

ASIAINFO HOLDINGS INC  
Form 10-Q  
August 09, 2005  
Table of Contents

---

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

---

**FORM 10-Q**

---

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2005

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

FOR THE TRANSITION PERIOD FROM \_\_\_\_ TO \_\_\_\_

Commission File Number 001-15713

---

**ASIAINFO HOLDINGS, INC.**

(Exact name of registrant as specified in its charter)

---

DELAWARE

752506390

Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

**4TH FLOOR, ZHONGDIAN INFORMATION TOWER  
6 ZHONGGUANCUN SOUTH STREET, HAIDIAN DISTRICT  
BEIJING 100086, CHINA**

(Address of principal executive office, including zip code)

**+8610 8216 6688**

(Registrant's telephone number, including area code)

**(Former Name, Former Address and Former Fiscal Year,  
if Changed Since Last Report)**

---

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

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

The number of shares outstanding of the Registrant's common stock as of August 5, 2005 was 46,722,831

**Table of Contents**

ASIAINFO HOLDINGS, INC.

FORM 10-Q

FOR THE QUARTER ENDED JUNE 30, 2005

TABLE OF CONTENTS

	<b><u>Page</u></b>
PART I. <u>FINANCIAL INFORMATION</u>	
Item 1. <u>Financial Statements (unaudited)</u>	3
a) <u>Condensed Consolidated Statement of Operations for the three months and six months ended June 30, 2005 and 2004</u>	3
b) <u>Condensed Consolidated Balance Sheets as of June 30, 2005 and December 31, 2004</u>	4
c) <u>Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2005 and 2004</u>	5
d) <u>Notes to Condensed Consolidated Financial Statements for the six months ended June 30, 2005 and 2004</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	31
Item 4. <u>Controls and Procedures</u>	32
PART II. <u>OTHER INFORMATION</u>	32
Item 1. <u>Legal Proceedings</u>	32
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	33
Item 6. <u>Exhibits and Reports on Form 8-K</u>	34
<u>SIGNATURE</u>	35
<u>Exhibit Index</u>	36

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
<b>Revenues:</b>				
Software products and solutions				
Sales to non-related parties	\$ 14,061	\$ 8,422	\$ 25,859	\$ 17,469
Sales to related parties	2,061	907	6,351	1,532
<b>Total software products and solutions</b>	<b>16,122</b>	<b>9,329</b>	<b>32,210</b>	<b>19,001</b>
Service				
Sales to non-related parties	5,140	5,011	11,439	8,766
Sales to related parties	1,994	1,071	2,455	1,779
<b>Total Service</b>	<b>7,134</b>	<b>6,082</b>	<b>13,894</b>	<b>10,545</b>
Third party hardware				
Sales to non-related parties	3,450	6,149	9,163	22,474
Sales to related parties	378	948	1,250	2,469
<b>Total third party hardware</b>	<b>3,828</b>	<b>7,097</b>	<b>10,413</b>	<b>24,943</b>
<b>Total revenues</b>	<b>27,084</b>	<b>22,508</b>	<b>56,517</b>	<b>54,489</b>
<b>Cost of revenues:</b>				
Software products and solutions (including purchases from related parties of \$42 and \$7 for the three months ended June 30, 2005 and 2004, respectively, and \$86 and \$14 for the six months ended June 30, 2005 and 2004, respectively)				
	8,271	4,339	15,470	8,263
Service (including purchases from related parties of \$10 and \$2 for the three months ended June 30, 2005 and 2004, respectively, and \$50 and \$4 for the six months ended June 30, 2005 and 2004, respectively)				
	4,033	2,726	8,465	4,576
Third party hardware	3,637	6,742	9,893	23,696
<b>Total cost of revenues</b>	<b>15,941</b>	<b>13,807</b>	<b>33,828</b>	<b>36,535</b>

Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Gross profit	11,143	8,701	22,689	17,954
<b>Operating expenses:</b>				
Sales and marketing (including sales and marketing expenses to related parties of \$44 and \$3 for the three months ended June 30, 2005 and 2004, respectively, and \$111 and \$5 for the six months ended June 30, 2005 and 2004, respectively)	4,675	2,982	9,841	5,595
General and administrative (including general and administrative expenses to related parties of \$8 and \$4 for the three months ended June 30, 2005 and 2004, respectively, and \$71 and \$7 for the six months ended June 30, 2005 and 2004, respectively)	3,111	1,514	5,090	3,983
Research and development (including research and development expenses to related parties of \$11 and \$5 for the three months ended June 30, 2005 and 2004, respectively, and \$28 and \$11 for the six months ended June 30, 2005 and 2004, respectively)	2,755	2,292	5,933	4,314
Amortization of acquired intangible assets	427	151	854	329
<b>Total operating expenses</b>	<b>10,968</b>	<b>6,939</b>	<b>21,718</b>	<b>14,221</b>
<b>Income from operations</b>	<b>175</b>	<b>1,762</b>	<b>971</b>	<b>3,733</b>
<b>Other income</b>				
Interest income	811	563	1,619	915
Loss on sales of short-term investments	(11)		(14)	
Other income (expenses), net		1	11	(20)
<b>Total other income, net</b>	<b>800</b>	<b>564</b>	<b>1,616</b>	<b>895</b>
<b>Income before income taxes and equity in loss of an affiliate</b>	<b>975</b>	<b>2,326</b>	<b>2,587</b>	<b>4,628</b>
Income tax expense	146	293	388	581
<b>Income before equity in loss of an affiliate</b>	<b>829</b>	<b>2,033</b>	<b>2,199</b>	<b>4,047</b>
Equity in loss of an affiliate		(4)		(42)
<b>Net income</b>	<b>\$ 829</b>	<b>\$ 2,029</b>	<b>\$ 2,199</b>	<b>\$ 4,005</b>
<b>Net income per share:</b>				
Basic	\$ 0.02	\$ 0.04	\$ 0.05	\$ 0.09
Diluted	\$ 0.02	\$ 0.04	\$ 0.04	\$ 0.08
<b>Shares used in computation:</b>				
Basic	42,463,868	45,404,422	43,855,764	45,352,850
Diluted	48,356,425	46,905,096	49,646,084	47,129,904

See notes to condensed consolidated financial statements.

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

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

	<b>June 30, 2005</b>	<b>December 31, 2004<sup>(1)</sup></b>
	<b>(Unaudited)</b>	
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 85,191	\$ 94,156
Restricted cash	15,461	15,625
Short-term investments	41,750	56,949
Notes receivable (including notes receivable of \$591 and \$2,045 from related parties as of June 30, 2005 and December 31, 2004, respectively)	1,511	6,482
Accounts receivable		
Accounts receivable due from non-related parties (net of allowances of \$3,548 and \$3,497 as of June 30, 2005 and December 31, 2004, respectively)	50,096	44,538
Accounts receivable due from related parties (net of allowances of \$496 and \$147 as of June 30, 2005 and December 31, 2004, respectively)	8,064	13,814
	<u>58,160</u>	<u>58,352</u>
Total accounts receivable	58,160	58,352
Inventories	7,457	7,932
Other receivables (including other receivables of \$195 and \$198 due from related parties as of June 30, 2005 and December 31, 2004, respectively)	3,601	3,917
Deferred income taxes - current	1,826	1,715
Prepaid expenses and other current assets	5,492	4,851
	<u>220,449</u>	<u>249,979</u>
Total current assets	220,449	249,979
Property and equipment-net	2,499	1,895
Goodwill	37,704	37,704
Other acquired intangible assets-net	6,538	7,392
Deferred income taxes	267	394
	<u>\$ 267,457</u>	<u>\$ 297,364</u>
Total Assets	\$ 267,457	\$ 297,364
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Notes payable	\$ 4,971	\$ 5,720
Accounts payable (including accounts payable of nil and \$2,300 due to related parties as of June 30, 2005 and December 31, 2004, respectively)	10,035	16,793
Accrued expenses	14,335	14,701
Deferred revenue (including deferred revenue of \$2,102 and \$1,327 from related parties as of June 30, 2005 and December 31, 2004, respectively)	14,647	15,381
Accrued employee benefits	7,699	7,061
Other payables (including other payables of \$5 and \$135 due to related parties as of June 30, 2005 and December 31, 2004, respectively)	5,434	4,739
Shares payable for acquisition	27,213	27,213
Other taxes payable	1,979	2,142

Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Income taxes payable	1,958	1,822
<b>Total current liabilities</b>	<b>88,271</b>	<b>95,572</b>
<b>Commitments and contingencies (Note 13)</b>		
<b>Stockholders' Equity:</b>		
Common stock (authorized: 100,000,000 shares, \$0.01 par value; shares issued: June 30, 2005:46,642,050; December 31, 2004: 46,473,532; shares issued and outstanding: June 30, 2005: 41,550,117; December 31, 2004: 46,314,706)		
	466	465
Additional paid-in capital	212,062	211,394
Treasury stock at cost (June 30, 2005: 5,091,933 shares; December 31, 2004: 158,826 shares)	(26,248)	(868)
Accumulated deficit	(7,019)	(9,218)
Accumulated other comprehensive (loss) income	(75)	19
<b>Total stockholders' equity</b>	<b>179,186</b>	<b>201,792</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 267,457</b>	<b>\$ 297,364</b>

(1) December 31, 2004 balances were extracted from audited financial statements.

See notes to condensed consolidated financial statements.

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

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

	<b>Six Months Ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
	<b>(unaudited)</b>	
<b>Cash flows from operating activities:</b>		
Net income	\$ 2,199	\$ 4,005
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation	827	757
Amortization of other acquired intangible assets	854	329
Deferred income taxes	17	(2)
Equity in loss of an affiliate		42
Loss on disposal of property and equipment	20	13
Loss on sales of short-term investment	14	
Change in bad debt provision	276	(625)
<b>Changes in operating assets and liabilities:</b>		
Restricted cash	164	(674)
Notes receivable	4,971	3,409
Accounts receivable	(84)	(10,309)
Inventories	475	1,788
Other receivables	511	6,321
Prepaid expenses and other current assets	(1,416)	(897)
Notes payable	(749)	3,036
Accounts payable	(6,758)	(3,567)
Accrued expenses	(366)	1,262
Deferred revenue	(734)	1,004
Accrued employee benefits	639	979
Other payables	349	335
Other taxes payable	612	(570)
Income taxes payable	136	607
	<u>1,957</u>	<u>7,243</u>
<b>Net cash provided by operating activities</b>		
<b>Cash flows from investing activities:</b>		
Decrease in short-term investments	14,601	792
Purchases of property and equipment	(1,452)	(613)
Payment for acquisitions	(169)	(939)
Proceeds from sales of short-term investment	285	
Proceeds from disposal of property and equipment	1	6
	<u>13,266</u>	<u>(754)</u>
<b>Net cash provided by (used in) investing activities</b>		
<b>Cash flows from financing activities:</b>		
Repayment of short-term bank loans		(60)
Proceeds on exercise of stock options	669	1,157
Repurchase of common stock	(24,867)	
	<u>(24,198)</u>	<u>1,097</u>



Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Net cash (used in ) provided by financing activities	(24,198)	1,097
Net (decrease) increase in cash and cash equivalents	(8,975)	7,586
Cash and cash equivalents at beginning of period	94,156	119,395
Effect of exchange rate changes on cash and cash equivalents	10	(3)
Cash and cash equivalents at end of period	\$ 85,191	\$ 126,978

See notes to condensed consolidated financial statements.

**Table of Contents**

**ASIAINFO HOLDINGS, INC.**

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

Six Months Ended June 30, 2005 and 2004

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

**1. BASIS OF PREPARATION**

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

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X, as promulgated by the Securities and Exchange Commission (the SEC). Accordingly, they do not include all of the information and notes required by US GAAP for complete financial statements. However, management believes that the disclosures are adequate to ensure the information presented is not misleading. US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, contingencies and results of operations. While management has based their assumptions and estimates on the facts and circumstances existing at June 30, 2005, final amounts may differ from these estimates.

In the opinion of the management of the Company, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, which are necessary for a fair presentation of the results for the interim period presented. These financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company's audited financial statements on Form 10-K for the fiscal year ended December 31, 2004. The results of operations for the interim periods presented are not indicative of the operating results to be expected for any subsequent interim period or for our fiscal year ending December 31, 2005. Certain prior period balances have been reclassified to conform to the current period presentation.

Revenue from software products and solutions includes the benefit of the rebate of valued added taxes on sales of software and services received from the Chinese tax authorities as part of the People's Republic of China (PRC) government's policy of encouragement of software development in the PRC. The rebate was \$1,088 and \$805 for the three months ended June 30, 2005 and 2004, respectively, and \$2,236 and \$1,410 for the six months ended June 30, 2005 and 2004, respectively.

Revenue in excess of billings is recorded as unbilled receivables and included in accounts receivable, and amounted to \$24,315 as of June 30, 2005 and \$33,084 as of December 31, 2004. Billings in excess of revenues recognized are recorded as deferred revenue. Billings are rendered based on agreed milestones included in the contracts with customers.

As of June 30, 2005 and December 31, 2004, the balance of accounts receivable of \$33,845 and \$25,268, respectively, represented amounts billed but not yet collected. All billed and unbilled amounts are expected to be collected within one year.

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

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

The RMB is not fully convertible into US dollars or other foreign currencies. The rate of exchange quoted by the People's Bank of China on June 30, 2005 was US\$1.00=RMB8.2765. No representation is made that the RMB amounts could have been, or could be, converted into United States dollars at that rate or at any other rate.

### **Recently Issued Accounting Pronouncements**

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R). SFAS 123R is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation* and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. SFAS 123R requires all share-based payments to employees including grants of employee stock options, to be recognized in the financial statement based on their fair values. SFAS 123R is effective at the beginning of the first fiscal year beginning after June 15, 2005 (as modified by the SEC on April 14, 2005). Under APB Opinion No. 25, *Accounting for Stock Issued to Employees*, no stock-based compensation cost had been reflected in the net income of the Company for grants of stock options to employees. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) regarding the SEC's interpretation of SFAS 123R and the valuation of share-based payments for public companies. Beginning on January 1, 2006, the Company will recognize compensation expense in its financial statements based on the fair value of all share-based payments to employees. The Company is evaluating the requirements of SFAS 123R and SAB 107 and expects that the adoption of SFAS 123R on January 1, 2006 will have a material impact on the Company's consolidated results of operations and earnings per share. The Company has not yet determined the method of adoption or the effect of adopting SFAS 123R, and it is evaluating the transition method and pricing model alternatives upon adoption.

## **Table of Contents**

In March 2005, the FASB issued FIN 47, Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143 (FIN 47), which requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. FIN 47 is effective for fiscal years ending after December 15, 2005. The Company is currently evaluating the effect that the adoption of FIN 47 will have on its consolidated results of operations and financial condition but does not expect it to have a material impact.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company is currently evaluating the effect that the adoption of SFAS No. 154 will have on its consolidated results of operations and financial condition but does not expect it to have a material impact.

The adoption of EITF Issue No. 03-13, Applying the Conditions in Paragraph 42 of FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, in Determining Whether to Report Discontinued Operations in the first quarter of 2005 did not have material impact on the Company's results of operations and financial condition.

The company does not expect that the adoption of the following recent accounting pronouncements in January 2006 will have material impact on its financial statements:

SFAS No. 151, Inventory Costs - An Amendment of ARB No. 43, Chapter 4 (SFAS 151). SFAS 151 amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and spoilage. This statement requires that those items be recognized as current period charges regardless of whether they meet the criterion of so abnormal, which was the criterion specified in ARB No. 43. In addition, this Statement requires that allocation of fixed production overheads to the cost of production be based on normal capacity of the production facilities; and

SFAS No. 153, Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29 (SFAS 153). SFAS 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, Accounting for Nonmonetary Transactions, and replaces it with an exception for exchanges that do not have commercial substance.

## **2. CASH AND CASH EQUIVALENTS**

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

## **3. SHORT-TERM INVESTMENTS**

Short-term investments are classified as available-for-sale and consist principally of corporate stock and bonds, variable rate preferred securities and certificates of deposit issued by major financial institutions. The available-for-sale investments are carried at fair market value and their unrealized holding gains or losses resulting from the change in market value are recorded in accumulated other comprehensive income (loss) in

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

stockholders' equity. As of June 30, 2005 and December 31, 2004, all short-term investments of the Company had maturities of less than one year. The Company incurred a loss of \$11 (proceeds from the sales of corporate stock of \$461 with cost of \$472) and \$14 (proceeds from the sales of corporate stock of \$484 with cost of \$498) on the sales of short-term investments during the three and six month periods ended June 30, 2005, and no gains or losses on the sale of short-term investments during the comparable periods in 2004.

**Table of Contents**

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

	June 30, 2005		December 31, 2004	
	Cost	Fair value	Cost	Fair value
Certificate of deposit	\$ 5,156	\$ 5,156	\$ 7,163	\$ 7,163
Corporate bonds			2,594	2,594
Variable rate preferred securities	35,000	35,000	45,000	45,000
Corporate stock	1,658	1,594	2,153	2,192
<b>Total</b>	<b>\$ 41,814</b>	<b>\$ 41,750</b>	<b>\$ 56,910</b>	<b>\$ 56,949</b>

**4. NOTES RECEIVABLE**

As of June 30, 2005 and December 31, 2004, the balances of notes receivable of \$1,511 and \$6,482, respectively, represented bank acceptance drafts of \$515 and \$4,344 that are non-interest bearing and due within six months and commercial acceptance notes of \$996 and \$2,138.

**5. COMPREHENSIVE INCOME**

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

	Three Months Ended June 30,	
	2005	2004
Net income	\$ 829	\$ 2,029
Unrealized gain in available-for-sale investments	189	
Change in cumulative foreign currency translation adjustment	3	
<b>Comprehensive income</b>	<b>\$ 1,021</b>	<b>\$ 2,029</b>

	Three Months Ended June 30,	
	2005	2004
Net income	\$ 2,199	\$ 4,005
Unrealized loss in available-for-sale investments	(104)	

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

Change in cumulative foreign currency translation adjustment	10	(3)
Comprehensive income	\$ 2,105	\$ 4,002

### 6. CREDIT FACILITIES

As of June 30, 2005 and December 31, 2004, the Company had total short-term banking facilities for working capital purposes totaling \$35,707 and expiring by December 2005. The facilities were secured by bank deposits of \$14,000 as of June 30, 2005 and December 31, 2004. At June 30, 2005 and December 31, 2004, unused short-term credit facilities were \$28,046 and \$27,340 and used facilities totaled \$7,661 and \$8,367, respectively. The used facilities are pledged as security for standby letters of credit and notes issued to hardware suppliers and customers. Additional bank deposits of \$1,461 and \$1,625 were used for issuing standby letters of credit and bank acceptance drafts as of June 30, 2005 and December 31, 2004, respectively. Bank deposits pledged as security for these credit facilities totaled \$15,461 and \$15,625 as of June 30, 2005 and December 31, 2004, respectively, and are presented as restricted cash in the condensed consolidated balance sheets.

### 7. NOTES PAYABLE

As of June 30, 2005 and December 31, 2004, the balances of notes payable of \$4,971 and \$5,720, respectively, represented commercial notes of \$847 and \$1,733, and bank acceptance drafts of \$4,124 and \$3,987, respectively, which are non-interest bearing and due within six months.

**Table of Contents****8. INCOME TAXES**

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

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

	<b>Six Months Ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
US federal rate	35%	35%
Difference between statutory rate and foreign effective tax rate	(17)	(35)
Change in statutory tax rates of foreign subsidiaries	(20)	
Increase in valuation allowance	13	12.5
Others	4	
	<u>15%</u>	<u>12.5%</u>

**9. STOCK OPTIONS**

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

	<b>Number of shares</b>	<b>Weighted average exercise price per share</b>
Outstanding, January 1, 2005	10,740,594	\$ 6.77
Granted	50,000	4.67
Cancelled	(230,329)	6.85
Exercised	(15,230)	3.62
	<u>10,545,035</u>	6.76
Granted		
Cancelled	(458,263)	6.88
Exercised	(153,288)	4.01
	<u>9,933,484</u>	6.80



The exercise price of all options granted during six months ended June 30, 2005 was equal to the fair market value of the Company's common stock on the dates of grant.

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

	<b>Three Months Ended</b>	
	<b>June 30,</b>	
	<b>2005</b>	<b>2004</b>
Net income as reported	\$ 829	\$ 2,029
Deduct: Total stock-based compensation expense under SFAS No. 123, net of tax effect	(895)	(1,685)
Pro forma net (loss) income	\$ (66)	\$ 344
Net income per share as reported		
Basic	\$ 0.02	\$ 0.04
Diluted	\$ 0.02	\$ 0.04
Pro forma net (loss) income per share		
Basic	\$ (0.00)	\$ 0.01
Diluted	\$ (0.00)	\$ 0.01

**Table of Contents**

	Six Months Ended June 30,	
	2005	2004
Net income as reported	\$ 2,199	\$ 4,005
Deduct: Total stock-based compensation expense under SFAS No. 123, net of tax effect	(2,272)	(3,472)
Pro forma net (loss) income	\$ (73)	\$ 533
Net income per share as reported		
Basic	\$ 0.05	\$ 0.09
Diluted	\$ 0.04	\$ 0.08
Pro forma net (loss) income per share		
Basic	\$ (0.00)	\$ 0.01
Diluted	\$ (0.00)	\$ 0.01

**10. NET INCOME PER SHARE**

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

	Three Months Ended June 30,	
	2005	2004
Net income (numerator)		
Net income		
Basic and diluted	\$ 829	\$ 2,029
Shares (denominator):		
Weighted average common stock outstanding		
Basic	42,463,868	45,404,422
Dilutive effect of employee stock options	1,394,427	1,500,674
Dilutive effect of forward contract	4,498,130	
Diluted	48,356,425	46,905,096
Net income per share:		
Basic	\$ 0.02	\$ 0.04
Diluted	\$ 0.02	\$ 0.04

Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

	Six Months Ended June 30,	
	2005	2004
<b>Net income (numerator)</b>		
Net income		
Basic and diluted	\$ 2,199	\$ 4,005
<b>Shares (denominator):</b>		
Weighted average common stock outstanding		
Basic	43,855,764	45,352,850
Dilutive effect of employee stock options	1,292,190	1,777,054
Dilutive effect of forward contract	4,498,130	
<b>Diluted</b>	<b>49,646,084</b>	<b>47,129,904</b>
<b>Net income per share:</b>		
Basic	\$ 0.05	\$ 0.09
<b>Diluted</b>	<b>\$ 0.04</b>	<b>\$ 0.08</b>

As of June 30, 2005 and 2004, the Company had 4,716,332 and 10,407,195, respectively, common stock options outstanding, that could have potentially diluted earnings per share ( EPS ) in the future, but which were excluded in the computation of diluted EPS in the periods, as their exercise prices were above the average market values in such periods.

**Table of Contents**

As of June 30, 2005, the Company has included 4,498,130 shares issuable to Lenovo under the forward contract as part of the purchase price consideration per the acquisition of Lenovo's IT service business in the calculation of its diluted EPS, as such issuance would have a potential dilutive effect.

**11. SEGMENT INFORMATION**

Since the acquisition of the non-telecom IT services business of Lenovo Group Limited in October 2004, the Company has been organized as two business units, AsiaInfo Technologies (AsiaInfo Technologies), encompassing the Company's traditional telecom business, and Lenovo-AsiaInfo (Lenovo-AsiaInfo), providing IT services including IT consulting, software customization, and business process outsourcing services, to China's enterprise market. The business units are further organized into three operating segments by product types: (1) software products and solutions, (2) service and (3) third party hardware. The Company follows the provisions of SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, which establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. As segment reporting only occurred after acquisition of Lenovo, prior years' comparative information cannot be reclassified into these two business units.

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

Condensed statement of operations and total assets for the Company's reportable segments:

	Three Months Ended June 30,			
	2005		2004	
	AsiaInfo Technologies	Lenovo- AsiaInfo	Total	Total
<b>Revenues:</b>				
Software products and solutions	\$ 12,113	\$ 4,009	\$ 16,122	\$ 9,329
Service	4,650	2,484	7,134	6,082
Third party hardware	3,479	349	3,828	7,097
<b>Total revenues</b>	<b>20,242</b>	<b>6,842</b>	<b>27,084</b>	<b>22,508</b>
<b>Cost of revenues:</b>				
Software products and solutions	5,671	2,600	8,271	4,339
Service	2,252	1,781	4,033	2,726
Third party hardware	3,305	332	3,637	6,742

Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Total cost of revenues	11,228	4,713	15,941	13,807
Gross profit	9,014	2,129	11,143	8,701
Business unit expenses:				
Sales and marketing	2,247	2,428	4,675	2,982
General and administrative <sup>(1)</sup>	1,082	397	1,479	1,514
Research and development	2,256	499	2,755	2,292
Amortization of acquired intangible assets		427	427	151
Total business unit expenses	5,585	3,751	9,336	6,939
Contribution profit (loss)	\$ 3,429	\$ (1,622)	\$ 1,807	\$ 1,762

**Table of Contents**

	Six Months Ended June 30,			
	2005		2004	
	AsiaInfo Technologies	Lenovo- AsiaInfo	Total	Total
Software products and solutions	\$ 23,813	\$ 8,397	\$ 32,210	\$ 19,001
Service	8,802	5,092	13,894	10,545
Third party hardware	9,729	684	10,413	24,943
<b>Total revenues</b>	<b>42,344</b>	<b>14,173</b>	<b>56,517</b>	<b>54,489</b>
Cost of revenues:				
Software products and solutions	10,494	4,976	15,470	8,263
Service	4,801	3,664	8,465	4,576
Third party hardware	9,242	651	9,893	23,696
<b>Total cost of revenues</b>	<b>24,537</b>	<b>9,291</b>	<b>33,828</b>	<b>36,535</b>
<b>Gross profit</b>	<b>17,807</b>	<b>4,882</b>	<b>22,689</b>	<b>17,954</b>
Business unit expenses:				
Sales and marketing	4,838	5,003	9,841	5,595
General and administrative <sup>(1)</sup>	929	340	1,269	3,983
Research and development	4,861	1,072	5,933	4,314
Amortization of acquired intangible assets		854	854	329
<b>Total business unit expenses</b>	<b>10,628</b>	<b>7,269</b>	<b>17,897</b>	<b>14,221</b>
<b>Contribution profit (loss)</b>	<b>\$ 7,179</b>	<b>\$ (2,387)</b>	<b>\$ 4,792</b>	<b>\$ 3,733</b>

	As of June 30, 2005			As of December 31, 2004		
	AsiaInfo Technologies	Lenovo- AsiaInfo	Total	AsiaInfo Technologies	Lenovo- AsiaInfo	Total
Total assets <sup>(2)</sup>	\$ 170,817	\$ 96,640	\$ 267,457	\$ 234,580	\$ 62,784	\$ 297,364

<sup>(1)</sup> General and administrative expenses reported reflect only the direct controllable expenses of each business unit and do not include allocation of corporate general and administrative expenses.

<sup>(2)</sup> Included in total assets are net accounts receivable of \$43,673 and \$14,487 for AsiaInfo Technologies and Lenovo-AsiaInfo at June 30, 2005, respectively, and \$42,762 and \$15,590 for AsiaInfo Technologies and Lenovo-AsiaInfo at December 31, 2004, respectively.

Reconciliation of operating segment contribution profit to income before provision for income taxes:

Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2005	2004	2005	2004
Total contribution profit for reportable segments	\$ 1,807	\$ 1,762	\$ 4,792	\$ 3,733
Corporate general and administrative expenses	(1,632)		(3,821)	
Net interest income	811	563	1,619	915
Loss from sales of short-term investments	(11)		(14)	
Other income (expense), net		1	11	(20)
Income before income taxes and equity in loss of affiliate	\$ 975	\$ 2,326	\$ 2,587	\$ 4,628

For the three months and six months ended June 30, 2005 and 2004, almost all of the Company's revenues have been derived from sales to customers in the PRC. Revenues are attributed to the country based on the country of installation of hardware, software and performance of system integration work and software related services. As of June 30, 2005 and 2004, 100% of the Company's long-lived assets are located in the PRC.

**Table of Contents****12. RELATED PARTIES TRANSACTIONS**

The Company has entered into a series of contractual agreements with Lenovo Group Limited and its affiliates ( Lenovo ) in connection with the acquisition of Lenovo's non-telecommunications related IT services business in October 2004. The Company has entered into a forward contract to deliver shares of the Company's common stock having an aggregate market value of approximately \$27,213 at any time during the twelve month period following the closing date. On July 1, 2005, the Company settled the forward contract by delivering from treasury stock 4,498,130 shares of its common stock, with a fair value of \$25,189, and paying cash of \$2,024 to Lenovo. Upon settlement of the forward contract, Lenovo will own approximately 11 percent of the Company's outstanding common stock.

In the three months ended June 30, 2005 and 2004, the Company entered into network solutions and software revenue contracts with China Netcom (Group) Company Limited ( China Netcom , formerly known as China Netcom Corporation Ltd.) with a total contract value of approximately \$2,054 and \$3,023, respectively. In the six months ended June 30, 2005 and 2004, the Company entered into network solutions and software revenue contracts with China Netcom with a total contract value of approximately \$5,964 and \$5,088, respectively. Edward Tian, a Director and major shareholder of the Company, is the Chief Executive Officer of China Netcom, as well as the Vice President of China Netcom's parent company, China Network Communication Group Corporation.

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

	Three Months Ended June 30,				Six Months Ended June 30,			
	2005		2004		2005		2004	
	China Lenovo	Netcom Total	China Netcom	Total	China Lenovo	Netcom Total	China Netcom	Total
<b>Revenues:</b>								
Software products and solutions	\$ 95	\$ 1,966	\$ 2,061	\$ 907	\$ 2,941	\$ 3,410	\$ 6,351	\$ 1,532
Service	2	1,992	1,994	1,071	31	2,424	2,455	1,779
Third party hardware		378	378	948		1,250	1,250	2,469
<b>Total revenues</b>	<b>97</b>	<b>4,336</b>	<b>4,433</b>	<b>2,926</b>	<b>2,972</b>	<b>7,084</b>	<b>10,056</b>	<b>5,780</b>
<b>Purchases:</b>								
Software products and solutions	33	9	42	7	67	19	86	14
Service	2	8	10	2	39	11	50	4
<b>Total purchases</b>	<b>35</b>	<b>17</b>	<b>52</b>	<b>9</b>	<b>106</b>	<b>30</b>	<b>136</b>	<b>18</b>
<b>Operating expenses:</b>								
Sales and marketing	33	11	44	3	96	15	111	5
General and administrative	2	6	8	4	63	8	71	7
Research and development	3	8	11	5	14	14	28	11
<b>Total operating expenses</b>	<b>\$ 38</b>	<b>\$ 25</b>	<b>\$ 63</b>	<b>\$ 12</b>	<b>\$ 173</b>	<b>\$ 37</b>	<b>\$ 210</b>	<b>\$ 23</b>



Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

	As of June 30, 2005			As of December 31, 2004		
	China			China		
	Lenovo	Netcom	Total	Lenovo	Netcom	Total
<b>Balances with related parties:</b>						
Notes receivable	\$	\$ 591	\$ 591	\$	\$ 2,045	\$ 2,045
Net accounts receivable	1,512	6,552	8,064	8,457	5,357	13,814
Other receivables	189	6	195	198		198
Accounts payable				2,300		2,300
Deferred revenue	709	1,393	2,102	64	1,263	1,327
Other payables	5		5	135		135

All contract prices and terms with related parties are entered into at market prices.

---

**Table of Contents****13. COMMITMENTS AND CONTINGENCIES**

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

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

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

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



**Table of Contents**

**14. STOCK REPURCHASE PROGRAM**

In the fourth quarter of 2004, the Board of Directors has approved a stock repurchase program ( the Program ) under which the Company may purchase up to 5,000,000 shares of its outstanding common stock, par value US \$0. 01, for a period of up to six months. The Board of Directors approved an increase of an additional 500,000 shares in the second quarter of 2005, for a maximum of 5,500,000 shares under the Program, and approved an extension on the repurchase period to August 17, 2005.

For the six month period ended June 30, 2005, the Company purchased 4,933,107 shares of its common stock at a cost of \$25,380. From the commencement of the Company s stock repurchase program through June 30, 2005, the Company has purchased a total of 5,091,933 shares for a total cost of \$26,248.

---

**Table of Contents**

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

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

**Overview**

We are a leading provider of high-quality software, solutions and IT services in China, helping our customers increase their business value in fast-growing and evolving markets. In the telecommunications market, our software product and solutions services enable our customers to build, maintain, operate, manage and continuously improve their communications infrastructure. Our largest customers are the major telecommunications carriers in China and their provincial subsidiaries. In addition to providing software product solutions to China's telecom carriers, we also offer a wide range of enterprise solutions to small, medium and large sized Chinese enterprises, across multiple vertical industries.

We commenced our operations in the United States in 1993 and moved our major operations from the United States to China in 1995. We began generating significant network solutions revenues in 1996 and significant software revenues in 1998. We conduct the bulk of our business through our operating subsidiaries, most of which are Chinese companies.

We have derived, and believe that we will continue to derive, a significant portion of our revenues from a limited number of large telecommunications customers, such as China Mobile Communications Corporation, or China Mobile, China United Telecommunications Corporation, or China Unicom, China Telecommunications Corporation, or China Telecom and China Network Communications Group Corporation, or China Netcom Group. Sales to China Mobile and its subsidiaries amounted to approximately 50%, 38% and 42% of total revenues in 2004, 2003 and 2002, respectively. Sales to China Netcom Group and its subsidiaries amounted to approximately 9%, 13% and 6% of total revenues in 2004, 2003 and 2002, respectively. Sales to China Unicom and its subsidiaries amounted to approximately 24%, 38% and 22% of total revenues in 2004, 2003 and 2002, respectively. Sales to China Telecom and its subsidiaries amounted to approximately 3%, 9% and 21% of total revenues in 2004, 2003 and 2002, respectively. We expanded our customer base in 2004 through our acquisition of Lenovo's IT services business, which has customers in a variety of industry sectors. However, our operating results are still dependent on our large customers in the telecommunications sector, and the loss of any of those customers could have a material adverse impact on us.

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

telecommunications-related spending, which would likely have an adverse impact on our business.

## **Revenues**

We report our revenues on the basis of the three principal types of revenues derived from our business: software products and solutions revenue, service revenue and third party hardware revenue.

**Table of Contents**

**Software products and solutions revenue.** We typically sell our software as part of total solutions for our customers, which include proprietary software licenses, professional services related to the design and implementation of the solution (such as consulting, training, technical support and maintenance) and, in cases where the customer requests a turn-key solution, related hardware. Software products and solutions revenue includes two types of revenues: software license revenue and software services revenue. Software license revenue consists of fees received from customers for licenses or sublicenses to use our software products or third party software products in perpetuity, typically up to a specified maximum number of users. In most cases where a customer is required to purchase additional licenses from us because the number of users exceeds the number of licensed users, we enter into an extension agreement with the customer to expand and upgrade the customer's system. These extension contracts will usually include a license for the additional users, an updated versions of our software and, if required, additional services and hardware for the customer's network. Our software license revenue also includes the benefit of value-added tax rebates on software license sales, which are part of the Chinese government's policy of encouraging China's software industry. Software services revenue consists of revenue from software installation, customization, training and other services.

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

**Third party hardware revenue.** Third party hardware revenue consists of hardware sales for equipment procured by us on behalf of our customers from hardware vendors. We procure for and sell hardware to our customers as part of our total solutions strategy. We typically minimize our exposure to hardware risks by sourcing equipment from hardware vendors against letters of credit from our customers. As the telecommunications-related IT services market in China develops, our customers are increasingly purchasing hardware directly from hardware vendors and hiring us for our software and professional services.

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

	<b>Six Months Ended June 30, Year Ended December 31,</b>			
	<b>2005</b>	<b>2004</b>	<b>2004</b>	<b>2003</b>
	<b>(amounts in thousands of US dollars)</b>			
Software products and solutions revenue	32,210	19,001	44,825	31,488
Service revenue	13,894	10,545	21,232	22,891
Hardware revenue net of hardware costs	520	1,247	2,030	3,091
<b>Total revenues net of hardware costs</b>	<b>46,624</b>	<b>30,793</b>	<b>68,087</b>	<b>57,470</b>
Total hardware costs	9,893	23,696	38,590	58,704
<b>Total revenues</b>	<b>56,517</b>	<b>54,489</b>	<b>106,677</b>	<b>116,174</b>

The information on revenues net of hardware costs, or net revenues, in the above table is a non-GAAP financial measure within the meaning of Item 10 of Regulation S-K under the Securities Exchange Act of 1934, as amended. We have provided a reconciliation of this non-GAAP financial measure to the most directly comparable GAAP financial measure, total revenues. We believe that the presentation of this non-GAAP measure provides useful information for investors regarding our regular financial performance because total revenues net of hardware costs more

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

accurately reflect the core of our business, which is the provision of software solutions and services. We believe such measure provides transparency to our investors because it is the measure used by our management to evaluate the competitiveness and development of our business. In addition, third party hardware revenue tends to fluctuate from period to period depending on the requirements of our customers. As a result, a presentation that excludes hardware costs allows investors to better evaluate the performance of our core business.

We have evaluated the criteria outlined in EITF No. 99-19, Reporting Revenue Gross as Principal Versus Net as an Agent, in determining whether it is appropriate under GAAP to record the gross amount of revenues and related costs or the net amount earned after deducting hardware costs paid to the supplier. We record the gross amounts billed to our customers because we are the primary obligor in these transactions, bear the inventory risk, have latitude in establishing prices, are involved in the determination of the product specifications, bear credit risk and have the right to select suppliers. The presentation above of additional information on revenues net of hardware costs is not meant to be considered in isolation or as a substitute for our financial results prepared in accordance with GAAP.



## **Table of Contents**

### **Cost of Revenues**

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

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

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

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

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

*Service costs.* Service costs consist primarily of compensation and travel expenses for the professionals involved in designing and implementing IT services, management consulting and network solutions projects. Service costs also include hardware warranty costs. We accrue hardware warranty costs upon final acceptance. We typically obtain manufacturers' warranties for hardware we sell, which cover a portion of the warranties that we give to our customers. We currently accrue 0.2% of hardware sales to cover potential warranty expenses. This estimate of warranty cost is based on our current experience with contracts for which the warranty period has expired.

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

### **Operating Expenses**

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

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

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

**Taxes**

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

Under the income tax laws of China, foreign invested enterprises, or FIEs, satisfying certain criteria can enjoy preferential tax treatment. Several of our operating subsidiaries are FIEs and enjoy certain preferential tax treatments in China. Please refer to Note 11 to our consolidated financial statements included in our annual report on Form 10-K for the fiscal year ended on December 31, 2004 for details of the preferential treatments for these subsidiaries.

## **Table of Contents**

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

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

## **Foreign Exchange**

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

Pursuant to an announcement by China's central bank, as of July 29, 2005 the exchange rate between the Renminbi and the U.S. dollar decreased 2% to US\$1.00 = RMB8.1080.

## **Critical Accounting Policies**

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

**Revenue recognition.** We generally charge a fixed price for all of our projects and recognize revenue based on the percentage of completion of the project as required under Statement of Position No. 81-1, Accounting for Performance of Construction-Type and certain Production-Type Contracts (SOP 81-1). With respect to software products and solutions, revenue from customer orders requiring significant production, modifications, or customizations of the software are recognized over the installation and customization period. Labor costs and direct project expenses are used to determine the stage of completion. Costs related to insignificant obligations for a period of up to one year, which include telephone support, are accrued at the time the revenue is recorded. In cases where the customer requires additional software licenses, we

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

typically enter into an extension agreement with the customer to expand and upgrade the customer's system. Revenue arising from such extension agreements is also recognized under SOP 81-1. We recognize service revenue (which is charged on a fixed price basis) based on the percentage of completion of the project as required under SOP 81-1. We use labor costs and direct project expenses to determine the state of completion. We recognize third party hardware revenue upon delivery of the hardware to the customer. Since a large part of the cost of certain projects often relates to hardware, the timing of hardware delivery can cause our quarterly gross revenue and inventory level to fluctuate significantly. However, those fluctuations do not significantly affect our gross profits because third party hardware revenue generally approximates the costs of the hardware.

---

**Table of Contents**

Recognized revenues and profit are subject to adjustments in current periods as the contract progresses to completion. If we do not have a sufficient basis to measure progress toward completion, revenue will be recognized upon completion. For arrangements with multiple elements, we allocate revenue to each element of a transaction based upon its fair value as determined by vendor specific objective evidence (VSOE). Revenue is deferred for the fair value of any undelivered elements and recognized for the remainder of the arrangement fee attributable to the delivered elements when the basic criteria in Statement of Position No. 97-2 Software Revenue Recognition (SOP 97-2) have been met. Revenue in excess of billings is recorded as unbilled receivables and amounts billed but not yet collected are recorded as billed receivables. Billings in excess of revenues recognized are recorded as deferred revenue. Provisions for estimated losses on contracts are made in the period in which the anticipated losses become known. Actual costs and gross margins on such contracts could differ from management's estimates and those differences could be material to the consolidated financial statements. Historically, our estimates for costs and gross margins have not differed significantly from actual costs and gross margins. However, any material deviation of such costs and gross margins from our estimates would impact our future operating results.

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

**Goodwill.** Beginning in 2002, with the adoption of SFAS 142, Goodwill and Other Intangible Assets, goodwill is no longer amortized, but instead tested for impairment upon first adoption and annually thereafter, or more frequently if events or changes in circumstances indicate that it might be impaired. We use a two-step impairment test to identify potential goodwill impairment and recognize a goodwill impairment loss in the statement of operations when the carrying amount of goodwill exceeds its implied fair value. Prior to 2002, goodwill was amortized using a straight-line method over its economic life of five years. Accumulated amortization recorded through December 31, 2001 was \$2,971,000. Goodwill impairment tests were performed in the first and second quarters of 2003 for our acquisitions of Bonson Information Technology Holdings, Ltd., and Zhejiang AsiaInfo Dekang Telecommunications Technology, Inc., respectively. We perform all goodwill impairment tests in the fourth quarter of each year. The latest goodwill impairment tests were performed in the fourth quarter of 2004 and no impairment losses were recognized. We periodically evaluate the recoverability of our intangible assets and take into account events or circumstances that warrant revised estimates of useful lives or that indicate that impairment exists.

**Consolidated Results of Operations**

**Revenues.** Total revenues, including hardware costs, were \$27.1 million and \$56.5 million, respectively, in the three- and six-month periods ended June 30, 2005, representing increases of 20% and 4%, respectively, against the comparable periods in 2004 and an 8% decrease compared the previous quarter. The increases in our total revenue in the three- and six-month periods ended June 30, 2005 were primarily attributable to the inclusion of Lenovo-AsiaInfo's operating results in those periods.

Net revenues (i.e. total revenues net of third party hardware costs) were \$23.4 million and \$46.6 million, respectively, for the three- and six-month periods ended June 30, 2005, representing increases of 49% and 51% against the comparable periods in 2004, and remaining flat sequentially. The increase in our net revenues was primarily attributable to the Company's continued focus on increasing high-margin software and service revenues. We are pleased that net revenues remained relatively flat sequentially, despite the seasonal slowdown in orders during the first quarter of the year. Lenovo-AsiaInfo contributed 28% to net revenue for the quarter, which was slightly below the previously stated target of 30%, due to the closing of certain low margin businesses at Lenovo-AsiaInfo.

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

Software revenue was \$16.1 and \$32.2 million in the three- and six-month periods ended June 30, 2005, representing an increase of 73% and 70% over the comparable periods in 2004, and remaining flat sequentially. Service revenue was \$7.1 and \$13.9 million, respectively, in the three- and six-month periods ended June 30, 2005, representing increases of 17% and 32% over the comparable periods in 2004 and a 6% increase sequentially largely due to the revenue recognition of one large service contract. Third party hardware revenue was \$3.8 million and \$10.4 million, respectively, in the three- and six-month periods ended June 30, 2005, representing decreases of 46% and 58% over the comparable periods in 2004 and a 42% increase over the previous quarter. During the three- and six-month periods ended June 30, 2005, the IT services business we acquired from Lenovo in the fourth quarter of 2004 contributed 25% and 26% to software revenue, respectively, 35% and 37% to service revenue, respectively, and 9% and 7% to third party hardware revenue, respectively.

**Cost of revenues.** Our cost of revenues increased 15% to \$15.9 million and decreased 7% to \$33.8, respectively, in the three- and six-month periods ended June 30, 2005. Our cost or revenue decreased 11% against the previous quarter. The sequential and period on period decreases in cost of revenue were primarily due to decreased hardware orders.

## **Table of Contents**

**Gross profit.** Our gross profit was \$11.1 million and \$22.7 million, respectively, in the three- and six-month periods ended June 30, 2005, representing increases of 28% and 26%, respectively, against the comparable periods in 2004, and a slight sequential decrease. Our gross margin increased to 41% and 40%, respectively, in the three- and six-month periods ended June 30, 2005, as compared to 39% and 33%, respectively, in the comparable periods of 2004 and 39% in the previous quarter. These increases are primarily due to reduced hardware pass-through and the increase in higher-margin software revenue.

**Operating expenses.** Our operating expenses in the three- and six-month periods ended June 30, 2005 were \$11.0 million and \$21.7 million, respectively, representing increases of 58% and 53% against the comparable periods in 2004 and a slight sequential increase. Lenovo-AsiaInfo contributed 34% and 33% of the Company's total operating expenses in the three- and six-month periods ended on June 30, 2005.

Sales and marketing expenses were \$4.7 million and \$9.8 million, respectively, in the three- and six-month periods ended June 30, 2005, representing increases of 57% and 76% against the comparable periods in 2004 and a slight sequential decrease. The period as period increases were primarily attributable to sales and marketing expenses of \$2.4 million and \$5.0 million from Lenovo-AsiaInfo, respectively, in the three- and six-month periods ended June 30, 2005.

General and administrative expenses were \$3.1 million and \$5.1 million in the three- and six-month periods ended on June 30, 2005, representing increases of 105% and 28%, respectively, compared with the same period last year and a sequential increase of 57%. These increases were primarily attributable to the increase of bad debt provision during the quarter.

Research and development expenses were \$2.8 million and \$5.9 million in the three- and six-month periods ended on June 30, 2005, representing increases of 20% and 38%, respectively, compared with the same period in 2004 and a sequential decrease of 13%. These increases are primarily attributable to our research and development efforts in developing software products to support our future growth. The sequential decrease of 13% is attributable to the transfer of certain of our R&D personnel to our service team in order to support our clients on-site.

**Net income.** Net income for the quarter ended on June 30, 2005 was \$0.8 million, or \$0.02 per basic share, compared to \$2.0 million or \$0.04 per basic share for the year-ago period, and \$1.4 million or \$0.03 per basic share, for the previous quarter.

## **Liquidity and Capital Resources**

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

Our net operating cash flow was negative \$2.3 million for the second quarter of 2005, driven by the higher settlement of accounts payable over the quarter. Our total cash position, including cash and cash equivalents, restricted cash and short term investments, decreased from \$159.1 million at March 31, 2005 to \$142.4 million at June 30, 2005. This decrease was primarily attributable to repurchases of our common stock

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

during the second quarter of 2005, as well as the negative operating cash flow.

Our accounts receivable balance at June 30, 2005 was \$58.2 million, consisting of \$33.9 million in billed receivables and \$24.3 million in unbilled receivables. Our billed receivables are based on revenue we have booked and billed. Our unbilled receivables are based on revenue we have booked through the percentage completion method, but for which we have not yet billed the customer. For example, we recognize revenues for hardware pass-through at the time the hardware is accepted by the customer, based on the cost of the underlying hardware. However, our contracts with our customers will often allow the customers to withhold 10-20% of the total contract payments until final project acceptance, which on average is eight to nine months after hardware delivery. As a result, revenues from hardware pass-through generally represent a significant portion of our unbilled receivables and can cause the aging of these receivables to be relatively long.



## **Table of Contents**

At the end of the second quarter, our days sales outstanding were 185 days, as compared to 182 days at March 31, 2005, as a result of lower gross revenues during the quarter.

Total shareholders' equity decreased by 6% sequentially as a result of a \$13.5 million increase in treasury stock. As of today, we have repurchased about 5.3 million shares of our common stock as part of the share repurchase program, which was announced in November 2004 and was revised in the second quarter 2005. We re-allocated 4.5 million of the treasury shares to Lenovo in July 2005 as part of the acquisition consideration for Lenovo's IT services division. Upon delivery of these shares, Lenovo hold approximately 11% of our outstanding common stock.

As of June 30, 2005, we had total short-term credit facilities for working capital purposes totaling \$35.7 million, expiring by December 2005, which were secured by bank deposits of \$14.0 million. \$7.7 million of the short-term credit facilities were used to issue letters of credit and notes payable at that date. Additional bank deposits of \$1.5 million were used for issuing standby letters of credit and bank acceptance drafts. Bank deposits pledged as security for these standby letters of credit, bank acceptance drafts and short-term credit facilities totaled \$15.5 million as of June 30, 2005, and are presented as restricted cash in our condensed consolidated balance sheets.

We anticipate that the net proceeds of our initial public offering in March 2000, together with available funds and cash flows generated from operations, will be sufficient to meet our anticipated needs for working capital, capital expenditures and business expansion through 2005. We may need to raise additional funds in the future, however, in order to fund acquisitions, develop new or enhanced services or products, respond to competitive pressures to compete successfully for larger projects involving higher levels of hardware purchases, or if our business otherwise grows more rapidly than we currently predict. We anticipate that we would raise additional funds, if necessary, through new issuances of shares of our equity securities in one or more public offerings or private placements, or through credit facilities extended by lending institutions.

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

## **Off-Balance Sheet Arrangements**

As of June 30, 2005, we have not entered into any off-balance sheet arrangements with any individuals or entities.

## **Recent Accounting Pronouncements**

The following are recently issued accounting pronouncements.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R). SFAS 123R is a revision of SFAS No. 123, Accounting for Stock-Based Compensation and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS 123R requires all share-based payments to employees including grants of employee stock options, to be recognized in the financial statement based on

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

their fair values. SFAS 123R is effective at the beginning of the first fiscal year beginning after June 15, 2005 (as modified by the SEC on April 14, 2005). Under APB Opinion No. 25, *Accounting for Stock Issued to Employees*, no stock-based compensation cost had been reflected in the net income of the Company for grants of stock options to employees. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 ( *SAB 107* ) regarding the SEC's interpretation of SFAS 123R and the valuation of share-based payments for public companies. Beginning on January 1, 2006, the Company will recognize compensation expense in its financial statements based on the fair value of all share-based payments to employees. The Company is evaluating the requirements of SFAS 123R and SAB 107 and expects that the adoption of SFAS 123R on January 1, 2006 will have a material impact on the Company's consolidated results of operations and earnings per share. The Company has not yet determined the method of adoption or the effect of adopting SFAS 123R, and it is evaluating the transition method and pricing model alternatives upon adoption.

In March 2005, the FASB issued FIN 47, *Accounting for Conditional Asset Retirement Obligations*, an interpretation of FASB Statement No. 143 ( *FIN 47* ), which requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. FIN 47 is effective for fiscal years ending after December 15, 2005. The Company is currently evaluating the effect that the adoption of FIN 47 will have on its consolidated results of operations and financial condition but does not expect it to have a material impact.

---

## **Table of Contents**

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company is currently evaluating the effect that the adoption of SFAS No. 154 will have on its consolidated results of operations and financial condition but does not expect it to have a material impact.

The adoption of EITF Issue No. 03-13, Applying the Conditions in Paragraph 42 of FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, in Determining Whether to Report Discontinued Operations in the first quarter of 2005 did not have material impact on the Company's results of operations and financial condition.

The company does not expect that the adoption of the following recent accounting pronouncements in January 2006 will have material impact on its financial statements:

SFAS No. 151, Inventory Costs - An Amendment of ARB No. 43, Chapter 4 (SFAS 151). SFAS 151 amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and spoilage. This statement requires that those items be recognized as current period charges regardless of whether they meet the criterion of so abnormal, which was the criterion specified in ARB No. 43. In addition, this Statement requires that allocation of fixed production overheads to the cost of production be based on normal capacity of the production facilities; and

SFAS No. 153, Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29 (SFAS 153). SFAS 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, Accounting for Nonmonetary Transactions, and replaces it with an exception for exchanges that do not have commercial substance.

## **Certain Risks That May Affect Our Operating Results and Our Common Stock**

In addition to the other information in this report, the following factors should be considered in evaluating our business and our future prospects:

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

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

Historically, China's telecommunications sector has been subject to a number of state-mandated restructurings. For example, in 2002 China Telecom was split geographically into a northern division (comprising ten provinces) and a southern division (comprising 21 provinces). Under

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

the restructuring, the northern division of China Telecom merged with China Netcom and was renamed China Network Communications Group Corporation, or China Netcom Group, while the southern division continued to use the China Telecom name. As a result of the restructuring, new orders for telecommunications infrastructure expansion and improvement projects decreased in 2002, adversely affecting our net revenue. Any similar restructurings of this nature could cause our operating results to vary unexpectedly from quarter to quarter in the future.

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

We have derived, and believe that we will continue to derive, a significant portion of our revenues from a limited number of large customers in the telecommunications industry, such as China Mobile, China Unicom, China Telecom and China Netcom Group. China Mobile accounted for 50% of our revenues in 2004. The loss, cancellation or deferral of any large contract by any of our large customers would have a material adverse effect on our revenues, and consequently our profits. Our acquisition of Lenovo's IT services business in October 2004 was part of our strategy to further diversify our business and gradually reduce such concentration risk in the future. However, in the near term, the expected revenue to be generated by our business outside the telecommunications industry is still limited compared to our overall revenues. Moreover, we cannot provide any assurance that a material proportion of our revenues will be derived from other industries in the future.

## **Table of Contents**

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

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

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

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

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

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

Although we had net income in 2001, 2002 and 2004, we sustained net losses in 2000 and 2003. There are no assurances that we can sustain profitability or avoid net losses in the future. We continue to expect that certain of our operating expenses will increase as our business grows. The level of these expenses will be largely based on anticipated organizational growth and revenue trends and a high percentage, particularly compensation expenses, will be fixed. As a result, any delays in expanding sales volume and generating revenue could result in substantial operating losses.

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

We maintain a relatively stable work force of software and network engineers engaged in all phases of planning and executing projects on behalf of our customers. As a result, our operating costs are relatively fixed from quarter to quarter, regardless of fluctuations in our revenues. In recent periods, this has resulted in our gross profit decreasing as a percentage of our net revenues. For example, during the second quarter of 2003 our revenues were impacted by the outbreak of SARS and our gross profit as a percentage of net revenue decreased to 56% as compared to 66% in

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

the comparable period of 2002. Future fluctuations in our net revenues could result in similar decreases in our operating margins. In addition, enhanced competition in the software market and other markets in which we operate could result in reduced prices, which, together with our relatively fixed operating costs, could also result in reduced operating margins.

---

**Table of Contents**

***Business acquisitions we undertake may be challenging, and we may realize losses on our investments.***

On October 19, 2004, we completed our acquisition of the IT services business of Lenovo Group Limited and formed a new division, Lenovo-AsiaInfo, comprised primarily of the acquired assets and our existing enterprise IT services business. In the future, we may acquire other companies or assets that we feel will enhance our revenue growth, operations and profitability. Such acquisitions could result in the use of significant amounts of cash and dilutive issuances of our common stock. Such acquisitions involve other significant risks, including:

the difficulties of integrating, assimilating and managing the operations, technologies, intellectual property, products and personnel of the acquired business;

the diversion of management attention from other business concerns;

the additional expense associated with acquired contingent liabilities;

the loss of key employees in acquired businesses; and

the risk of being sued by terminated employees and contractors.

We will need to integrate and manage any businesses we determine to acquire in the future. Our failure to do so successfully could have a material adverse effect on our business, results of operations and financial condition.

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

In 2001, the State Secrecy Bureau of China promulgated the Administrative Measures for Qualification of Computer Information Systems Integration Involving State Secrets, which expressly prohibits foreign persons or foreign-invested enterprises from engaging in systems integration businesses involving state secrets ( hereinafter referred to as ) restricted businesses. We and our PRC operating subsidiaries are considered foreign persons or foreign-invested enterprises under PRC laws. In addition to a number of other types of IT services, one of the businesses operated by the IT services division we acquired from Lenovo in 2004 was a restricted business. As a result, we operate the restricted business through affiliated entities in which we do not hold a direct equity interest. We currently operate the restricted business through Lenovo Computer System and Technology Services Ltd., or Lenovo Computer, and, upon the receipt by Lenovo Security Technologies (Beijing), Inc., or Lenovo Security, of certain business licenses and qualifications, we intend to operate the restricted business through Lenovo Security. Lenovo Computer is owned by certain subsidiaries of Lenovo. Lenovo Security is owned by Legend Holdings Limited, the parent company and controlling shareholder of Lenovo, and certain of our employees who are PRC citizens. Lenovo Computer currently conducts substantially all of our operations in relation to the restricted business, generates substantially all of our revenue relating to such business, and makes use of the licenses and approvals that are essential to such business. We do not currently have any equity interest in Lenovo Computer or Lenovo Security and instead enjoy economic benefits substantially similar to equity ownership in such companies through contractual arrangements between Lenovo-AsiaInfo Technologies, Inc., or Lenovo-AsiaInfo, our wholly-owned subsidiary, and these affiliated entities and their respective shareholders. Further information on these arrangements is set forth under the heading Certain Relationships and Related Transactions in the definitive proxy statement for our 2005 annual meeting of shareholders, filed with the Securities and Exchange Commission on March 16, 2005.

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



---

**Table of Contents**

In June of 2004 we entered into similar contractual arrangements with Beijing Star VATS Technologies, Inc., or Star VATS, a domestic company owned by certain of our employees who are PRC citizens, which was established to engage in the value-added telecommunications services, or VATS, business in China. As with the restricted business as certain regulations in China restrict foreign ownership of companies engaged in the VATS business in China. Star VATS is in the process of developing VATS products and services that we hope to offer in China. We anticipate that if we successfully launch our VATS products and services, all of our business related to such products and services will be conducted through Star VATS. Star VATS will generate any revenue relating to such business and will make use of the licenses and approvals that are essential to such business. We do not have any equity interest in Star VATS, but instead have the right to enjoy economic benefits similar to equity ownership through our contractual arrangements with Star VATS and its shareholders. In the opinion of our Chinese legal counsel, T&C Law Firm, the contractual arrangements among us, Star VATS, and the shareholders of Star VATS were in compliance with all existing PRC laws and regulations at the time of the company's formation. There are, however, substantial uncertainties regarding the interpretation and application of current and future PRC laws and regulations, including regulations governing the validity and enforcement of such contractual arrangements. Accordingly, we cannot assure you that PRC government authorities will not ultimately take a view contrary to the opinion of our Chinese legal counsel. If the PRC government finds that our contractual arrangements with Star VATS do not comply with its restrictions on certain foreign invested companies from engaging in VATS businesses, we could be subject to severe penalties.

***Recent PRC regulations relating to acquisitions of PRC companies by foreign entities may limit our ability to acquire PRC companies and adversely affect the implementation of our acquisition strategy, and the failure by our shareholders who are PRC residents to make or obtain any required registrations or approvals pursuant to such regulations may subject us to fines and legal sanctions, restrict our cross-border investment activities, or limit our PRC subsidiaries' ability to distribute dividends to our company.***

The PRC State Administration of Foreign Exchange, or SAFE, issued a public notice on January 24, 2005 concerning the application of foreign exchange regulations on mergers and acquisitions in China. The public notice states that if an offshore company controlled by PRC residents intends to acquire a PRC company, such acquisition will be subject to strict examination by the relevant foreign exchange authorities. The public notice also states that the approval of the relevant foreign exchange authorities is required for any sale or transfer by PRC residents of a PRC company's assets or equity interests to foreign entities, such as us, for equity interests or assets of the foreign entities.

In April 21, 2005, SAFE issued another public notice clarifying the January notice. In accordance with the April notice, if an acquisition of a PRC company by an offshore company controlled by PRC residents had been confirmed by a Foreign Investment Enterprise Certificate prior to the issuance of the January notice, each of the PRC residents is required to submit a registration form to the local SAFE branch to register his or her respective ownership interests in the offshore company. The SAFE notices do not specify the timeframe during which such registration must be completed. The PRC resident must also amend such registration form if there is a material event affecting the offshore company, such as, among other things, a change to share capital, a transfer of shares, or if such company is involved in a merger and an acquisition or a spin-off transaction or uses its assets in China to guarantee offshore obligations. In the past, we have acquired a number of PRC company's assets or equity interests through issuances of our shares of common stock to individuals who may be deemed to be PRC residents for purpose of the SAFE notices.

As it is uncertain how the SAFE notices will be interpreted or implemented, there is significant uncertainty as to whether the notices apply to any of our past acquisitions. Moreover we cannot predict how these regulations will affect our future acquisition strategy and business operations. For example, if we decide to acquire additional PRC companies, we cannot assure you that we or the owners of such companies will be able to obtain the necessary approvals or complete the necessary filings and registrations required by the SAFE notices. This may restrict our ability to implement our acquisition strategy and could adversely affect our business and prospects.

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

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

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

## **Table of Contents**

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

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

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

Effective January 1, 2002, we adopted SFAS No. 142, which requires us, among other things, to review goodwill and intangible assets for impairment annually. In connection with our business acquisitions, we make assumptions regarding estimated future cash flows and other factors to determine the fair value of goodwill and intangible assets. In assessing the related useful lives of those assets, we have to make assumptions regarding their fair value, our recoverability of those assets and our ability to successfully develop and ultimately commercialize acquired technology. If those assumptions change in the future when we conduct our periodic reviews in accordance with applicable accounting standards, we may be required to record impairment charges.

We recorded a non-cash impairment charge of \$30.2 million as a result of an independent valuation during the first quarter of 2003 of the goodwill and acquired intangible assets mainly attributable to our acquisition of Bonson in February 2002. In December 2003 we recorded an impairment charge of \$2.2 million related to our minority investment in another IT company. There is no assurance that future reviews will not result in further write-downs to goodwill and other intangible assets.

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

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

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

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

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

We customarily provide our customers with one to three year warranties, under which we agree to maintain installed systems at no additional cost to our customers. The maintenance services cover both hardware and our proprietary and third party software products. Although we seek to arrange back-to-back warranties with hardware and software vendors, we have the primary responsibility to maintain the installed hardware and software. Our contracts often do not have disclaimers or limitations on liability for special, consequential and incidental damages, nor do we typically cap the amounts our customers can recover for damages. In addition, we do not currently maintain any insurance policy with respect to our exposure to warranty claims. The failure of our installed projects to operate properly could give rise to substantial liability for special, consequential or incidental damages, which in turn could materially and adversely affect us.

## **Table of Contents**

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

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

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

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

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

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

We enter into confidentiality agreements with most of our employees and consultants, and control access to, and distribution of, our documentation and other licensed information. Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use our licensed services or technology without authorization, or to develop similar technology independently. Policing unauthorized use of our licensed technology is difficult and there can be no assurance that the steps we take will prevent misappropriation or infringement of our proprietary technology. In addition, litigation may be necessary to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others, which could result in substantial costs and diversion of our resources.

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

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

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

**Table of Contents**

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

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

effect service of process upon those persons within the United States; or

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

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

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

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

Substantially all of our revenues, expenses and liabilities are denominated in either U.S. dollars or Renminbi. As a result, we are subject to the effects of exchange rate fluctuations between those currencies. Because of the unitary exchange rate system introduced in China on January 1, 1994, the official bank exchange rate for conversion of Renminbi to U.S. dollars experienced a devaluation of approximately 50%. We report our financial results in U.S. dollars, therefore, any future devaluation of the Renminbi against the U.S. dollar may have an adverse effect on our reported net income.

Substantially all our revenues and expenses relating to hardware sales are denominated in U.S. dollars, and substantially all our revenues and expenses relating to the software and services component of our business are denominated in Renminbi. The value of our shares may be affected by the foreign exchange rate between the U.S. dollar and the Renminbi because the value of our business is effectively denominated in Renminbi, while our shares are traded in U.S. dollars. Furthermore, an increase in the value of the Renminbi may require us to exchange more U.S. dollars into Renminbi to meet the working capital requirements of our subsidiaries in China. Depreciation of the value of the U.S. dollar will also reduce the value of the cash we hold in U.S. dollars, which we may use for purposes of future acquisitions or other business expansion.

In July 2005, the People's Bank of China, or PBOC, revalued the Renminbi by 2.1% against the U.S. dollar. Moreover, according to the PBOC, the Renminbi will no longer be pegged to the US dollar, but instead it will float in a tight band against a basket of foreign currencies. While we do not believe that this change will have significant impact to our results of operations, we cannot guarantee that future changes in exchange rate policy will not affect our business.

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

Our main domestic competitors in China include local systems integration and IT services firms, including Digital China, Huawei, Linkage and Neusoft. Our international competitors include multinational companies such as IBM Global Services and HP Services, which are establishing more active presences in the IT services market in China. In addition, top international consulting companies such as Deloitte Consulting, Capgemini, Accenture, and Bearing Point, have also entered China's IT services market.

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



## **Table of Contents**

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

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

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

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

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

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

In the past, following periods of volatility in the market price of a particular company's securities, securities class action litigation has often been brought against that company. Many companies in our industry have been subject to this type of litigation in the past, and we are currently involved in this type of litigation as a result of allegedly improper allocation procedures relating to the sale of our common stock in connection with our initial public offering in March of 2000. For more information on that litigation, please see the discussion under the heading "Item 3. Legal Proceedings" in Part I of this Report. Litigation is often expensive and diverts management's attention and resources, which could materially and adversely affect our business.

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

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

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

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

## **Table of Contents**

We currently have authorized the size of our board of directors to be not less than three nor more than ten directors. The terms of the office of the ten-member board of directors have been divided into three classes: Class I, whose term will expire at the annual meeting of the stockholders to be held in 2006; Class II, whose term will expire at the annual meeting of stockholders to be held in 2007; and Class III, whose term will expire at the annual meeting of stockholders to be held in 2008. This classification of the board of directors may have the effect of delaying or preventing changes in our control or management.

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

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

We have entered into change of control severance agreements with most of our executive officers. These agreements provide, among other things, that the executive officers would be entitled to various benefits upon the occurrence of either a covered termination (as defined therein) or a change of control (as defined therein), including payment of one year of base salary and bonus, immediate vesting of 50% of any outstanding unvested stock options held by the executive officer and provisions of medical benefits and housing allowance. The potential obligations to pay the executive officers the above amounts may discourage a potential acquiror from effecting a change of control.

### ***We are subject to potential liabilities and anticipate significant increases in expenses in complying with the Sarbanes-Oxley Act.***

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

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

Section 404 of the Sarbanes-Oxley Act requires our management and our independent auditors to assess our internal controls over financial reporting on an annual basis. During the course of our assessment of our internal control environment throughout the year 2004, we identified certain deficiencies that, if not remedied and re-tested by December 31, 2004, would result in material weaknesses in our internal control environment. As of December 31, 2004, we were able to successfully remediate and re-test all previously identified potential material weaknesses in our internal control environment except for a weakness related to our provisioning for income tax under U.S. GAAP. There is a risk that our inability to conclude that there were no material weaknesses in our internal financial reporting as of December 31, 2004 could negatively impact investor confidence and our stock price.

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

We are exposed to interest-rate risk primarily associated with our cash, short-term investments and short-term bank loans. To date, we have not entered into any types of derivatives to hedge against interest-rate changes.

We are exposed to exchange rate risk in connection with the relative value of the U.S. dollar and the Renminbi. Substantially all of our revenues and expenses relating to hardware sales are denominated in U.S. dollars, and substantially all of our revenues and expenses relating to the service and software components of our business are denominated in Renminbi. As of June 30, 2005, the rate of exchange quoted by the People's Bank of China was US\$1.00 = RMB8.2765. Hypothetically, if the exchange rate were to increase by 2% to US\$1.00 = RMB8.4420, our net assets would potentially decrease by \$1,807. If the exchange rate were to decrease by 2% to US\$1.00 = RMB8.1110, our net assets would potentially increase by \$1,881. To reduce currency risk related to the Renminbi, we maintain a significant portion of our cash deposits in U.S. dollars. At times, we have used these U.S. dollar deposits to collateralize Renminbi denominated loans from Chinese banks.

## **Table of Contents**

Pursuant to an announcement by China's central bank, as of July 22, 2005 the exchange rate between the Renminbi and the U.S. dollar decreased 2% to US\$1.00 = RMB8.11, thus increasing the value of our net assets in U.S. dollars by \$1,881.

The value of our shares may be affected by the foreign exchange rate between U.S. dollars and Renminbi because the value of our business is effectively denominated in Renminbi, while our shares are traded in U.S. dollars. Furthermore, an increase in the value of the Renminbi may require us to exchange more U.S. dollars into Renminbi to meet the working capital requirements of our subsidiaries in China. Depreciation of the value of the U.S. dollar will also reduce the value of the cash we hold in U.S. dollars, which we may use for purposes of future acquisitions or business expansion. We actively monitor our exposure to these risks and adjust our cash position in the Renminbi and the U.S. dollar when we believe such adjustments will reduce our foreign exchange risk. For example, in February 2004 we exchanged approximately \$28 million cash in U.S. dollar into Renminbi.

There have been no significant changes in our exposure to changes in either interest rates or foreign currency exchange rates for the quarter ended June 30, 2005. Our exposure to interest rate changes is limited as we do not have variable rate or long-term borrowings. We are subject to variable interest rates on our bank deposits that are short-term investments. As there are no significant market price movements, such investments are held at cost.

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

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

Prior to the filing date of this quarterly report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-14 under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective.

### **Changes in Internal Controls Over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act). During the assessment of our internal control over financial reporting performed in connection with the preparation of management's annual report on internal control over financial reporting contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004, we identified that our management lacked appropriate experience and expertise relating to accounting for income taxes under U.S. GAAP. In order to remediate this weakness, we had hired an experienced in-house U.S. tax expert in May, 2005 and have established a new control process for U.S. tax accounting. Except for the foregoing, there were no significant changes in our internal controls over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

On December 4, 2001, a securities class action case was filed against us, certain of our officers and directors and the underwriters of our initial public offering, or IPO. The lawsuit alleged violations of the federal securities laws and was docketed in the United States District Court for the Southern District of New York as *Hassan v. AsiaInfo Holdings, Inc., et al.* The lawsuit alleged, among other things, that the underwriters of our IPO improperly required their customers to pay the underwriters excessive commissions and to agree to buy additional shares of our common stock in the aftermarket as conditions to their purchasing shares in our IPO. The lawsuit further claimed that these supposed practices of the underwriters should have been disclosed in our IPO prospectus and registration statement. The suit seeks rescission of the plaintiffs' alleged purchases of our common stock as well as unspecified damages. In addition to the case against us, various other plaintiffs have filed approximately 1,000 other, substantially similar class action cases against approximately 300 other publicly traded companies and their IPO underwriters in New York City, which along with the case against us have all been transferred to a single federal district judge for purposes of case management. On July 15, 2002, together with the other issuer defendants, we filed a collective motion to dismiss the consolidated, amended complaints against the issuers on various legal grounds common to all or most of the issuer defendants. The underwriters also filed separate motions to dismiss the claims against them. On October 9, 2002, the court dismissed without prejudice all claims against the individual defendants in the litigation. The dismissals were based on stipulations signed by those defendants and the plaintiffs' representatives. On February 19, 2003, the court issued its ruling on the motions to dismiss filed by the underwriter and issuer defendants. In that ruling the court granted in part and denied in part those motions. As to the claims brought against us under the anti-fraud provisions of the securities laws, the court dismissed all such claims without prejudice. As to the claims brought under the registration provisions of the securities laws, which do not require that intent to defraud be pleaded, the court denied the motion to dismiss such claims as to us and as to substantially all of the other issuer defendants. The court also denied the underwriter defendants' motion to dismiss in all respects.

**Table of Contents**

In June 2003, based on a decision made by a special independent committee of our board of directors, we elected to participate in a proposed settlement agreement with the plaintiffs in this litigation. If ultimately approved by the court, this proposed settlement would result in a dismissal, with prejudice, of all claims in the litigation against us and against any of the other issuer defendants who elect to participate in the proposed settlement, together with the current or former officers and directors of participating issuers who were named as individual defendants. The proposed settlement does not provide for the resolution of any claims against the underwriter defendants, and the litigation against those defendants is continuing. The proposed settlement provides that the class members in the class action cases brought against the participating issuer defendants will be guaranteed a recovery of \$1 billion by insurers of the participating issuer defendants. If recoveries totaling \$1 billion or more are obtained by the class members from the underwriter defendants, however, the monetary obligations to the class members under the proposed settlement will be satisfied. In addition, all participating issuer defendants will be required to assign to the class members certain claims that we may have against the underwriters. The plaintiffs have filed a motion asking the Court to give its preliminary approval to the form of the settlement documents, including the notice of the settlement to be sent to class members.

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

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

On March 2, 2000, our Registration Statement on Form S-1 covering the offering of 5,000,000 shares of our common stock (No.333-93199) was declared effective. The underwriters in the offering exercised an over-allotment option to purchase an additional 750,000 shares of our common stock. The total price to the public for the shares offered and sold was \$138,000,000. The net proceeds of the offering (after deducting expenses) was approximately \$126,610,000.

The net proceeds have been used for general corporate purposes, including working capital, and expenses such as research and development and sales and marketing, as well as acquisition or investment in complementary businesses or products. The remaining net proceeds from the offering have been invested in cash, cash equivalents, and short-term investments. The use of proceeds from the offering does not represent a material change in the use of proceeds described in the prospectus contained in the Registration Statement on Form S-1 described above. None of the net proceeds of the offering have been paid directly or indirectly to our directors, officers or their associates, to persons owning ten percent or more of our common stock, or to our affiliates.

In the fourth quarter of 2004, our board of Directors approved a stock repurchase program under which we may repurchase up to 5,000,000 shares of our outstanding common stock for a period of up to six months. In the second quarter of 2005, our Board of Directors authorized an extension of the stock repurchase program. Under the extended program, we may repurchase a total of up to 5,500,000 shares of our outstanding common stock. Our Board also authorized an extended period for the repurchase program, which will now terminate on August 17, 2005. During the three- and six-month periods ended June 30, 2005, we repurchased 2,560,052 shares at a cost of \$13.5 million and 4,933,107 shares at a cost of \$25.4 million, respectively. The following table provides a breakdown of the purchases we made under the repurchase plan during the quarter ended June 30, 2005.





**Table of Contents**

Period	Issuer Purchases of Equity Securities			(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	
April 1, 2005 - April 30, 2005	1,644,000	5.16	1,644,000	1,324,119
June 1, 2005 - June 30, 2005	916,052	5.53	916,052	408,067
Total	2,560,052	5.29	2,560,052	408,067

**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K***(a) Exhibits*

Please see the Exhibit Index attached hereto.

*(b) Reports on Form 8-K*

We furnished a Current Report on Form 8-K on May 30, 2005 relating to a press release announcing the extension of our stock repurchase program. We furnished a Current Report on Form 8-K on July 27, 2005 relating to our quarterly earnings announcement for the quarter ended June 30, 2005.

**Table of Contents**

Signature

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

Date: August 9, 2005

AsiaInfo Holdings, Inc.

By: /s/ Ying Han

---

Name: Ying Han

Title: Chief Financial Officer

(duly authorized officer and principal financial officer)

35

**Table of Contents**

## EXHIBIT INDEX

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

<b>Exhibit Number</b>	<b>Description</b>
3.1	Certificate of Incorporation of AsiaInfo Holdings, Inc., dated June 8, 1998*
3.2	Certificate of Amendment to Certificate of Incorporation of AsiaInfo Holdings, Inc., dated August 27, 1999*
3.3	Certificate of Amendment to Certificate of Incorporation of AsiaInfo Holdings, Inc., dated November 15, 2000**
3.4	Certificate of Correction to Certificate of Amendment to Certificate of Incorporation of AsiaInfo Holdings, Inc., dated January 18, 2001**
3.5	Amended and Restated By-Laws of AsiaInfo Holdings, Inc., dated October 21, 2004###
4.1	Specimen Share Certificate representing AsiaInfo Holdings, Inc. shares of common stock*
10.1	Lease of AsiaInfo's headquarters at 6 Zhongguancun South Street, Beijing, China, dated August 31, 1999*
10.2	Master Executive Employment Agreement between AsiaInfo Holdings, Inc. and Ying Han dated May 30, 2003#
10.3	Change of Control Severance Agreement between AsiaInfo Holdings, Inc. and Ying Han dated May 30, 2003#
10.4	Master Executive Employment Agreement between AsiaInfo Holdings, Inc. and Steve Zhang dated April 1, 2004*****
10.5	Change of Control Severance Agreement between AsiaInfo Holdings, Inc. and Steve Zhang dated April 1, 2004*****
10.6	Acquisition Agreement between AsiaInfo Holdings, Inc. and Lenovo Group Limited dated July 27, 2004##
10.7	Supplement and Amendment No.1 to Acquisition Agreement dated as of October 1, 2004###
10.8	Trademark License Agreement between Bonson Information Technology Limited and Lenovo (Beijing) Limited dated October 19, 2004####
10.9	Patent, Copyright and Technology License Agreement between Lenovo (Beijing) Limited, Legend Holdings Limited, Bing Yu and Zheng Wang dated October 19, 2004####
10.10	Patent Assignment Agreement between Lenovo (Beijing) Limited, Legend Holdings Limited, Bing Yu and Zheng Wang dated October 19, 2004####
10.11	Exclusive Business Cooperation Agreement between Lenovo-AsiaInfo Technologies, Inc. and Lenovo Computer System and Technology Services Co., Ltd. dated October 19, 2004####
10.12	Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Lenovo (Beijing) Limited and Lenovo Computer System and Technology Services Co., Ltd. dated October 19, 2004####
10.13	Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Lenovo Manufacturing Limited and Lenovo Computer System and Technology Services Co., Ltd. dated October 19, 2004####

**Table of Contents**

<b>Exhibit Number</b>	<b>Description</b>
10.14	Equity Transfer Arrangement Agreement between Lenovo-AsiaInfo Technologies, Inc., Lenovo Group Limited, Lenovo (Beijing) Limited, Lenovo Manufacturing Limited, Lenovo Computer System and Technology Services Co., Ltd. and Bonson Information Technology Limited dated October 19, 2004#####
10.15	Power of Attorney executed by Lenovo (Beijing) Limited dated October 19, 2004#####
10.16	Power of Attorney executed by Lenovo Manufacturing Limited dated October 19, 2004#####
10.17	Loan Agreement between Lenovo-AsiaInfo Technologies, Inc. and Legend Holdings Limited dated October 19, 2004#####
10.18	Employment Agreement between AsiaInfo Holdings, Inc. and Bing Yu dated September 9, 2004#####
10.19	Employment Agreement between AsiaInfo Holdings, Inc. and Yue Ma dated October 1, 2004#####
10.20	AsiaInfo Holdings, Inc. 2005 Stock Incentive Plan, as amended through April 8, 2005****
10.21	Power of Attorney executed by Legend Holdings Limited dated December 2, 2004#####
10.22	Exclusive Business Cooperation Agreement between Lenovo-AsiaInfo Technologies, Inc. and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004 #####
10.23	Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Lenovo Holdings Limited and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004#####
10.24	Equity Transfer Arrangement Agreement between Lenovo-AsiaInfo Technologies, Inc., Lenovo Holdings Limited and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004 #####
10.25	Loan Agreement executed by Lenovo-AsiaInfo Technologies, Inc. and Bing Yu dated October 19, 2004 #####
10.26	Loan Agreement executed by Lenovo-AsiaInfo Technologies, Inc. and Zheng Wang dated October 19, 2004#####
10.27	Power of Attorney executed by Bing Yu dated December 2, 2004#####
10.28	Power of Attorney executed by Zheng Wang dated December 2, 2004#####
10.29	Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Zheng Wang and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004 #####
10.30	Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Bing Yu and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004 #####
10.31	Exclusive Option Agreement between Lenovo-AsiaInfo Technologies, Inc., Zheng Wang and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004#####
10.32	Exclusive Option Agreement between Lenovo-AsiaInfo Technologies, Inc., Bing Yu and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004#####
11.1	Statement regarding computation of per share earnings (included in note 11 to the consolidated financial statements included in this report)
24.1	Power of Attorney (included on signature page to this report)
31.1	Certification of Principal Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith)

**Table of Contents**

<b>Exhibit Number</b>	<b>Description</b>
31.2	Certification of Principal Financial Officer required by Rules 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith)
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)
*	Incorporated by reference to our Registration Statement on Form S-1 (No.333-93199).
**	Incorporated by reference to our Annual Report on Form 10-K for the fiscal year ended December 31, 2000.
***	Incorporated by reference to our Proxy Statement for the 2003 Annual Meeting of Stockholders filed on March 21, 2003.
****	Incorporated by reference to our Revised Proxy Statement for the 2004 Annual Meeting of Stockholders filed on April 14, 2004.
*****	Incorporated by reference to our Annual Report on Form 10-K for the fiscal year ended December 31, 2004
#	Incorporated by reference to our Quarterly Report on Form 10-Q filed on August 14, 2003.
##	Incorporated by reference to our Quarterly Report on Form 10-Q filed on August 9, 2004.
###	Incorporated by reference to our Current Report on Form 8-K filed on October 25, 2004.
####	Incorporated by reference to our Quarterly Report on Form 10-Q filed on November 9, 2004.
#####	Incorporated by reference to our Quarterly Report on Form 10-Q filed on May 10, 2005.