold its entire share ownership of 7,766,993 shares in Epro for HK\$21 million. Upon execution of the Agreement, the Company received a payment of HK\$3 million. PacificNet shall receive the remaining purchase price in installments over the next twenty-four months. Pursuant to the terms of the Agreement, within sixty days of the closing, Epro shall repay PacificNet HK\$2 million for an interest bearing loan granted from PacificNet to Epro. As at December 31, 2007, PacificNet Epro Holdings is classified under 'Net Assets Held for Disposal' in the accompanying financial statements.

Information relating to the operations of the subsidiaries up to the periods of disposal/held for disposal during the year ended December 31, 2007 is as follows (in thousands of US Dollars)

| 2007 (In US\$ thousands)                             | Linkhead +PacTelso (\$) | Clickcom (\$) | Power (\$) | Solutions (\$) | 3G (\$) | EPRO (\$) | AD (\$) | Total (\$) |
|--|-------------------------|---------------|------------|----------------|---------|-----------|---------|------------|
| Income (loss) from discontinued operations           | (84)                    | 41            | (478)      | (10)           | (228)   | 491       | (50)    | (318)      |
| Gain on disposal                                     | 244                     | 60            | 1,274      | 218            | 333     | -         | 53      | 2,181      |
| Net assets held for disposition (remaining interest) | -                       | -             | -          | -              | -       | 2,692     | -       | 2,692      |

## 15. LEGAL PROCEEDINGS

## 1. Johnson Controls Hong Kong Limited (JCHKL) vs. PacificNet Power Limited

On January 19, 2007, Johnson Controls Hong Kong Limited filed a civil claim against PacificNet Power Limited (a 51% owned subsidiary of PacificNet) in the High Court of the Hong Kong Special Administrative Region seeking HK\$4,800,000 as payment for services rendered to replace 3 sets of rain water-cooled chillers, together with energy saving performance (the "Chiller System"), at the Fortress Tower in Hong Kong.

In connection with the claim, PacificNet Power reviewed a letter from its client, China Weal Property Management Ltd., dated January 22, 2007 stating that the construction work by JCHKL had not been completed as of the date of the letter, and that certain violations itemized in a letter issued by the Hong Kong Environment Protection Department (EPD) (Noise Abatement Notice No. N806030) addressed to JCHKL with respect to acoustic problems with JCHKL's equipment had not been abated.

The board of directors of PacificNet Power Limited has reviewed the case with its client, China Weal Property Management Ltd., and our Hong Kong legal counsel and it is the honest belief of the board that the project work undertaken JCHKL is defective in numerous aspects. As a result, the board believes that the construction work has not been completed by JCHKL, and therefore, JCHKL is not entitled to payment for its services.

On February 13, 2007, the board instructed the Hong Kong legal counsel to issue a Defense and Counterclaim to JCHKL to counter-claim that ( i ) JCHKL's construction work has not complied with the applicable rules and

regulations of various government authorities in Hong Kong; (ii) the Chiller System provided by JCHKL was defective and merchantable unfit and JCHKL has failed and/or refused to rectify such defective works; and (iii) JCHKL shall return the work deposit in the amount of HK\$1,500,000 to PacificNet Power Limited and shall compensate and keep PacificNet Power Limited indemnified against all the loss and damages suffered as a result of any claims from the China Weal Property Management Ltd..

The case is now in the discovery stage before proceeding to the stage of fixing a date for trial in the High Court of Hong Kong and the board intends to vigorously defend against the allegations. We are unable to predict the outcome of these actions, or a reasonable estimate of the range of possible loss, if any.

F-32

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## 2. PacificNet Power Limited vs Johnson Controls Hong Kong Limited (JCHKL)

On or about December 2005, Johnson Controls Hong Kong Limited approached PacificNet Power Limited (a 51% owned subsidiary of PacificNet) and made a representation that they had submitted a tender to “The Incorporated Owners of Nan Fung Centre, Tsuen Wan (“the Employer”) for the “construction and replacement works of existing air-cooled chiller plant by new water-cooled chiller plant for Tsuen Wan Nan Fung Centre and energy saving performance contract” (“the Contract”). JCHKL invited and induced PacificNet Power Limited to act as the main contractor for the Contract and it would then act as a sub-contractor.

PacificNet Power also expressly made known to JCHKL that the said construction and replacement works and the guaranteed energy saving should meet all the tender requirements if PacificNet Power accepted the invitation to act as the main contractor for the Contract, and PacificNet Power further said that if there should be any quality defects with the system and/ or the construction work, the Employer and/ or their prospective tenants would claim against JCHKL and JCHKL should compensate.

PacificNet Power however received some correspondences and complaints from the Employer about the poor and/ or sub-standard works done by JCHKL. PacificNet Power, after separate investigation, discovered the poor workmanship and sub-standard works done by JCHKL. Accordingly, the Employer and/ or their representatives have delayed the monthly installments payment to PacificNet Power.

On April 23, 2007, PacificNet Power instructed the Hong Kong lawyers to issue a letter to the Defendant requesting and demanding them, being the sub-contractor of the Construction and Replacement Works Contract, to take immediate rectification action within seven days from the date of the said letter to (i) rectify and complete all outstanding defective works of the Construction and Replacement Works Contract; (ii) replace the water-cooled chiller plant and/or equipments which are not conformed with the requirements of the tender documents previously submitted by the Defendant to the Employer; and (iii) improve the poor performance of energy saving of the new water-cooled chiller plant.

Despite the said letter, JCHKL had failed and/ or refused to rectify and complete all outstanding works and/ or replace the defective system. And therefore PacificNet Power claims against JCHKL for: (i) refund HK\$6,414,300.00, being the Contract Price paid by PacificNet Power to JCHKL; (ii) costs and expenses incurred by PacificNet Power to rectify all defective works of the Contract; (iii) all damage and loss suffered by PacificNet Power, and further and other relief.

On July 25, 2007, JCHKL issued a Defense and Counterclaim to PacificNet Power to argue that: (i) they had carried out the works according to the Contract terms; (ii) the works had been approved by PKL Consultants Limited, the consultant representative of the Employer; and (iii) a sum of HK\$30,000 is still due and owing by PacificNet Power to JCHKL.

The case is now in the discovery stage before proceeding to the stage of fixing a date for trial in the High Court of Hong Kong. We are unable to predict the outcome of these actions, or a reasonable estimate of the range of possible loss, if any.

## 3. PacificNet Inc. vs. HLB Hodgson Impey Cheng (HLB or Defendant), a firm of Chartered Accountants and Certified Public Accountants in Hong Kong

On September 20, 2007, PacificNet Inc. filed a claim against its former auditors HLB Hodgson Impey Cheng (HLB), a firm of Chartered Accountants and Certified Public Accountants, in the High Court of the Hong Kong Special Administrative Region seeking refund of the professional fees, compensation of professional fees and expenses for Company to engage and deploy new auditors to take over the incomplete audit works from the Defendant and

returning and/or providing all relevant accounting records, vouchers, audit program and working papers retained by the Defendant and losses and damages incurred.

The case is now in the pleadings stage. We are unable to predict the outcome of these actions, or a reasonable estimate of the range of possible loss, if any.

4. Iroquois Master Fund, Ltd. vs. Pacificnet Inc.

On or about October 3, 2007 Iroquois Master Fund, Ltd. filed a complaint in the Supreme Court of the State of New York against PacificNet Inc., claiming that the Company is in default under the Amended and Restated Convertible Debenture due March 2009 (the Amended Debenture”) in the principal amount of \$3,000,000 and the Convertible Debenture due February 2009 (the New Debenture”) in the principal amount of \$420,000.

F-33

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Iroquois Master Fund, Ltd. is seeking damages of \$3,253,163.80 in the aggregate, together with any accrued but unpaid interest through the date of judgment. Iroquois Master Fund, Ltd. has also demanded reimbursement of its attorney fees and other costs and expenses incurred together with costs and disbursements of this action.

On or about December 5, 2007, PacificNet filed its answer denies that PacificNet is in default and assert an agreement that would enable it to bring the interest payments up to date by the issuance of stock in the near future.

On March 27, 2008, three holders of PACT's Convertible Subordinated Debentures filed an involuntary petition for Chapter 11 relief in federal bankruptcy court late Saturday, March 22, 2008 in Wilmington, DE. The Company has retained counsel to oppose the filing because the petition fails to meet the standard for invoking an involuntary bankruptcy and fails to take into consideration other agreements between the Company and the petitioning creditors. The Company intends to vigorously oppose the petition and move for dismissal of the filing, and if successful will seek damages and attorney fees. Subsequently, PACT also received default notice from all but one of the debentureholder including Iroquois Master Fund Ltd., Alpha Capital AG, Whalehaven Capital Fund Limited, DKR Soundshore Oasis Holding Fund Ltd., Basso Fund Ltd., Basso Multi-Strategy Holding Fund Ltd., and Basso Private Opportunities Holding Fund Ltd. from the same Convertible Subordinated Debentures related to the private offering of \$8,000,000 principal amount variable debentures consummated on March 13, 2006, and due March 2009.

PACT has retained counsel to oppose the above petition. The amount of the debt in question is as follows: Iroquois Master Fund Ltd. \$2.5 million, Whalehaven Capital Fund Limited \$958,000, Alpha Capital AG \$685,000 DKR Soundshore Oasis Holding Fund Ltd \$960,000, and Basso Fund Ltd., Basso Multi- Strategy Holding Fund Ltd., and Basso Private Opportunities Holding Fund Ltd., a combined amount of \$500,000.

## 16. CURRENT VULNERABILITY DUE TO CERTAIN CONCENTRATIONS

The Company's operations are carried out in the PRC. Accordingly, the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environments in the PRC, by the general state of the PRC's economy. The Company's business may be influenced by changes in governmental policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation, among other things.

## 17. EVENTS SUBSEQUENT TO DECEMBER 31, 2007

### 1) STATUS OF ACQUISITION OF OCTAVIAN INTERNATIONAL LIMITED ("OCTAVIAN")

On January 22 2008, PacificNet Inc. (NASDAQ:PACT) (the "Company" or "PacificNet"), announced the acquisition of Octavian International Limited ("Octavian"), a worldwide supplier of gaming technology, solutions and systems. The Company had previously reported on a Form 8-K filed with the Securities and Exchange Commission on December 13, 2007, the execution of definitive agreements, including that certain Agreement among, PacificNet Games International Corporation, Octavian, Emperor Holdings Limited, Ziria Enterprises Limited and the Company on December 7, 2007, for the acquisition of 100% of Octavian (the "Agreement"). PacificNet, through its wholly-owned subsidiary, Pacificnet Games International Corporation, signed an agreement to acquire from Ziria Enterprises Limited, a company incorporated in Cyprus (the "Seller"), 100% of the issued and outstanding shares (the "Shares") of Emperor Holdings Limited, a company incorporated in Cyprus (the "Holding Company"), which is the parent company of Octavian.

Up to April 14, 2008, Ziria Enterprises Limited did not deliver to PacificNet the share certificates of Emperor Holdings Limited, the legal owner of Octavian International Limited. As a result of Ziria's failure to deliver the share certificates, which was a condition to closing the acquisition of Octavian, on May 21, 2008, the Company, Ziria, PacificNet Games International Corporation, Octavian and Emperor Holdings Limited terminated the agreement to

acquire Octavian. Under the acquisition agreement, if the transaction had been consummated, PacificNet was obligated to issue, in the aggregate, 2,330,000 restricted shares of PACT representing approximately 19.5% of PacificNet's outstanding shares and cash of up to \$18,900,000, which would have been paid upon the completion of certain net profit performance targets.

F-34

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All parties involved have agreed not to complete the merger but will remain distribution partners of complimentary products in each others respective markets.

As a result of the failure of the Octavian acquisition to be consummated and the termination of the acquisition agreement, on May 21, 2008, Mr. Harmen Brenninkmeijer, Chief Executive Officer of Octavian, resigned as a member of the Board of Directors of PacificNet. It was a condition to the closing of the acquisition of Octavian that Mr. Brenninkmeijer was appointed to the Board of Directors. There was no disagreement between Mr. Brenninkmeijer and PacificNet on any matter relating to PacificNet's operations, policies or practices.

## 2) SALE OF INTEREST IN EPRO. ("EPRO")

On April 18, 2008, PacificNet, consummated the sale of the Company's subsidiary, PacificNet Epro Holdings Limited, a company incorporated in the Hong Kong Special Administrative Region of the PRC ("Epro"), which is primarily engaged in the business of providing call center telecom and customer relationship management services as well as other business outsourcing services in China. Pursuant to the terms of the Sales and Purchase Agreement (the "Agreement") entered into between the Company and Epro Group International Limited (the "Epro Group International"), PacificNet sold its entire share ownership of 7,766,993 shares in Epro for HK\$21 million.

Upon execution of the Agreement, the Company received a payment of HK\$3 million. PacificNet shall receive the remaining purchase price in installments over the next twenty-four months.

Pursuant to the terms of the Agreement, within sixty days of the closing, Epro shall repay PacificNet HK\$2 million for an interest bearing loan granted from PacificNet to Epro.

## 3) SALE OF GUANGZHOU 3G

PacificNet and Heyspace entered into a Supplement Agreement for 3G's deal on 20th March, 2008. According to this supplement agreement, PacificNet will apply \$500,000 received as of December 31, 2007 against the 5% ownership interest and the remaining \$500,000 will be served as a collateral along with the transfer of the share certificates of 46% shares to PacificNet from Heyspace. If Heyspace fails to pay the remaining USD\$5,000,000 on or before 31 March, 2009, PacificNet has right to reclaim for the unpaid 46% shares of Pacific 3G Information & Technology Co., Limited, and demand for an annual interest rate of 12% (See note 14 for details). As at December 31, 2007, Company has made a provision of \$3.5 million against receivable from Heyspace and the net amount is included under other receivables in the accompanied financial statements.