PACIFICNET INC
Form 10KSB/A
April 04, 2007

**U.S. SECURITIES AND EXCHANGE COMMISSION**
WASHINGTON, D.C. 20549

**FORM 10-KSB/A#2**

**x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECRITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005**

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

**FOR THE TRANSITION PERIOD FROM _________ TO _________**

*COMMISSION FILE NUMBER: 000-24985*

**PACIFICNET INC.**
(Exact name of small business issuer in its charter)

| | |
|---|---|
| **DELAWARE**<br>(State or other jurisdiction of incorporation or organization) | **91-2118007**<br>(I.R.S. Employer Identification No.) |
| 23/F, TOWER A, TIMECOURT, NO.6 SHUGUANG XILI, CHAOYANG DISTRICT, BEIJING, CHINA 100028<br>(Address of principal executive offices) | N/A<br>(Zip Code) |

Registrant's Telephone Number: 0086-10-59225000
601 New Bright Building, 11 Sheung Yuet Road, Kowloon Bay, Kowloon, Hong Kong.
(Former Name and Address)

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

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

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act o

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO o

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. o

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

Issuer's revenues for its most recent fiscal year: $44,341,000. The aggregate market value of the common stock held by non-affiliates of the registrant as of March 31, 2006 was approximately $66,627,235, based upon the closing sale price of $7.39 per share as reported by The NASDAQ National Market on such date. There were 13,238,497 shares of the Company's common stock outstanding on March 31, 2006.

Transitional Small Business Disclosure Format (check one): Yes o No x

DOCUMENTS INCORPORATED BY REFERENCE - NONE

Explanatory Note:

This Annual Report on Form 10-KSB/A ("Form 10-KSB") is being filed as Amendment No. 2 to our Annual Report on Form 10-KSB/A for the year ended December 31, 2005, which was originally filed with the Securities and Exchange Commission ("SEC") on April 28, 2006 and amended on November 3, 2006. We are amending and restating the following specific items in this Amendment No. 2:

(i) Part II. Item 7. Financial Statements - to remove the audit report of Clancy and Co., P.L.L.C., and to include the following legend on the Company's financial statements "The financial statements of PacificNet and Subsidiaries for the fiscal years ended December 31, 2005 and 2004 are unaudited."

(ii) Part II. Item 8A. Controls and Procedures - to disclose that our disclosure controls and procedures are not effective.

(iii) Part III. Item 9. Directors, Executive Officer, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act to update officer information for our recently appointed CFO.

(iv) Part III. Item 13. Exhibits and Reports on Form 8-k- to reflect inclusion of updated officer certifications in Exhibits 31 and 32 for this Amendment No. 2, and to remove the incorrect reference to the filing of Exhibit 23.1 to the Form 10-KSB/A.

PacificNet is currently in the process of evaluating the reasons for the withdrawal of the audit reports by its previous independent auditor, Clancy & Co. P.L.L.C., for the years ended December 31, 2005 and 2004, and determining how quickly it can obtain the reinstatement of such audit reports or new audit reports regarding such years from its current independent public auditors, Kabani & Company, Inc. The audit committee of the Company is aware of the issues raised and is conducting an internal investigation of certain of PacificNet's option grant practices for the years 2003, 2004 and 2005 and expects that the results of that investigation will influence the resolution of the larger issues of the audit report. Pending the results of the internal investigation, a determination will be made as to whether a restatement of our financial statements for the years ended December 31, 2003, 2004 and 2005 will be required.

PART II



PART III



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

**PART II**

**ITEM 7. FINANCIAL STATEMENTS**

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

**INDEX TO FINANCIAL STATEMENTS**



**ITEM 8A. CONTROLS AND PROCEDURES**

**EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES.**

We maintain controls and procedures designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those controls and procedures performed as of the period covered by this report, our chief executive officer and the chief financial officer concluded that our disclosure controls and procedures were inadequate, need to be strengthened and are not sufficiently effective to ensure that information required to be disclosed by us in our reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. Material weaknesses in our internal controls over financial reporting could further adversely impact our current inability to report timely financial information. Despite the drastic strengthening of our disclosure controls and procedures over the past 12 months, our efforts have been insufficient and delayed due to our significant growth and expansion as described in Item 1 and our recent adoption of FIN46R. We are developing a plan to ensure that all information will be recorded, processed, summarized and reported on a timely basis. This plan is dependent, in part, upon reallocation of responsibilities among various personnel, hiring additional experienced personnel, allocating additional Information Technology spending, and possible raising additional funding. It should also be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

Clancy and Co., P.L.L.C. ("Clancy"), our previous independent auditors, informed the Board of Directors on April 27, 2006, of several "significant deficiencies" that collectively constituted a "material weakness" in our internal control over financial reporting under standards established by the Public Company Accounting Oversight Board.

**A SIGNIFICANT DEFICIENCY** is a control deficiency, or combination of control deficiencies, that adversely affects the Company's ability to initiate, authorize, record, process or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Company's annual or interim financial statements that is more than inconsequential and will not be prevented or detected.

**A MATERIAL WEAKNESS** is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement or the annual or interim financial statements will not be prevented or detected.

The following conditions were identified:

- The current organization of the accounting department does not provide PacificNet with the adequate skills to accurately account for and disclose significant transactions or disclosures.

- Certain key managers in the accounting department do not appear to have the knowledge and experience required for their responsibilities.

- Substantive matters are not being addressed appropriately by the Board and Audit Committee resulting in inadequate oversight from the Board and Audit Committee.

- The process that PacificNet is currently using to monitor the ongoing quality of internal controls performance, identify deficiencies and trigger timely corrective action is not working effectively.

- There is no adequate means of accurately capturing and recording certain significant and complex business transactions.

Accordingly, the Company's internal controls over financial reporting are not effective.

Based upon the Company's evaluation, which considered the above findings of Clancy, the Company's management, including the Chief Executive Officer, Chief Financial Officer and President concluded that, as of December 31, 2005, the Company's internal controls over financial reporting were not effective.

**PART III**

**ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS;**

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

Set forth below are the names of the directors, executive officers and significant employees of the Company as of April 4, 2007:

| Name | Age | Title |
|---|---|---|
| Tony Tong | 38 | Chairman and Chief Executive Officer |
| Victor Tong | 35 | President, Secretary, and Director |
| Daniel Lui | 43 | Chief Financial Officer |
| Shaojian (Sean) Wang | 41 | Director |
| Peter Wang | 51 | Independent Director (1)(3) |
| Michael Ha | 36 | Independent Director (2)(3) |
| Jeremy Goodwin | 33 | Independent Director (1)(3) |
| Tao Jin | 38 | Independent Director (1)(2)(3) |
| Mary Ma | 35 | Vice President of Finance and Chief Financial Officer for ChinaGoHi Subsidiary |
| Wenming Wang | 44 | President of ChinaGoHi Operation |
| Jingjin Wu | 46 | Vice President of ChinaGoHi & DRTV Operations |
| David Lin | 39 | Vice President of Investment Management |
| Victor Choy | 37 | Vice President, Mobile Distribution Services |
| Brian Lin | 41 | Vice President, Northern China |
| Fei Sun | 40 | Vice President, Southern China |
| Philip Cheng | 42 | Vice General Manager |
| Jack Ou | 39 | Vice General Manager, Southern China |
| Mike Fei | 38 | Company Secretary and General Counsel |
| Star Mu | 37 | Regional Manager, Northern China |
| Shannon Lee | 29 | Vice President of Investment |
| Jacob Lakhany | 29 | Director of Investor Relations and Public Relations |
| Super Yongchao Wang | 32 | Vice President of Value Added Services |
| Telly Wai-Hon Wong | 44 | Vice President of Call Center Services |
| Carol Men-Yee Chang | 43 | Vice President & COO of Call Center Operations |
| Joyce Mei-Wei Poon | 40 | Vice President of CRM Services |
| Fiona Yee-Chong Cheuk | 31 | Marketing and PR Manager, CRM & Call Center Services |

(1) Member of Audit Committee

(2) Member of Nominating Committee
(3) Member of Compensation Committee

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

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

**MR. TONY TONG**, age 38, is the Chairman, CEO, Executive Director, and co-founder of PacificNet since 1999. From 1995 to 1997, Mr. Tong served as the Chief Information Officer of DDS Inc., a leading SAP-ERP consulting company in the USA, which was later acquired by CIBER, Inc. (NYSE: CBR). >From 1993 to 1994, Mr. Tong worked for Information Advantage, Inc. (Nasdaq:IACO), a leading business intelligence, Data-Mining and CRM technology provider serving Fortune 500 clients. IACO consummated an IPO on Nasdaq in 1997 and was later acquired by Sterling Software and Computer Associates (NYSE:CA). From 1992 to 1993, Mr. Tong worked as a Business Process Re-engineering Consultant at Andersen Consulting (now Accenture, NYSE:ACN). From 1990 to 1991, Mr. Tong worked for ADC Telecommunications (Nasdaq:ADCT), a global supplier of telecom equipment. Mr. Tong's R&D achievements include being the inventor and patent holder of US Patent Number 6,012,066 (granted by US Patent and Trademark Office) titled "Computerized Work Flow System, an Internet-based workflow management system for automated web creation and process management." Mr. Tong also serves on the board of advisors of Fortune Telecom (listed on Hong Kong Stock Exchange: 0110.HK), a leading distributor of mobile phones, PDAs, telecom services, and accessories in China and Hong Kong. Mr. Tong is a frequent speaker on technology investment in China, and was invited to present at the Fourth APEC International Finance & Technology Summit in 2001. Mr. Tong is the Vice Chairman (PRC) of Hong Kong Call Centre Association, a Fellow of Hong Kong Institute of Directors, a consultant on privatization and securitization for China's State-owned Assets Supervision and Administration Commission (SASAC), and a frequent speaker for LexisNexis, a licensed Continued Professional Development (CPD) trainer, on China investment. Mr. Tong graduated with Bachelor of Mechanical/Industrial Engineering Degree from the University of Minnesota and served on the Computer Engineering Department Advisory Board and was an Adjunct Professor at the University of Minnesota, USA.

**MR. VICTOR TONG**, age 35, is the President of PacificNet, and has served on our board as an Executive Director since 2002. Mr. Victor Tong gained his consulting, systems integration, and technical expertise through his experience at Andersen Consulting (now Accenture, NYSE:ACN), American Express Financial Advisors (IDS), 3M, and the Superconductivity Center at the University of Minnesota. In 1994, Victor co-founded Talent Information Management ("TIM"), a leading internet application development and consulting company in Minnesota. PacificNet.com was originally founded as an operating division of TIM. In 1997, Mr. Tong successfully sold GoWeb internet consulting division of TIM to Key Investment, a leading technology and media investment company owned by Vance Opperman, a billionaire in Minnesota who founded West Publishing. Mr. Tong became the President of KeyTech, a leading information technology consulting company based in Minnesota. In 1999, he was recognized in "City Business 40 Under 40" as one of the future business and community leaders in Minnesota. Mr. Tong won the Student Commencement Speaker Award and graduated with honors with a Bachelor of Science in Physics from the University of Minnesota. Mr. Tong was an adjunct professor at the College of Software of Beihang University, one of the top software colleges in China. Victor Tong is the brother of Tony Tong.

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

**MR. SHAOJIAN (SEAN) WANG**, age 41, has served on our board as a Director since 2002. From 2002 to May 2006, Mr. Wang also served as Chief Financial Officer of PacificNet. Mr. Wang is now President and Chief Operating Officer of Hurray! Holding Co., Ltd.(Nasdaq:HRAY), a NASDAQ-listed Chinese VAS company. Previously, Mr. Sean Wang was COO and acting Chief Financial Officer (CFO) at GoVideo and Opta Corporation, a public listed consumer electronics company in the US controlled by TCL, a leading consumer electronics maker in China. From 1987 to 2002, he served as a country manger at Ecolab, Inc. and as the managing director at Thian Bing Investments PTE, Ltd. From 1993 to 2002, Mr. Wang served as managing director of Thian Bing Investments PTE, Ltd. where he managed the Singapore-based company's multi-million dollar investment operations and identified strategic and investment opportunities. From 1987 to 1993, Mr. Wang held a number of increasingly important positions with Minnesota-based Ecolab Inc., culminating in his serving as general manager for the company's Indonesia operations. Mr. Sean Wang attended Peking University and received a BS in Economics from Hamline University and an MBA from Carlson School of Management, University of Minnesota.

**MR. PETER WANG**, age 51, has served on our board as an Independent Director since December 24, 2003. Mr. Wang is currently the Chairman and CEO of China Biopharma, Inc. (www.chinabiopharma.com.cn, OTCBB:CPBC, formerly Techedge Inc.), a fast growing developer, producer and distributor of human vaccine products in China, including human vaccines against influenza, hemorrhagic fever, and Japanese Encephalitis. Mr. Wang was a co-founder of Unitech Telecom (now named UTStarcom, NASDAQ:UTSI). Under his management, UTStarcom created the first digital loop carrier system and installed the first PHS system in China. As an entrepreneur, he has successfully co-founded and built other ventures in the US, including World Communication Group and World PCS, Inc. Mr. Wang has more than 20 years of experience in communication products and services. Mr Wang is Co-Chairman of Business Advisory Council of the National Republican Congressional Committee. In 2004, Mr. Wang received the Outstanding 50 Asian Americans In Business award for his entrepreneurial achievement and technology leadership in the telecommunications industry. Mr. Wang holds a BS. in Math & Computer Science and a M.S. in Electrical Engineering from University of Illinois, as well as an MBA in Marketing from Southeast-Nova

University.

**MR. MICHAEL CHUN HA**, age 36, has served on our board as an Independent Director since December 24, 2003. Mr. Ha graduated from the Faculty of Law, University of Hong Kong in 1994 with a bachelor degree in law and was admitted as a solicitor of the High Court of the Hong Kong Special Administrative Region in 1997 and a solicitor of the Supreme Court of England and Wales in 1998. From 1995 to 2002, Mr. Ha worked as lawyer in a number of international and Hong Kong prestigious law firms, specializing in the areas of corporate finance, securities offerings, takeovers, cross-border mergers and acquisitions, venture capital, corporate restructuring, regulatory and compliance issues, project finance, and general commercial transactions and services in Hong Kong and the People's Republic of Hong Kong. In 2002, Mr. Ha commenced his own practice in the trade name of "Ha and Ho Solicitors" and the firm specializes in the areas of general commercial transactions, corporate finance and civil and criminal litigations. Mr. Ha is also the company secretary of, Shanxi Central Pharmaceutical International Company Limited, a Hong Kong main board listed company from year 2000 and a director of a private investment company, Metro Concord Investment Limited, from year 2002.

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

**MR. TAO JIN**, age 38, has served on our board as an Independent Director since January 6, 2005. Mr. Jin is a resident partner at Jun He Law Offices (www.JunHe.com), a leading Chinese law firm specializing in commercial legal practice with over 160 lawyers and offices in Beijing, Shanghai, Shenzhen, Dalian, Haikou and New York. Founded in April 1989, Jun He was one of the first private law firms formed in China, and has been a pioneer in the re-established Chinese legal profession with a focus in representing foreign clients in business activities throughout China. Over the past few years, Jun He has been honored a number of times as one of the best law firms in China by the Ministry of Justice of China. With a team of more than 160 well-trained lawyers, Jun He is one of the largest and most established law firms in China. Prior to joining Jun He, Mr. Jin served as Vice President and Assistant General Counsel of J.P. Morgan Chase Bank, as the head legal counsel for capital markets transactions in Asia, and for JPMorgan's M&A transactions in China. Mr. Jin joined Jun He as a partner in 2005. From 1999 to 2002, Mr. Jin served as a Senior New York Qualified Lawyer for Sullivan & Cromwell, which represented China Unicom, PetroChina and China Telecom in their IPO's and dual listings in New York and Hong Kong. From 1996 to 1999, Mr. Jin served as Associate Lawyer for Cleary, Gottlieb Steen & Hamilton, which represented various Fortune 500 companies and investment banks in public and private securities offerings and M&A activities. Mr. Jin received his Juris Doctor in 1996 with high honors from Columbia University, and received B.S. in Psychology in 1990 from Beijing University.

**The following is the list of PacificNet's management team, key positions and brief biography:**

**MS. MARY MA,** age 35, has been with PacificNet since February 2004. Previously, Ms. Ma worked as Manager of Corporate Finance and Audit Division for China Motion, a telecom company listed on the Hong Kong Stock Exchange. Ms. Ma also worked as Finance Manager for Shenzhen Lufthansa Technik Ltd., a subsidiary of Germany Lufthansa Group. Ms. Ma also worked as Vice President for a public company listed on NASDAQ where she gained working experience in the US. Ms. Ma is experienced accountant with working knowledge of Chinese Accounting Standard, IAS and USGAAP, corporate finance, finance analysis and operation. Ms. Ma received MBA degree from American Kennedy Western University, and bachelor degree in Accounting.

**MR. WENMING WANG,** age 44, has been the President of PacificNet's ChinaGoHi Operation since December 2005. In addition to being a successful self-made private entrepreneur in China, Mr. Wang has been elected a congressman of People's Congress for Shenzhen Municipality, China, since 2005. Mr. Wang is the Founder, Chairman and Chief Executive Officer of Shenzhen Guhaiguanchao Investment Advisory Co., Ltd. (ChinaGoHi), a leading investment advisory services company in China. Mr. Wang is also the chief publisher of Sino-Business Weekly (ISSN 1671-6728, www.fmm88.com , www.lcgj.cn), a leading financial investment management magazine covering China's stock market and securities investment. Mr. Wang has extensive experience in China's stock market and investment consulting industry for more than 10 years since the launch of China's stock markets. Under his leadership, Shenzhen Guhaiguanchao has achieved growing revenue, profits, and industry recognition since its establishment in 2002, and was by Shenzhen government as "Shenzhen's Top 100 Tax-paying Enterprises" in 2003 and 2004.

**MR. WU JINGJIN,** age 46, is one of the co-founders and executive director of Shenzhen Guhaiguancao Investment Advisory Co., Ltd. (ChinaGoHi) a leading investment advisory company in mainland China. Mr. Wu was one of the pioneer analysts in mainland China and has extensive working experience in China's investment banking and investment consulting industry since the launch of China's stock market. From1994-1999, Mr. Wu worked as Senior Manager at J&A Securities, one of the leading investment banks in mainland China at that time. Mr. Wu holds an MBA degree from the State University of New York at Buffalo.

**MR. DAVID LIN,** age 39, has been with PacificNet since 2004. Previously, Mr. Lin worked as Assistant President of ABB Meishi Power Investment Co., Ltd. Mr. Lin also worked as Corporate Secretary and Assistant General Manager for a public company listed on NASDAQ where he gained working experience in the US. Mr. Lin received Master degree of finance from Fudan University, and Bachelor degree of English from Tianjin University.

**MR. VICTOR CHOY,** age 37, joined PacificNet in 2005 as Vice President of Mobile Distribution Services. From 2003 to present, Mr. Choy is a partner and director of Ora Telecom China, a subsidiary of the Singapore based manufacturer and distributor of original accessories for major brands including Nokia and Motorola, as well as OEM branded Bluetooth products, with sales offices in 12 countries in Asia and Europe. Mr. Choy has over 13 years of telecom experience in HK, China and SE Asia. From 1998 to 2002, Mr. Choy worked as the General Manager of Asia Pacific (APAC) for Avenir Telecom, a listed company from France and a leading mobile distributor, telecom retailer, Internet service provider, and mobile accessory manufacturer in Europe. Mr. Choy helped Avenir Telecom build its APAC business from $0 to annual revenues of US$100 million within 2 years of operation in mobile phone and accessories distribution. In 2000, Mr. Choy expanded the company into China and found Avenir Telecom China Limited in Shenzhen In one year, the Avenir China opened 7 retail outlets in the city of Shenzhen and Guangzhou and also started the distribution of products for China Mobile and China Unicom by signing first level distributorship agreements. At Avenir, Mr. Choy initiated a JV between Cetelec and China Motion, a Hong Kong listed telecom company, to run an customer service center for mobile phones and pagers in Shenzhen. Mr. Choy formed a cooperation with France Telecom's Rapidlink subsidiary, to provide retail and distribution services to China Unicom Guangdong. Mr. Choy received the Bachelor of Science degree in Actuarial Science and Computer Science from University of Toronto in 1992.

**MR. BIN "BRIAN" LIN,** age 41, was promoted to the Vice President for PacificNet China Operations in 2005. Mr. Lin is currently the President of Linkhead, a leading IVR and CTI technology provider 51% owned by PacificNet. Previously, Mr. Lin worked for Nortel in Canada, Tandem Computer, Motorola, and UTStarcom. Mr. Lin received the Master of Applied Science degree in Electrical Engineering from the University of Toronto in 1989.

**MR. FEI SUN,** age 40, has been with PacificNet since 2003 and has served several positions including Manager of Shenzhen office, Director of Investment, etc. Mr. Sun has been a director of Linkhead for 10 years and serves as the General Manager of Linkhead Shenzhen Office. >From 1991, Mr. Sunfei worked in Japan as the Chief Representative of China in a software company co-organized by CATIC and Japanese Central Electronic Power Research Institution, focused on software development and organized the Japanese company software development outsourced to the Chinese company. Mr. Sun graduated with Master Degree of Electronic Engineering from China Northeast Industrial University.

**MR. PHILIP CHENG,** age 42, has been with PacificNet since 2005. As the Vice General Manager of PacificNet, Philip is responsible for the company's synergy development, corporate strategy coordinating and execution for all PacificNet's subsidiaries so as to enhance the internal control and resource sharing among the group. Prior to joining PacificNet, Mr. Cheng worked for CSL, the largest mobile operator in Hong Kong, and was in charge of CSL's Value-Added Services development in China. Previously, Mr. Cheng worked as deputy general manager in the VAS department for Guangzhou Suntek Technology, a leading telecom equipment and VAS provider listed on China's stock exchange. Mr. Cheng received his Master and Bachelor degree of Science respectively in 1988 and 1985 from Southern China University of Technology, Department of Radio Engineering, Major of Communications, and performed his master research in Digital Signal Processing.

**MR. JACK OU,** age 39, joined PacificNet in 2005 as Manager and Financial Controller of PacificNet Guangzhou Operations. >From 1986 to 1998, Mr. Jack Ou worked as the Vice Director at the Guangzhou Justice Bureau and as PRC attorney at Guangdong Overseas Chinese Law Firm. Subsequently, Mr. Jack Ou worked as the Manager of Research Department and Assistant General Manager in Guangdong Huafu Investment Inc. From 2003 to 2005, Mr. Ou served as a Manager and Research Analyst at Everbright Securities, a leading securities brokerage firm in China. Mr. Ou published many research reports covering China stock market and listed companies, with a focus on analyzing the financial accounting reports of China's listed companies. Mr. Ou is an accredited PRC lawyer and received his Law Degree from the Sun Yat-Sen University, Guangzhou, China. Mr. Ou also graduated from Guangdong Communist Party Executive College and received a Master of Economics Degree.

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

**MR. STAR MU,** age 37, joined PacificNet in 2003 as Regional Manager, North China. Mr. Mu received his bachelor degree in Computer Science from the Northwestern Polytechnic University of China in 1992.

**MISS. SHANNON LEE,** age 29, joined PacificNet in 2005 as Vice President of China Investment of PacificNet. >From 2003 to 2004, Miss Li served as a Project Manager (Investment) of Sun & Sun Capital Holdings Pte. Ltd., a leading Singapore-based investment bank focusing on IPO and investment banking services. Previously, Miss Li worked as the Executive Assistant to President at Linkhead (now 51% owned by PacificNet). Miss Li graduated with honors with a Bachelor of Science in Automobile Design and Manufacturing from Harbin Institute of Technology, China in 1998 and received the Master of Business Administration degree from the University of Nottingham, UK in 2003.

**MR. JACOB LAKHANY,** age 29, is the Director of Investor Relations and has been with PacificNet since 2003. Previously Mr. Lakhany was a Quality Assurance Supervisor for APAC Customer Service, a leading CRM call center services company listed on NASDAQ, where he gained experience in the outsourced telemarketing industry overseeing service quality and relationships with companies such as Citibank, Sears, Shell, Chase Manhattan, and Bank One. Mr. Lakhany attended Northern State University in Aberdeen, SD.

**MR. SUPER YONGCHAO WANG,** age 32, joined PacificNet as VP of VAS in 2005. Mr. Wang is also the President of Guangzhou 3G Information Technology Co., Ltd. (GZ3G), a 51% owned subsidiary of PacificNet. Previously, Mr. Wang was the Deputy General Manager of Suntek Information (Listed on China's Shanghai stock exchange), the first private voice information IVR service provider in China. >From 1996 to 1999, Mr. Wang served as the Deputy General Manager of GD Suntek, managing 18 branches' operation nationwide. In 2000 Mr. Wang founded Guangzhou Sunroom Information Ltd. (GZ-Sunroom, subsidiary of GZ3G) focusing on wireless value-added services provision and was appointed CEO of the company. In the following two years, GZ-Sunroom worked with 27 branches of China Mobile successfully to launch its VAS and IVR business. GZ-Sunroom had become one of the largest mobile and telephone information service providers (SP) serving 26 provinces in China. Mr. Wang received the B.A in Business Administration from Jinan University in Guangzhou in 1994 and studied master course of Economics at Guangdong Academy of Sciences in 2002.

**MR. TELLY WONG,** age 44, joined PacificNet in 2003 as part of the Epro acquisition. Mr. Wong is the Managing Director and a co-founder of PacificNet Epro for the last 10 years, and is responsible for directing the overall business policies and strategies and overseeing the business development of Epro's overall call center and CRM services. Prior to Epro, Mr. Wong was the MIS Manager of Star Paging, one of the largest paging operation in Hong Kong. During his services with Star Paging, Mr. Wong was responsible for managing the entire management information system of the paging group. He was also a founder of Brightfair Technology Ltd which was incorporated in 1989 and mainly involved in paging system software design for carriers in the countries of South East Asia. Mr. Wong, holds a Master Degree in Business Administration,

**MS. CAROL CHANG,** age 43, joined PacificNet in 2003 as part of the Epro acquisition. Ms. Chang joined Epro in 1988 as Marketing Executive and was late promoted to Epro Telecom's General manager in 1994 and then to Chief Operating Officer for PacificNet Epro's call center operations. Ms. Chang is now mainly responsible for Hong Kong call center business operations. Ms. Chang holds a BSc Degree in Computer Science from the University of Texas at Austin, USA.

**MS. JOYCE POON,** age 40, joined PacificNet in 2003 as part of the Epro acquisition. Ms. Poon is the General Manager of PacificNet Epro responsible for the development and management of CRM consulting and training services in China. Mr. Poon has been with Epro since it's founding in 1994, serving many key roles in customer service operations and business development. Her most recent role was, and continues to be, in charge of the Company's Training and Consulting Division she formed two years ago. The Division has enjoyed steady growth and has received high praises from some of the largest enterprise clients in China. Ms Poon, General Manager, of PRC Business, holds a MBA Degree in Marketing.

**MS. FIONA CHEUK,** age 31, joined PacificNet Epro in 2004 as Marketing Manager. The major duty of Ms. Cheuk is to drive innovative and effective marketing strategy of exploring more business opportunities for the company. She also takes responsibility for delivering efficient marketing communications of raising brand awareness and revealing value differentiation of our products and services in the competitive market. Prior to joining Epro, Ms. Cheuk gained customer relationship management and marketing experiences while working at SmarTone Telecom (HKSE:0315.HK) and Cisco Systems. Ms. Cheuk holds a MBA Degree in Marketing from Western Sydney University.

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

Section 16(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), requires our executive officers, directors and persons who beneficially own more than 10% of a registered class of our equity securities to file with the Securities and Exchange Commission initial reports of ownership and reports of changes in ownership of our common stock and other equity securities. Such executive officers, directors, and greater than 10% beneficial owners are required by SEC regulation to furnish us with copies of all Section 16(a) forms filed by such reporting persons.

Based solely on our review of such forms furnished to us and written representations from certain reporting persons, we believe that the following executive officers and directors failed to timely file Form 4's and 5's: Tony Tong failed to timely file Form 4's, one Form 4 reporting the exercise of a stock option and three Form 4's each reporting the grant of stock options; Victor Tong failed to timely file Form 4's, one Form 4 reporting the exercise of a stock option and four Form 4's each reporting the grant of stock options; Shaojian Wang failed to timely file Form 4's, two Form 4's each reporting the exercise of stock options and three Form 4's each reporting the grant of stock options; Michael Chun Ha failed to timely file Form 4's, one Form 4 reporting the exercise of an option and three Form 4's each reporting the grant of stock options; Peter Wang failed to timely file three Form 4's each reporting the grant of stock options; Jeremy Goodwin failed to timely file three Form 4's each reporting the grant of stock options and Tao Jin failed to timely file three Form 4's each reporting the grant of stock options.

**AUDIT COMMITTEE OF THE BOARD OF DIRECTORS**

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

The board of directors has established an audit committee in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934, as amended. The members of the Audit Committee are Messrs. Peter Wang, Jeremy Goodwin and Tao Jin, each of whom are considered "independent" under the NASDAQ National Market listing standards currently in effect.

The board of directors has determined that each of the members of the audit committee qualify as an "audit committee financial expert" under the Securities and Exchange Commission's definition.

**ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K.**

EXHIBITS

The following exhibits are filed as part of this report:

| **EXHIBIT NUMBER** | **DESCRIPTION** |
|---|---|
| 2.1 | Share Exchange Agreement by and among Davin Enterprises, Inc., Carl Tong, Leo Kwok and Acma Strategic Holdings Limited dated December 15, 1997. (1) |
| 2.2 | Share Exchange Agreement dated February 17, 2000, between Registrant and holders of membership interests in PacificNet.com LLC.(2) |
| 2.3 | Supplement to Share Exchange Agreement dated April 29, 2000, between Registrant and holders of membership interests in PacificNet.com LLC. (2) |
| 2.4 | Agreement dated September 30, 2000, among the Company and the "Purchasers" named therein. (3) |
| 2.5 | Supplemental Agreement dated October 3, 2000, among the Company and the "Purchasers" named therein. (3) |
| 2.6 | Deed of Waiver, dated October 3, 2000, by Creative Master Limited in favor of the Company. (3) |
| 3.1 | Certificate of Incorporation, as amended. (4) |
| 3.2 | Form of Amended By Laws of the Company. (4) Specimen Stock Certificate of the Company. |
| 4.1 | Securities Purchase Agreement, dated as of January 15, 2004, among PacificNet Inc. and the purchasers identified therein (5) |
| 4.2 | Form of Common Stock Warrant issued to each of the purchasers (5) |
| 4.3 | Form of Common Stock Warrant issued to each of the purchasers, dated December 9, 2004 (10) |
| 4.4 | Form of Common Stock Warrant issued to each of the purchasers, dated November 17, 2004 (10) |
| 4.5 | Securities Purchase Agreement, dated February 28, 2006, among PacificNet Inc. and the Holders identified therein (12) |
| 4.6 | Form of Variable Rate Convertible Debenture due March 2009 issued to each of the Holders (12) |
| 4.7 | Form of Common Stock Purchase Warrant issued to each of the holders (12) |
| 4.8 | Form of Registration Rights Agreement, dated February 28, 2006 (17) |
| 10.1 | Form of Indemnification Agreement with officers and directors. (1) |
| 10.2 | Amendment to 1998 Stock Option Plan. (8) |
| 10.3 | Form of Notice of Stock Option Grant and Stock Option Agreement under the 1998 Stock Option Plan. (2) |
| 10.4 | Amendment dated January 31, 2002 to the Subscription Agreement by and between the Company and Sino Mart Management Ltd., dated as of December 9, 2001 (6) |
| 10.6 | Sub-Lease Agreement dated August 30, 2002.(8) |
| 10.7 | Agreement dated on December 1, 2003 for the Sale and Purchase and Subscription of Shares in Epro Telecom Holdings Limited (9) |

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| EXHIBIT NUMBER | DESCRIPTION |
|---|---|
| 10.8 | Agreement dated on December 15, 2003 for the Sale and Purchase of Shares in Beijing Linkhead Technologies Co., Ltd. (9) |
| 10.9 | Securities Purchase Agreement, dated as of December 9, 2004, among PacificNet Inc. and the purchasers identified therein (10) |
| 10.10 | Securities Purchase Agreement, dated as of November 17, 2004, among PacificNet Inc. and the purchasers identified therein (10) |
| 10.11 | Agreement for the Sale and Purchase of Shares in Shanghai Classic Group Limited (4) |
| 10.12 | Agreement for the Sale and Purchase of Shares of Cheer Era Limited (11) |
| 10.13 | Agreement for the Sale and Purchase of Shares in Pacific Smartime Solutions Limited |
| 10.14 | Agreement for the Sale and Purchase of Shares in Guangzhou Clickcom Digit-net Science and Technology Ltd. (16) |
| 10.15 | PacificNet Inc. 2005 Stock Option Plan (15) |
| 10.16 | Agreement for the Sale and Purchase of Shares in GuangZhou 3G Information Technology Co., Ltd. (16) |
| 10.17 | Agreements of Consulting, Pledge, and Power of Attorney of Clickcom and Sunroom (14) |
| 10.18 | Agreement for the Sale and Purchase of Shares in Lion Zone Holdings (13) |
| 10.19 | Form of Lock-Up Agreement, dated March 13, 2006 (17) |
| 10.20 | Form of Voting Agreement, dated March 13, 2006 (17) |
| 14 | Code of Ethics (9) |
| 21 | List of Subsidiaries (Included in Exhibit 99.1) |
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/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. |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/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 | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. 1350 (Section 906 of the Sarbanes-Oxley Act of 2002), filed herewith. |
| 99.1 | Corporate structure chart of our corporate and share ownership structure (14) |
| 99.2 | Subscription Agreement by and between the Company and Sino Mart Management Ltd., dated as of December 9, 2001 (6) |
| 99.3 | 19.9% Private Placement Agreement and Amendments between Ho Shu-Jen and PacificNet.com Inc. (7) |

+ Filed herewith.

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

(2) Incorporated by reference to the Company's Form 8-K filed on August 11, 2000.

(3) Incorporated by reference to the Company's Form 8-K filed on October 17, 2000.

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

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

(6) Incorporated by reference to the Company's Form 8-K filed on March 20, 2002.

(7) Incorporated by reference to the Company's Form 10-KSB filed on April 16, 2002.

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

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

(10) Previously filed as an exhibit to the Form SB-2 Registration Statement filed on December 30, 2004.
(11) Incorporated by reference to the Company's Form 8-K filed on April 19, 2004.
(12) Incorporated by reference to the Company's Form 8-K filed on March 6, 2006
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**SIGNATURES**

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

**PACIFICNET INC.**

| | |
|---|---|
| | PACIFICNET INC. |
| Date: April 4, 2007 | BY: /S/ TONY TONG<br>Tony Tong<br>Chief Executive Officer (Principal Executive Officer) |
| Date: April 4, 2007 | BY: /S/ DANIEL LUI<br>Daniel Lui<br>Chief Financial Officer (Principal Financial Officer) |

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

| NAME | TITLE | DATE |
|---|---|---|
| /s/ TONY TONG<br>Tony Tong | Director, Chairman and CEO | April 4, 2007 |
| /s/ VICTOR TONG<br>Victor Tong | Director, President and Secretary | April 4, 2007 |
| /s/ DANIEL LUI<br>Daniel Lui | Chief Financial Officer | April 4, 2007 |
| /s/ PETER WANG<br>Peter Wang | Director | April 4, 2007 |
| /s/ MICHAEL CHUN HA<br>Michael Chun Ha | Director | April 4, 2007 |
| /s/ TAO JIN<br>Tao Jin | Director | April 4, 2007 |

| | | |
|---|---|---|
| /s/ JEREMY GOODWIN | Director | April 4, 2007 |
| Jeremy Goodwin | | |

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**INDEX TO EXHIBITS**

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**INDEX TO FINANCIAL STATEMENTS**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The audit report of Clancy and Co., P.L.L.C. for the fiscal years ended December 2005 and 2004, has been withdrawn effective as of March 16, 2007. As a result of this withdrawal the Company's Financial Statements for the fiscal years ended 2005 and 2004 are unaudited.

**THE FINANCIAL STATEMENTS OF PACIFICNET AND SUBSIDIARIES FOR THE FISCAL YEARS ENDED DECEMBER 31, 2005 AND 2004 ARE UNAUDITED**

**PACIFICNET INC. AND SUBSIDIARIES**
**CONSOLIDATED BALANCE SHEETS**
(In thousands of United States dollars, except par values and share numbers)

| | (Restated) December 31,2005 | (Restated) December 31,2004 |
|---|---|---|
| **ASSETS** | | |
| Current Assets: | | |
| Cash and cash equivalents | $ 9,579 | $ 6,764 |
| Restricted cash - pledged bank deposit | 1,652 | 3,501 |
| Accounts receivables ônet of allowance for doubtful accounts of $5 and $0 | 5,998 | 5,644 |
| Inventories | 1,836 | 1,297 |
| Loan receivable from related parties | 2,520 | -- |
| Loan receivable from third parties | 1,572 | -- |
| Other current assets | 7,973 | 4,325 |
| Total Current Assets | 31,130 | 21,531 |
| Property and equipment, net | 4,300 | 1,118 |
| Investments in affiliated companies and subsidiaries | 410 | 1,063 |
| Marketable equity securities - available for sale | 539 | 29 |
| Goodwill | 14,824 | 9,509 |
| **TOTAL ASSETS** | **$ 51,203** | **$ 33,250** |
| | | |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Current Liabilities: | | |
| Bank line of Credit | $ 1,060 | $ 651 |
| Bank loans-current portion | 188 | 1,327 |
| Capital lease obligations - current portion | 126 | 80 |
| Accounts payable | 3,186 | 3,150 |
| Accrued expenses | 4,620 | 128 |
| Income tax payable | 296 | 10 |
| Subscription payable | 775 | -- |
| Loan payable to related party | 369 | -- |
| Total Current Liabilities | 10,620 | 5,346 |
| Long-term liabilities: | | |
| Bank loans - non current portion | 6 | 69 |
| Capital lease obligations - non current portion | 78 | 129 |
| Total long-term liabilities | 84 | 198 |
| Total liabilities | 10,704 | 5,544 |
| Minority interest in consolidated subsidiaries | 8,714 | 2,396 |
| Commitments and contingencies | | |
| Stockholders' Equity: | | |
| Preferred stock, par value $0.0001, Authorized - 5,000,000 shares | | |
| Issued and outstanding - none | -- | -- |
| Common stock, par value $0.0001, Authorized - 125,000,000 shares Issued and outstanding: | | |

| | | | | |
|---|---|---|---|---|
| December 31, 2005 - 12,000,687 issued, 10,831,024 outstanding | | | | |
| December 31, 2004 - 10,627,737 shares issued, 9,791,583 outstanding | | 1 | | 1 |
| Treasury stock, at cost (2005: 1,169,663 shares; 2004: 836,154 shares) | | (119) | | (104) |
| Additional paid-in capital | | 57,690 | | 53,916 |
| Cumulative other comprehensive income (loss) | | 247 | | (24) |
| Accumulated deficit | | (25,990) | | (28,479) |
| Less stock subscription receivable | | (44) | | -- |
| Total Stockholders' Equity | | 31,785 | | 25,310 |
| **TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY** | **$** | **51,203** | **$** | **33,250** |

**THE FINANCIAL STATEMENTS OF PACIFICNET AND SUBSIDIARIES FOR THE FISCAL YEARS ENDED DECEMBER 31, 2005 AND 2004 ARE UNAUDITED**

**PACIFICNET INC. AND SUBSIDIARIES**
**CONSOLIDATED INCOME STATEMENTS**
(In thousands of United States dollars, except loss per share and share amounts)

| | | 2005 | | (RESTATED) 2004 |
|---|---|---|---|---|
| **YEAR ENDED DECEMBER 31:** | | | | |
| Revenues | $ | 44,341 | $ | 29,709 |
| Services | | 20,994 | | 10,222 |
| Product sales | | 23,347 | | 19,487 |
| Cost of revenues | | (33,439) | | (24,074) |
| Services | | (12,540) | | (6,507) |
| Product sales | | (20,899) | | (17,567) |
| Gross margin | | 10,902 | | 5,635 |
| | | | | |
| Selling, general and administrative expenses | | (5,811) | | (3,435) |
| Depreciation and amortization | | (293) | | (78) |
| Interest expense | | (229) | | (185) |
| **EARNINGS FROM OPERATIONS** | | **4,569** | | **1,937** |
| | | | | |
| Interest income | | 246 | | 79 |
| Sundry income | | 830 | | 422 |
| **Earnings before Income Taxes, Minority Interest and Discontinued Operations** | | **5,645** | | **2,438** |
| | | | | |
| Provision for income taxes(1) | | (222) | | (30) |
| Share of profit of associated companies | | (8) | | 32 |
| Minority interests | | (2,926) | | (1,623) |
| Earnings before Discontinued Operations | | 2,489 | | 817 |
| **LOSS FROM DISCONTINUED OPERATIONS** | | **--** | | **(43)** |
| | | | | |
| **Net Earnings Available to Common Stockholders** | **$** | **2,489** | **$** | **774** |
| **BASIC EARNINGS PER COMMON SHARE:** | | | | |
| Earnings from continuing operations | $ | 0.25 | $ | 0.11 |
| Earnings from discontinued operations | | -- | | -- |
| Net earnings | $ | 0.25 | $ | 0.11 |
| **DILUTED EARNINGS PER COMMON SHARE:** | | | | |
| Earnings from continuing operations | $ | 0.23 | $ | 0.09 |
| Earnings from discontinued operations | | -- | | -- |
| Net earnings | $ | 0.23 | $ | 0.09 |

The accompanying notes are an integral part of these consolidated financial statements.

* Income taxes of $66,000, $110,000, $20,000 and $26,000 generated from the Company's four business units: (1) CRM Outsourcing Services, (2) Value Added Services (VAS), (3) Telecom Distribution Services and (4) Other Business.

**THE FINANCIAL STATEMENTS OF PACIFICNET AND SUBSIDIARIES FOR THE FISCAL YEARS ENDED DECEMBER 31, 2005 AND 2004 ARE UNAUDITED**

**PACIFICNET INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**
(In thousands of United States dollars)

| | Preferred Stock | Common Stock | Additional Paid-in Capital | Stock Subscription Receivable | Cumulative Other Comprehensive Income/(loss) | Accumul-ated Deficit (RESTATED) | Treasury Stock | Total Stockholders' Equity (RESTATED) |
|---|---|---|---|---|---|---|---|---|
| **BALANCE AT DECEMBER 31, 2003 (5,363,977 SHARES), as originally reported** | **--** | **$ 1** | **$ 31,790** | **$ --** | **($24)** | **($29,850)** | **($5)** | **$ 1,912** |
| Effect of Correction of an Error (Note 1) | -- | -- | | | | 597 | | 597 |
| Balance at December 31, 2003 (5,363,977 shares), as restated | -- | $ 1 | $ 31,790 | $ -- | ($24) | ($29,253) | ($5) | $ 2509 |
| COMPREHENSIVE EARNINGS: | | | | | | | | |
| Net earnings | -- | -- | -- | | -- | 774 | | 774 |
| TOTAL COMPREHENSIVE EARNINGS: | | | | | | | | 774 |
| Issuance of common stock for acquisition of subsidiaries (1,756,240 shares) | -- | -- | 8,866 | | -- | -- | | 8,866 |
| Proceeds from the sale of common stock, net of related costs (2,205,697, shares) | -- | -- | 11,773 | | -- | -- | | 11,773 |
| Issuance of common stock for acquisition of Cheer Era (149,459 shares) | -- | -- | 771 | | -- | -- | | 771 |
| Repurchase of common shares (less 36,154 shares) | | | | | | | (99) | (99) |
| Exercise of stock options and warrants for cash (352,364 shares) | | | 716 | | | | | 716 |
| **BALANCE AT DECEMBER 31, 2004 (9,791,583 SHARES)** | **--** | **$ 1** | **$ 53,916** | | **($24)** | **($28,479)** | **($104)** | **$ 25,310** |
| COMPREHENSIVE EARNINGS: | | | | | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Net earnings | -- | -- | -- | | -- | 2,489 | | 2,489 |
| Cumulative Other Comprehensive gain | | | | | 271 | | | 271 |
| Total comprehensive earnings | | | | | | | | 2,760 |
| Issuance of common stock for acquisition of subsidiaries (515,900 shares) | -- | -- | 3,971 | | -- | -- | | 3,971 |
| Issuance of common stock (20,000 shares) for services | | | 63 | | | | | 63 |
| PIPE related Expenses | -- | -- | (547) | | | | | (547) |
| Repurchase of common shares for acquisition of Cheer Era (less 149,459 shares) | -- | -- | (771) | | | | | (771) |
| Cancellation of common shares (less 45,000 shares) | -- | -- | -- | | -- | -- | -- | -- |
| Repurchase of common shares (less 2,000 shares) | -- | | | | | | (15) | (15) |
| Exercise of stock options and warrants for cash (700,000 shares) | -- | | 1,058 | | | | | 1,058 |
| Less stock subscription receivable | | | | (44) | | | | (44) |
| **BALANCE AT DECEMBER 31, 2005 (10,831,024 SHARES)** | **--** | **$ 1** | **$ 57,690** | **$ (44)** | **$ 247** | **($25,990)** | **($119)** | **$ 31,785** |

**THE FINANCIAL STATEMENTS OF PACIFICNET AND SUBSIDIARIES FOR THE FISCAL YEARS ENDED DECEMBER 31, 2005 AND 2004 ARE UNAUDITED**

**PACIFICNET INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
(In thousands of United States dollars, except profit per share and share amounts)

| | (RESTATED) 2005 | (RESTATED) 2004 |
|---|---|---|
| **Cash Flows from operating activities** | | |
| Net earnings | $ 2,489 | $ 774 |
| *Adjustment to reconcile net earnings to net cash provided by (used in) operating activities:* | | |
| Equity loss (earnings) of associated company | 8 | (32) |
| Common stock issued for services rendered | 63 | -- |
| Minority Interest | 2,926 | 1,623 |
| Depreciation and amortization | 1,126 | 78 |
| *Changes in current assets and liabilities net of effects from purchase of subsidiaries:* | | |
| Accounts receivable and other current assets | 7,057 | (3,584) |
| Inventories | (539) | (1,221) |
| Accounts payable and other accrued expenses | (3,880) | (2,069) |
| ***Net cash provided by (used in) operating activities*** | **9,250** | **(4,431)** |
| | | |
| **Cash flows from investing activities** | | |
| Decrease (increase) in restricted cash | 1,849 | (3,289) |
| Increase in purchase of marketable securities | (521) | (46) |
| Acquisition of property and equipment | (2,252) | (206) |
| Acquisition of subsidiaries and affiliated companies | (1,183) | (724) |
| Loan receivables from third parties | (1,572) | |
| Loans receivable from related parties | (2,520) | |
| ***Net cash used in investing activities*** | **(6,199)** | **(4,265)** |
| | | |
| **CASH FLOWS PROVIDED BY FINANCING ACTIVITIES:** | | |
| Increase in loan payable to related party | 369 | -- |
| Advances (repayments) under bank line of credit | 409 | (548) |
| Advances under bank loan | (1,201) | (130) |
| Advances (repayments) of amount borrowed under capital lease obligations | (5) | (92) |
| Proceeds from sale of common stock | -- | 11,773 |
| Repurchase of treasury shares | (15) | (99) |
| Proceeds from exercise of stock options and warrants | 1,014 | 716 |
| Payment of certain PIPE related expenses | (547) | -- |
| ***Net cash provided by financing activities*** | **24** | **11,620** |
| | | |
| **Effect of exchange rate change on cash and cash equivalents** | **(260)** | 17 |
| | | |
| **NET INCREASE IN CASH AND CASH EQUIVALENT** | **2,815** | **2,941** |
| **CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR** | **6,764** | **3,823** |
| | | |
| **CASH AND CASH EQUIVALENTS, END OF YEAR** | **$ 9,579** | **$ 6,764** |

| | | | | |
|---|---|---|---|---|
| **CASH PAID (RECEIVED) FOR:** | | | | |
| Interest | $ | 229 | $ | 20 |
| Income taxes | $ | (53) | $ | 20 |
| **NON-CASH INVESTING AND FINANCING ACTIVITIES:** | | | | |
| Common stock issued for services rendered | | | | |
| Issuance of option shares through increase in subscription receivable | $ | 63 | | -- |
| Investment in subsidiary acquired through issuance of subscriptions payable | $ | 775 | | -- |
| Repurchase of shares issued to Cheer Era | $ | 771 | | -- |
| Investments in subsidiaries acquired through the issuance of common stock | $ | 3,971 | $ | 9,637 |

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

**1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

NATURE OF OPERATIONS

PacificNet Inc. (referred to herein as "PacificNet" or the "Company") was originally incorporated in the State of Delaware on April 8, 1987. Through our subsidiaries we provide outsourcing services, value-added telecom services (VAS) and communication products distribution services. Our business process outsourcing (BPO) services include call centers, providing customer relationship management (CRM), and telemarketing services, and our information technology outsourcing (ITO) includes software programming and development. We are value-added resellers and providers of telecom VAS, which is comprised of interactive voice response (IVR) systems, call center management systems, and voice over Internet protocol (VOIP), as well as mobile phone VAS, such as short messaging services (SMS) and multimedia messaging services (MMS). The Company's operations are primarily targeted in the China and Hong Kong market.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION AND BASIS OF PRESENTATION

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

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

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

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

- carrying amounts of the VIE are consolidated into the financial statements of PacificNet as the primary beneficiary (referred as "Primary Beneficiary" or "PB");
- inter-company transactions and balances, such as revenues and costs, receivables and payables between or among the Primary Beneficiary and the VIE(s) are eliminated in their entirety; and
- because there is no direct ownership interest by the Primary Beneficiary in the VIE, equity of the VIE is eliminated with an offsetting credit to minority interest.

PRC laws and regulations restrict us, as a foreign entity, from having a direct controlling interest in entities such as Guangzhou Dianxun Co., Ltd.(Dianxun-DE) and Guangzhou Sunroom Information Industry Co., Ltd.(Sunroom-DE) that hold operating licenses to engage in domestic telecom value-added services and online ecommerce in China. As a result, we conduct substantially all of our operations through Guangzhou Clickcom Digit-net Science(WOFE)and Technology Ltd. and Guangzhou 3G Information Technology Co., Ltd.(WOFE). We own 51% of the shares in each of the WOFEs and each WOFE signed Consulting and Services Agreements with Dianxun-DE and Sunroom-DE (the entities that actually carry out the operating activities). These agreements provide that all of the DE profits will flow through to the respective WOFEs. Pursuant to these agreements, the Company guarantees any obligations undertaken by these companies under their contractual agreements with third parties, and the Company is entitled to receive service fees in an amount equal to 51% of the net income of these companies. Accordingly, we bear the risks of, and enjoy the rewards associated with, the investments in the WOFEs.

The operations of DEs are managed by their original management teams, however, the Company has the power to appoint or change directors and senior management because it indirectly ultimately controls the voting power of the shareholders of each DE through the Power of Attorney given to PacificNet's President according to the operating agreements between the DEs and WOFEs. Pursuant to the Consulting and Service Agreements signed between each WOFE and their respective DE, the WOFE ("Party A") agrees to be the exclusive provider of telecom consulting services to the DE ("Party B"). During the term of the agreement, Party B shall not accept technical and consulting services provided by any third party. Party B agrees to pay a fee to Party A equal to 100% of its monthly net income for the services provided. Payment of the service fees has been secured through a share pledge agreement with the shareholders of each of the DEs, whereby they pledged all of their shares to the respective WOFE. Further,

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

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

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

o GuangZhou DianXun Company Limited (the "Dianxun-VIE"), a China company controlled through business agreement. Through Dianxun-VIE, a variable interest entity, PacificNet is able to provide indirectly to China's telecom operators, a wide variety of wireless Internet services for mobile phones, such as SMS, Wireless Application Protocol, or WAP, which allows users to access information instantly via handheld wireless devices, and Java mobile applications. The business of the VIE is managed by their original management teams Clickcom VIE is owned by Zhang Ming, CEO 60%, Lai Jinnan, COO 30%, Liu Dong, CTO 10% of the Company. The adjusted registered capital of the VIE is $125,000 (the original registered capital of Dianxun-VIE was approx. US$1.25m but was adjusted down to reflect the fair value of NAV at time of acquisition. (See Note 5) The VIE's board of directors has the power to appoint the General Manager of the VIE who in turn has the power to appoint other members of the management. PacificNet does not directly participate in the daily operation of the VIE. It however has the power to change the management, if needed, because PacificNet is directly or indirectly controlling the board of this VIE. As at the

December 31, 2005, Dianxun-VIE's revenues and net earnings accounted for approximately 1.5% and 5.6% of our consolidated revenues and net earnings before minority interests respectively.

o Guangzhou Sunroom Information Industrial Co., Ltd. ("Sunroom-VIE"), a PRC registered domestic enterprise, controlled by PacificNet through a series of contractual agreements. It is responsible for VAS in China under its ICP and VAS licenses. It is 31% owned by Mr. Wang Yongchao (CEO), 41.4% owned by Mr. Liao Mengjiang (COO) and 27.6% owned by non-participating shareholder, Mr. Sun Zhengquan. The registered capital of the VIE Company is $4.0 million. Sunroom-VIE is required to transfer their ownership in these entities to our subsidiaries when permitted by PRC laws and regulations and all voting rights are assigned to us. As of December 31, 2005, Sunroom-VIE's revenues and net loss accounted for approximately 11% and -1.2% of our consolidated revenues and net earnings before minority interests, respectively.

The initial capital investments in these VIEs were not funded by us but we have provided loans to these VIEs to fund their R&D and expansion plans. As of December 31, 2005, the amount of loans to Clickcom VIE and Sunroom VIE were approximately US$256,000 (low interest at 2%) and US$250,000 (interest free) respectively. None of the VIEs' assets were collateralized for our loans. Given the fact that we do not have direct ownership interests in these VIEs, the creditors of these VIEs will not have recourse to the general credit of our group being the primary beneficiary.

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

**BUSINESS COMBINATIONS**

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

**GOODWILL AND PURCHASED INTANGIBLE ASSETS (Correction of an error)**

Goodwill represents the excess of the purchase price over the fair value of the identifiable assets and liabilities acquired as a result of the Company's acquisitions of interests in its subsidiaries and VIEs. Under Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets ("SFAS 142")," goodwill is no longer amortized, but tested for impairment upon first adoption and annually, thereafter, or more frequently if events or changes in circumstances indicate that it might be impaired. The Company assesses goodwill for impairment periodically in accordance with SFAS 142.

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

We currently have seven reporting units: Lion Zone, Linkhead, EPRO, Shanghai Classic, Smartime/Soluteck, Clickcom-WOFE, and Guangzhou 3G-WOFE for the purpose of goodwill assessment. We determined our reporting units if the entity constituted a business, financial information was available, and segment management can regularly review the operating results of that component. Excluding investment holding vehicles and self-developed units, reporting units only include those operating units that PacificNet holds 50% or more through acquisition and maintain effective control. Units such as PacificNet Solution, PacificNet Limited, and PacificNet Communication are 100% owned by PacificNet through self development and not through acquisition. Therefore, there is no goodwill allocation to these self-developed units.

We allocated goodwill amongst the reporting units based on the consideration paid in shares and cash minus the proportional share of the fair value of net assets and liabilities at the time of acquisition specific to each reporting unit. The fair value of each reporting unit represents the amount at which the unit as a whole could be bought or sold in a current transaction between willing parties in an open marketplace. At the time of acquisition, the fair value of assets and liabilities was determined based on book value minus any potential write-down, if any, to reflect the fair value of the assets and liabilities acquired in the transaction. The Company has one class of goodwill arising from business combination resulting from the acquisitions of our subsidiaries. Goodwill has been revised to reflect certain expenses that should have been written off prior to certain acquisitions, not subsequent to the acquisitions, to better reflect the assets acquired and liabilities assumed in certain business combinations during 2003 in accordance with SFAS No. 141, "Business Combinations”. Originally, the Company had acquired certain intangible assets such as research and development costs and related party receivables that were considered as part of the purchase price allocation, then subsequently expensed them at year end. As of and for the year ended December 31, 2003, the correction of the error resulted in an approximate $597,000 increase in goodwill with an offsetting decrease in net loss, accumulated deficit, and and total stockholders’ equity. Net loss per share decreased from $0.36 to $0.24. Notes 4, 15 and Note 16 have been revised to reflect the corresponding correction of an error.

The total carrying amount of goodwill recorded on the balance sheets at December 31, 2005 is $14,824,000 and the changes in the carrying amount of goodwill for the following reporting periods are summarized below:

| (US$000s) | Group 1. Outsourcing Services Products | Group 2. Value-Added Services | Group 3. Distribution of Communications | Total |
|---|---|---|---|---|
| Balance as of December 31, 2003, as originally reported | $567 | $(147) | $-- | $420 |
| Effect of correction of an error | 393 | 204 | | 597 |
| Balance as of December 31,2003, as restated | 960 | 57 | | 1,017 |
| Goodwill acquired during the year | 2,976 | 4,416 | 1,100 | 8,492 |
| Impairment losses | -- | -- | -- | -- |
| Goodwill written off related to sale of business unit | -- | -- | -- | -- |
| Balance as of December 31, 2004 | 3,936 | 4,473 | 1,100 | 9,509 |
| Goodwill acquired during the year | -- | 5,315 | -- | 5,315 |
| Impairment losses | -- | -- | -- | -- |
| Goodwill written off related to sale of business unit | -- | -- | -- | -- |
| Balance as of December 31, 2005 | $3,936 | $9,788 | $1,100 | $14,824 |

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

The following table summarizes goodwill from the Company's acquisitions during 2005 and 2004:

| (USD000s) | December 31, 2005 | December 31, 2004 |
|---|---|---|
| Epro | $3,703 | $3,703 |
| Linkhead | 4,473 | 4,473 |
| Shanghai Classic (Yueshen) | 1,100 | 1,100 |
| Smartime (Soluteck) | 233 | 233 |
| Clickcom | 391 | - |
| GZ3G (Sunroom) | 4,042 | - |
| Lion Zone (ChinaGoHi) | 882 | - |
| Total | $ 14,824 | $ 9,509 |

IMPAIRMENT OF LONG-LIVED ASSETS

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

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

INVESTMENTS IN AFFILIATED COMPANIES

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

COMPREHENSIVE INCOME (LOSS)

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

REVENUE RECOGNITION

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

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

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

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

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

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

ALLOWANCE FOR DOUBTFUL ACCOUNTS

The Company presents accounts receivable, net of allowances for doubtful accounts and returns. The allowances are calculated based on a detailed review of certain individual customer accounts, historical rates and an estimate of the overall economic conditions affecting the Company's customer base. The Company frequently monitors its customers' financial condition and credit worthiness and only sells products, licenses or services to customers where, at the time of the sale, collection is reasonably assured. If the financial condition of its customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. The Company also records reserves for bad debt for all other customers based on a variety of factors including the length of time the receivables are past due, the financial health of the customer, macroeconomic considerations and historical experience. If circumstances related to specific customers change, the Company's estimates of the recoverability of receivables could be further adjusted. Allowance for doubtful accounts at December 31, 2005 was approximately $5,000 (2004: $0).

PROPERTY AND EQUIPMENT

Property and equipment is stated at cost and depreciated using the straight-line method over the shorter of the estimated useful life of the asset or the lease term, ranging from three to five years. Significant improvements and betterments are capitalized. Routine repairs and maintenance are expensed when incurred. When property and equipment is sold or otherwise disposed of, the asset account and related accumulated depreciation account are relieved, and any gain or loss is included in operations.

INVENTORIES

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

INCOME TAXES

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

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

RESEARCH AND DEVELOPMENT COSTS AND CAPITALIZED SOFTWARE COSTS

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

Software development costs are required to be capitalized when a product's technological feasibility has been established by completion of a detailed program design or working model of the product, and ending when a product is available for release to customers. For the years ended December 31, 2005 and 2004, the Company did not capitalize any costs related to the purchase of software and related technologies and content. Research and development costs charged to operations for 2005 were approximately 182,400 (2004: $161,000).

EARNINGS PER SHARE (EPS)

Basic and diluted earnings or loss per share (EPS) amounts in the financial statements are computed in accordance with SFAS No. 128, "Earnings Per Share." Basic EPS is based on the weighted average number of common shares outstanding Diluted EPS is based on the weighted average number of common shares outstanding and dilutive common stock equivalents. Basic EPS is computed by dividing net income/loss available to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) during the period. Dilutive earnings per share for 2005 exclude the potential dilutive effect of 473,456 warrants because their impact would be anti-dilutive based on current market prices. All per share and per share information are adjusted retroactively to reflect stock splits and changes in par value.

The reconciliation of the numerators and denominators of the basic and diluted EPS calculations was as follows for the years ended December 31:

| | FY2005 | FY 2004 |
|---|---|---|
| Numerator: earnings | $2,489 | $774 |
| Denominator: | | |
| Weighted-average shares used to compute basic EPS | 10,154,271 | 7,268,374 |
| Dilutive potential from assumed exercise of stock | 489,552 | 157,585 |

| | | |
|---|---|---|
| options | | |
| Dilutive potential from assumed exercise of stock warrants | 57,388 | 816,037 |
| Weighted-average shares used to compute diluted EPS | 10,701,211 | 8,241,996 |
| Basic earnings per common share: | $0.25 | $0.11 |
| Diluted earnings per common share: | $0.23 | $0.09 |

STOCK-BASED COMPENSATION PLANS

The Company has adopted SFAS No. 123, "Accounting for Stock Based Compensation". As permitted by SFAS No. 123, the Company measures compensation cost in accordance with Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees" and related interpretations. Compensation cost for stock options, if any, is measured as the excess of the quoted market price of the Company's stock at the date of grant over the amount an employee must pay to acquire the stock. Accordingly, no accounting recognition is given to stock option granted at fair market value until they are exercised. Upon exercise, net proceeds including tax benefits realized, are credited to equity. Details regarding a description and status of the Company's stock option plans can be found in Note 12.

The Company's net earnings (loss) and net earnings (loss) per common share would have changed to the pro forma amounts indicated below if compensation cost for the Company's stock option had been determined based on fair value at the grant date for awards in accordance with SFAS No. 123, (in thousands, except per share amounts):

| | FY2005 | FY2004 |
|---|---|---|
| Net earnings/ (loss): | | |
| As reported | $2,489 | $774 |
| Stock-based compensation cost, net of tax | (3,300) | (1,188) |
| Pro forma | (811) | (414) |
| Basic earnings/ (loss) per share: | | |
| As reported | $0.25 | $0.11 |
| Pro forma | (0.08) | (0.06) |
| Diluted profit/ (loss) per share: | | |
| As reported | $0.23 | $(0.09) |
| Pro forma | $(0.08) | $(0.05) |

The fair value of options granted during 2005 and 2004, respectively was approximately $4.82 and $1.88 per option respectively based on the Black-Scholes option pricing model using valuation assumptions of: a) average remaining contractual life of four and two years; b) expected volatility of 43.18% and 153.68%, c) dividend yield of 0% for both years; and d) a risk free interest rate of 5% and 3%.

ADVERTISING EXPENSES

Advertising expenses consist primarily of costs of promotion for corporate image and product marketing and costs of direct advertising. The Company expenses all advertising costs as incurred and classify these costs under selling, general and administrative expenses, which amounted to $150,047 in 2005 (2004: $9,908).

CASH EQUIVALENTS

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

RELATED PARTY TRANSACTIONS

A related party is generally defined as (i) any person that holds 10% or more of the Company's securities including such person's immediate families, (ii) the Company's management, (iii) someone that directly or indirectly controls, is controlled by or is under common control with the Company, or (iv) anyone who can significantly influence the financial and operating decisions of the Company. A transaction is considered to be a related party transaction when there is a transfer of resources or obligations between related parties. (See Note 12)

RECLASSIFICATION

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

FAIR VALUE OF FINANCIAL INSTRUMENTS

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

CONCENTRATION OF CREDIT RISK

CASH HELD IN BANKS. For those financial institutions that the Company maintains cash balances in the United States, the amounts are insured by the Federal Deposit Insurance Corporation up to $100,000.

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

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

MARKETABLE EQUITY SECURITIES

Marketable equity securities are classified as available-for-sale and are recorded at fair value in other assets on the balance sheet, with the change in fair value during the period excluded from earnings and recorded net of tax as a component of other comprehensive income. Realized gains or losses are charged to the income statement during the period in which the gain or loss is realized Investments classified as available-for-sale securities include marketable equity securities of Unit Trust Funds and are based primarily on quoted market prices at December 31, 2005. The component costs of these securities are summarized as follows: cost of $567,000, gross unrealized losses of $28,000 and estimated fair value of $539,000. The acquisition of marketable securities and unrealized losses on marketable equity securities are recorded on consolidated statements of cash flows.

FOREIGN CURRENCY

The Company's reporting currency is the U.S. dollar. The Company's operations in China and Hong Kong use their respective currencies as their functional currencies. The financial statements of these subsidiaries are translated into U.S. dollars using period-end rates of exchange for assets and liabilities and average rates of exchange in the period for revenue and expenses. Translation gains and losses are recorded in accumulated other comprehensive income or loss as a component of shareholders' equity. Net gains and losses resulting from foreign exchange transactions are included in General and Administrative Expenses an amount of US$76,000. During the year ended December 31, 2005, the foreign currency translation adjustments to the Company's comprehensive income was $271,000 and the currency translation gain was approximately $29,000, primarily as a result of the Chinese Renminbi appreciating against the U.S. dollar.

SEGMENT INFORMATION

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

RECENT ACCOUNTING PRONOUNCEMENTS

The Financial Accounting Standards Board issued the following recent accounting pronouncements:

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections". SFAS No. 154 replaces APB Opinion No. 20 "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements". SFAS No. 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. The adoption of SFAS No. 154 did impact the Company's consolidated financial statements.

In December 2004, the FASB issued SFAS No. 123R (revised 2004) "Share-Based Payment" which amends FASB Statement No. 123 and will be effective for public companies (small business issuers) for interim or annual periods beginning after December 15, 2005. SFAS 123R requires that compensation cost related to share-based payment transactions be recognized in the financial statements. Share-based payment transactions within the scope of SFAS 123R include stock options, restricted stock plans, performance-based awards, stock appreciation rights, and employee share purchase plans. The Company adopted the new standard as of January 1, 2006. Based on the Company's evaluation of the adoption of the new standard, the Company believes that it could have a significant impact to the Company's financial position and overall results of operations depending on the number of stock options granted in a given year.

**2. BUSINESS ACQUISITIONS**

During 2005 and 2004, PacificNet acquired various entities in accordance with the Company's strategy to grow via mergers and acquisitions. The entities acquired met various PacificNet acquisition criteria, which include reasonable expectations for positive earnings and cash flow within two years of acquisition and reputation for high quality and performance in the customer relationship management, brand name recognition, and well-established relationships with clients. Several factors contributed to the determination of the negotiated purchase price and deal structure. Among them were the value of assets acquired and liabilities assumed, historical EBITDA and projected EBITDA. The assets acquired and liabilities assumed were recorded at estimated fair values as determined by the Company's management based on information currently available and on current assumptions as to future operations

A summary of business acquisitions for the periods presented follows:

SHANGHAI CLASSIC GROUP LIMITED ("YUESHEN")

On April 12, 2004, the Company, through its subsidiary PacificNet Strategic Investment Holdings Limited, consummated the acquisition of a 100% controlling interest (the "Acquisition") in Shanghai Classic Group Limited, which owns 51% of Guangzhou YueShen TaiYang Technology Limited, a newly formed telecommunication company located and incorporated in the People's Republic of China ("Yueshen"). The Company acquired the 100% controlling interest in Shanghai Classic through the purchase of 85 shares (representing 100% of the issued and outstanding shares, the "Shanghai Shares") of Shanghai Classic Group Limited, which is also the beneficial owner of the 51% controlling interest in Yueshen. The consideration for the Acquisition was an aggregate value of approximately USD$1,196,143, which was paid in cash and shares of common stock of the Company (the "Common Stock"), and a warrant to purchase up to 50,000 shares of Common Stock. The consideration was paid as follows:

(i) approximately USD$616,195 by delivery of 106,240 shares of Common Stock as consideration for the purchase of 51 of the Shanghai Shares from Yan Kuan Li ("Ms. Li") within thirty (30) days of the signing of the agreement for the Acquisition. All of the Common Stock deliverable to Ms. Li is being held in escrow pursuant to the terms of an escrow agreement, which provides that the Common Stock will be released in installments over the twelve month period following the consummation of the Acquisition, provided, that Yueshen attains certain net income milestones during such period. In the event there is a shortfall in the net income during the period Ms. Li shall return to the Company shares of Common Stock equivalent to the dollar amount of such shortfall divided by $5.80; and

(ii) approximately USD$338,303 in cash as consideration for the purchase of 34 of the Shanghai Shares from Avatar Trading, Ltd. ("Avatar") within thirty (30) days of the closing of the Acquisition; and

(iii) approximately USD$241,645 in cash directly to Yueshen within thirty (30) days of the closing of the Acquisition, as consideration for the purchase of the Yueshen shares by Shanghai Classic.

(iv) A common stock purchase warrant to purchase 50,000 shares of PacificNet common stock, par value $0.0001 per share. The exercise price under this warrant shall be the 5-Day volume weighted average price of the common stock of PacificNet before the signing date of this Agreement, exercisable within 3 years from the date of issuance. The warrants are considered contingent consideration and have not been valued as the contingency has not been met.(See Note 5)

The cash portion of the purchase price for the Acquisition was paid from working capital of the Company. The value of the common shares issued was determined based on the average market price of PacificNet's common shares over a reasonable period before and after the terms of the acquisition were agreed to and announced.

A summary of the assets acquired and liabilities assumed in the acquisition follows:

| Estimated fair values: | |
|---|---|
| Current Assets | $211,886 |
| Property Plant and equipment | 38,917 |
| Goodwill | 1,100,585 |
| Total Assets Acquired | 1,351,388 |
| Current Liabilities assumed | (155,245) |
| Net assets acquired | $1,196,143 |

As of December 31, 2004 and 2005, Goodwill of $1,100,585 represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired and is not deductible for tax purposes The total amount of goodwill by reportable segment Communications Distribution Business was $1,100,585 (see Note 15).

In accordance with SFAS 142, goodwill is not amortized but is tested for impairment at least annually. The purchase price allocation for the Shanghai Classic acquisition was based on management's estimates and its overall industry experience. Immediately after the signing of the definitive agreement, the Company obtained effective control over Shanghai Classic. Accordingly, the operating results of Shanghai Classic have been consolidated with those of the Company starting April 12, 2004.

UNAUDITED PROFORMA CONSOLIDATED FINANCIAL INFORMATION DISCLOSURE FOR THE YEAR ENDED DECEMBER 31, 2005 AND 2004

The following un-audited pro forma consolidated financial information for the years ended December 31, 2004 and 2005, as presented below, reflects the results of operations of the Company assuming the acquisition occurred on January 1, 2004 and 2005 respectively, and after giving effect to the purchase accounting adjustments. These pro forma results have been prepared for information purposes only and do not purport to be indicative of what operating results would have been had the acquisitions actually taken place on January 1, 2004 and 2005 respectively, and may not be indicative of future operating results.

| | Year ended December 31 | |
|---|---|---|
| | 2005 | 2004 |
| | (UN-AUDITED AND IN THOUSANDS OF U.S. DOLLARS) | |
| Revenues | Fully | $12,547 |
| Net earnings attributable to shareholders | consolidated | 182 |
| Earnings per share - basic (cents) | | 0.02 |
| Earnings per share - diluted (cents) | In 2005 | 0.02 |

PacificNet included the financial results of the subsidiary in its consolidated 2005 financial results and from the date of the acquisition, April 12, 2004 through December 31, 2004.

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PACIFIC SMARTIME SOLUTIONS LIMITED ("SMARTIME")

On September 15, 2004, the Company, through its subsidiary PacificNet Strategic Investment Holdings Limited, consummated the acquisition of a 51% controlling interest (the "Acquisition") in Soluteck Technology (Shenzhen) Company Limited, a corporation incorporated in Shenzhen, China ("Soluteck"). The Company acquired the controlling interest in Soluteck through the purchase of 630 shares (the "Shares") of Pacific Smartime Solutions Limited ("Smartime"), the beneficial owner of an 81% controlling interest in Soluteck, from the shareholders of Smartime. The consideration for the Acquisition was payable as follows:

(i) USD$500,000, payable in shares of common stock of the Company (the "Common Stock"), equivalent to 100,000 restricted shares (the "Shares") of Common Stock, based on a fair market value of $5.00, deliverable within 30 days of signing the Agreement. All of the Shares deliverable to the Shareholders are being held in escrow pursuant to the terms of an escrow agreement, which provides that the Common Stock will be released in installments over the twelve month period ending on September 30, 2005; provided that Soluteck meets certain net income milestones during such period. If at the end of the second twelve month period ending on September 30, 2006, there is a shortfall in Soluteck's net income, the Shareholders shall return to the Company Shares equivalent to the dollar amount of such shortfall divided by $5.00; and

(ii) warrants to purchase up to 50,000 shares of common stock at an exercise price equal to the 5 day volume weighted average price of the Company's common stock before the signing of the Agreement. The warrants are exercisable for a period of 3 years from the date of issuance. The warrants are considered contingent consideration and have not been valued as the contingency has not been met. (See Note 5)

In connection with the Acquisition, the Company's subsidiary has agreed to provide Soluteck with an operating loan of RMB 3,000,000; provided that Soluteck secures certain contracts with Huawei. The loan would mature within 3 years with interest at a rate of 4% per year.

The Shares are restricted shares issued under an exemption from registration of the Securities Act of 1933, as amended. If at the time the Shareholders are eligible to sell the Shares under Rule 144, the fair market value of the Common Stock is less than USD$3.50, the Company shall issue additional shares of Common Stock for an aggregate amount of USD$100,000, up to a maximum of 60,000 shares of Common Stock. If at such time the fair market value of the Common Stock is more than USD$8.00 per share, the Shareholders and the Company will share on an equal basis any excess over USD$8.00 per share.

The value of the common shares issued was determined based on the average market price of PacificNet's common shares over a reasonable period before and after the terms of the acquisition were agreed to and announced.

A summary of the assets acquired and liabilities assumed in the acquisition follows:

| Estimated fair values: | |
|---|---|
| Current Assets | $460,957 |
| Property Plant and equipment | 60,505 |
| Intangible Assets | 562 |
| Goodwill | 233,000 |

| | |
|---|---|
| Total Assets Acquired | 755,024 |
| Current Liabilities assumed | (255,024) |
| Net assets acquired | $ 500,000 |

As of December 31, 2004 and 2005, goodwill of $233,000 represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired and is not deductible for tax purposes and the total amount of goodwill by reportable segment for Business Process Outsourcing was $3,936,000 in both years (see Note 15).

In accordance with SFAS 142, goodwill is not amortized but is tested for impairment at least annually. The purchase price allocation for Smartime acquisition is based on a management's estimates and overall industry experience Immediately after the signing of the definitive agreement, the Company obtained effective control over Smartime. Accordingly, the operating results of Smartime have been consolidated with those of the Company starting September 15, 2004.

UNAUDITED PRO FORMA CONSOLIDATED FINANCIAL INFORMATION DISCLOSURE FOR THE YEAR ENDED DECEMBER 31, 2005 AND 2004

The following un-audited pro forma consolidated financial information for the years ended December 31, 2004 and 2005, as presented below, reflects the results of operations of the Company assuming the acquisition occurred on January 1, 2004 and 2005 respectively, and after giving effect to the purchase accounting adjustments. These pro forma results have been prepared for information purposes only and do not purport to be indicative of what operating results would have been had the acquisitions actually taken place on January 1, 2004 and 2005 respectively, and may not be indicative of future operating results.

| | 2005 | 2004 |
|---|---|---|
| | (UN-AUDITED AND IN THOUSANDS OF U.S. DOLLARS) | |
| Revenues | Fully | $1,830 |
| Operating income | -- | |
| Net earnings attributable to shareholders | Consolidated | $269 |
| Earnings per share - basic (cents) | | $0.037 |
| Earnings per share - diluted (cents) | In 2005 | $0.037 |

PacificNet included the financial results of Smartime in its consolidated 2005 financial results and from the date of the purchase, September 15, 2004 through December 31, 2004.

PACIFICNET CLICKOM LIMITED

On December 16, 2004, we entered into an agreement to acquire a controlling interest in Guangzhou Clickcom Digit-net Science and Technology Ltd. ("Clickcom-WOFE") through the purchase of a 51% interest of Clickcom-WOFE's parent company, PacificNet Clickcom Limited, a British Virgin Islands Company ("Clickcom-BVI") from three shareholders, Mr. Jinnan Lai, Mr. Ming Zhang and Mr. Dong Liu who are majority shareholders of GuangZhou DianXun Company Limited ("Dianxun-DE"), a PRC registered Domestic Enterprise (DE) either. The acquisition was completed on March 28, 2005 upon receipt of the required business license and approval from the local government.

The total purchase consideration for 51% of Clickcom is approximately one million, which is payable 30% in cash and 70% in restricted shares of PACT. The purchase price is payable upon achievement of certain quarterly earn-out targets based on net profits, through the issuance of 130,000 restricted shares of common stock of PacificNet. As of December 31, 2005, cash consideration of $267,826 and stock consideration of $260,000, representing 52,000 restricted shares of PACT common stock valued at $5.00 per share, was recorded as the cost of the acquisition. Total unearned purchase consideration in the form of common stock to be distributed based on the achievement of earnings was 78,000 restricted shares (See Note 12). PacificNet will also issue warrants to purchase 50,000 shares of PacificNet's common stock. The warrants are considered contingent consideration and have not been valued as the contingency has not been met. (See Note 5)

The cash portion of the purchase price for the Acquisition was paid from working capital of the Company. The value of the common shares issued was determined based on the average market price of PacificNet's common shares over a reasonable period before and after the terms of the acquisition were agreed to and announced.

A summary of the assets acquired and liabilities assumed in the acquisition follows:

| Estimated fair values: | |
|---|---|
| Current Assets | $136,474 |
| Goodwill | 391,352 |
| Total Assets Acquired | 527,826 |
| Liabilities assumed | - |
| Net assets acquired | $527,826 |

At December 31, 2005, goodwill of $391,352 represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired and is not deductible for tax purposes and the total amount of goodwill by reportable segment for VAS Business was $9,788,000 in the same year (see Note 15)

In accordance with SFAS 142, goodwill is not amortized but is tested for impairment at least annually. The purchase price allocation for the Clickcom acquisition was based on a management's estimates and overall industry experience. Immediately after the signing of the definitive agreement, the Company obtained effective control over Clickcom. Accordingly, the operating results of Clickcom have been consolidated with those of the Company starting March 28, 2005. Pursuant to SFAS 141 "Business Combinations", the earn-out consideration is considered contingent consideration, which will not become certain until the audited combined after-tax profit of US$600,000 for 12 months ended December 31, 2005 is available. Accordingly, the contingent consideration of 78,000 restricted shares has not been reflected in the consolidated financial statements of the Company as of December 31, 2005 due to the performance target not being met.

**UNAUDITED PRO FORMA CONSOLIDATED FINANCIAL INFORMATION DISCLOSURE FOR THE YEAR ENDED DECEMBER 31, 2005 AND 2004**

The following un-audited pro forma consolidated financial information for the years ended December 31, 2004 and 2005, as presented below, reflects the results of operations of the Company assuming the acquisition occurred on January 1, 2004 and 2005 respectively, and after giving effect to the purchase accounting adjustments. These pro forma results have been prepared for information purposes only and do not purport to be indicative of what operating results would have been had the acquisitions actually taken place on January 1, 2004 and 2005 respectively, and may not be indicative of future operating results.

| | **Year ended December 31** | |
|---|---|---|
| | 2005 | 2004 |
| | (UN-AUDITED AND IN THOUSANDS OF U.S. DOLLARS) | |
| Revenues | $44,481 | $29,878 |
| Operating income | $4,737 | $1,958 |
| Net profit | $2,620 | $784 |
| Earnings per share - basic (cents) | $0.26 | $0.11 |
| Earnings per share - diluted (cents) | $0.24 | $0.10 |

PacificNet included the financial results of Clickcom in its consolidated 2005 financial results from the date of the purchase, March 28, 2005 through December 31, 2005.

**GUANGZHOU 3G INFORMATION TECHNOLOGY CO. LTD**

On March 30, 2005 we entered into an agreement to acquire a controlling interest in Guangzhou 3G Information Technology Co. Ltd. ("Guangzhou3G-WOFE"), a PRC registered wholly owned foreign enterprise (WOFE), through the purchase of a 51% interest of Guangzhou 3G's parent company, Pacific 3G Information & Technology Co. Limited, a British Virgin Islands Company ("Guangzhou3G-BVI") from three shareholders, ASIAFAME INTERNATIONAL LIMITED, STARGAIN INTERNATIONAL LIMITED, and TRILOGIC INVESTMENTS LIMITED. All of above three shareholders are incorporated in BVI. Guangzhou3G-WOFE conducts it VAS operations with Guangzhou Sunroom Information Industrial Co., Ltd. ("Sunroom-DE"), a PRC registered Domestic Enterprise (DE), through a series of contractual agreements.

The details of the acquisition are as follows:

The purchase price for 51% controlling interest is approximately $5.9 million which is payable 29% in cash and 71% in restricted shares of PacificNet The purchase price includes $500,000 cash payable to Guangzhou 3G, and the remaining amount payable to the selling shareholders through the issuance of 522,750 restricted shares of common stock of PacificNet plus $1.18 million cash payable to the sellers upon achievement by Guangzhou 3G of certain quarterly earn-out targets based on net profits. As of December 31, 2005, cash consideration of $1,683,000 and stock consideration of $2,611,200, representing 326,400 restricted shares of PACT common stock valued at $8.00 per share, was recorded as the cost of the acquisition. Total unearned purchase consideration in the form of common stock to be distributed based on the achievement of earnings was 196,350 restricted shares (See Note 12). PacificNet also issue warrants to purchase 100,000 shares of PacificNet's common stock. The warrants have never been issued since it is contingent upon a certain earning milestone which has not been met.

The cash portion of the purchase consideration was paid from working capital of the Company. The value of the common shares issued was determined based on the average market price of PacificNet's common shares over a reasonable period before and after the terms of the acquisition were agreed to and announced.

A summary of the assets acquired and liabilities for Guangzhou 3G WOFE assumed in the acquisition follows:

| Estimated fair values: | |
|---|---|
| Current Assets | $253,000 |
| Goodwill | $4,041,200 |
| Total Assets Acquired | $4,294,200 |
| Liabilities assumed | -- |
| Net assets acquired | $4,294,200 |

At December 31, 2005, goodwill of $4,041,200 represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired and is not deductible for tax purposes and the total amount of goodwill by reportable segment for VAS Business was $9,788,000. (See Note 15).

In accordance with SFAS 142, goodwill is not amortized but is tested for impairment at least annually. The purchase price allocation for Guangzhou3G acquisition is based on a management's estimates and overall industry experience Immediately after the signing of the definitive agreement, the Company obtained effective control over Guangzhou3G. Accordingly, the operating results of Guangzhou 3G have been consolidated with those of the Company starting March 30, 2005. Pursuant to SFAS 141 "Business Combinations", the earn-out consideration is considered contingent consideration, which will not become certain until the audited combined after-tax profit of US$2,000,000 for the 12 months ended December 31, 2005 is available. Accordingly, the contingent consideration of 196,350 shares has not been reflected in the consolidated financial statements of the Company as of December 31, 2005.

**UNAUDITED PRO FORMA CONSOLIDATED FINANCIAL INFORMATION DISCLOSURE FOR THE YEAR ENDED DECEMBER 31, 2005 AND 2004**

The following un-audited pro forma consolidated financial information for the years ended December 31, 2004 and 2005, as presented below, reflects the results of operations of the Company assuming the acquisition occurred on January 1, 2004 and 2005 respectively, and after giving effect to the purchase accounting adjustments. These pro forma results have been prepared for information purposes only and do not purport to be indicative of what operating results would have been had the acquisitions actually taken place on January 1, 2004 and 2005 respectively, and may not be indicative of future operating results.

| | Year ended December 31 | |
|---|---|---|
| **GZ3G** | 2005 | 2004 |
| | (UN-AUDITED AND IN THOUSANDS OF U.S. DOLLARS) | |
| Revenues | $45,312 | $32,690 |
| Operating income | $4,910 | $1,374 |
| Net profit | $2,734 | $458 |
| Earnings per share - basic (cents) | $027 | $006 |
| Earnings per share - diluted (cents) | $026 | $006 |

PacificNet included the financial results of 3G in its consolidated 2005 financial results from the date of the purchase, March 30, 2005 through December 31, 2005.

**SHENZHEN GUHAIGUANCHAO INVESTMENT CONSULTANT COMPANY LIMITED ("CHINAGOHI")**

On December 19, 2005, we closed an agreement to purchase a 51% interest in Shenzhen GuHaiGuanChao Investment Consultant Company Limited ("ChinaGoHi"), a wholly owned foreign enterprise (WOFE) registered in China and a provider of DRTV infomercial marketing company for financial advisory services in China. On October 3, 2005 we announced that we had signed an agreement dated as of September 30, 2005 to acquire 51% of the outstanding shares of ChinaGoHi from Hitching International Corporation ("HIC"), the former majority owner of ChinaGoHi to be closed upon the completion of due diligence and the approval of the WOFE structure by China's Industry and Commerce Department.

As a result of the due diligence process and receipt of the Chinese government's WOFE approval, we and HIC agreed to amend the Sale and Purchase Agreement and entered into a Supplementary Agreement dated as of December 1, 2005 (the "Supplementary Sale and Purchase Agreement") and permitted us to have direct ownership of ChinaGoHi through the acquisition of 51% of the outstanding shares from Lion Zone Holdings Limited instead of HIC.

We agreed to purchase 12,850 existing ordinary shares (the "Sale Shares") of ChinaGoHi from Lion Zone Holdings Limited (the "Seller") and to subscribe 5,000 newly issued ordinary shares (the "Subscription Shares") from the Seller, which together with the Sale Shares, being 17,850 or 51% of the 35,000 entire outstanding shares of ChinaGoHi. The purchase price for 51% of the outstanding shares of ChinaGoHi is an aggregate of US$10.2 million: US$2.1 million payable in cash to the Seller and US$6.6 million in shares (approximately 825,000 shares) of our common stock valued at $8 per share. The purchase price is payable upon achievement of certain quarterly earn-out targets based on net profits, through the issuance of our 825,000 shares. In addition, we has agreed to issue our restricted shares, a number to be based on 51% of the net cash divided by the 60-day volume weighted average price of PacificNet, upon auditor's certification of ChinaGoHi's US$7 million accumulated net cash profit for the fiscal years ended 2003, 2004 and 2005 (subject to completion of 2005 annual USGAAP audit).

The cash portion of the acquisition consideration was for the working capital of the Company. The value of the common shares issued was determined based on the average market price of PacificNet's common shares over a reasonable period before and after the terms of the acquisition were agreed to and announced.

A summary of the assets acquired and liabilities assumed in the acquisition follows:

| Estimated fair values: | |
|---|---|
| Current Assets | $4,785,924 |
| Property Plant and equipment | 157,376 |
| Goodwill | 881,681 |
| Total Assets Acquired | $ 5,824,981 |
| Current Liabilities assumed | (2,449,981) |
| Long Term Liabilities assumed | -- |
| Net assets acquired | $ 3,375,000 |

As of December 31, 2005, the total amount of cash and stock consideration was $2,275,000 and $1,100,000 respectively.

At December 31, 2005, goodwill of $881,681 represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired and is not deductible for tax purposes and the total amount of goodwill by reportable segment for VAS Business was $9,788,000 (see Note 15).

In accordance with SFAS 142, goodwill is not amortized but is tested for impairment at least annually. The purchase price allocation for ChinaGohi acquisition is based on management's estimates and overall industry experience. Immediately after the signing of the definitive agreement, the Company obtained effective control over ChinaGohi. Accordingly, the operating results of ChinaGohi have been consolidated with those of the Company starting December 19, 2005. Pursuant to SFAS 141 "Business Combinations", the earn-out consideration is considered contingent consideration, which will not become certain until the audited combined after-tax profit of US$4,500,000 for 15 months ending December 31, 2006 is available. Accordingly, the contingent consideration of 687,500 restricted shares and cash of US$1,325,000 have not been reflected in the consolidated financial statements of the Company as of December 31, 2005.

**UNAUDITED PRO FORMA CONSOLIDATED FINANCIAL INFORMATION DISCLOSURE FOR THE YEAR ENDED DECEMBER 31, 2005 AND 2004**

The following un-audited pro forma consolidated financial information for the years ended December 31, 2004 and 2005, as presented below, reflects the results of operations of the Company assuming the acquisition occurred on January 1, 2004 and 2005 respectively, and after giving effect to the purchase accounting adjustments. These pro forma results have been prepared for information purposes only and do not purport to be indicative of what operating results would have been had the acquisitions actually taken place on January 1, 2004 and 2005 respectively, and may not be indicative of future operating results.

| | Year ended December 31 | |
|---|---|---|
| | 2005 | 2004 |
| | (UN-AUDITED AND IN THOUSANDS OF U.S. DOLLARS) | |
| Revenues | $55,209 | $39,164 |
| Operating income | $7,332 | $4,267 |
| Net profit | $3,354 | $1,688 |
| Earnings per share - basic (cents) | $0.33 | $0.23 |
| Earnings per share - diluted (cents) | $0.31 | $0.20 |

PacificNet included the financial results of Lion Zone in its consolidated 2005 financial results from the date of the purchase, December 19, 2005 through December 31, 2005.

**3. INVESTMENT IN AFFILIATED COMPANIES**

Investments in affiliated companies and goodwill consist of the following as of December 31, 2005 (in thousands):

| | COLLATERAL/OWNERSHIP % AND BUSINESS DESCRIPTION | |
|---|---|---|
| | AMOUNT | DESCRIPTION |
| INVESTMENTS IN AFFILIATED COMPANIES: | | |
| Take1 (Cheer Era Limited) [1] | $ 386 | 20% ownership interest; trader of vending machine located in Hong Kong |
| Xmedia Holdings Inc | 95 | 25% ownership; provides new media business development and marketing to advertisers. |
| Less: Provision for Impairment | (95) | |

| | |
|---|---|
| Total | $ 386 |

**TAKE 1 TECHNOLOGIES GROUP LIMITED (FORMERLY KNOWN AS: CHEER ERA LIMITED "CHEERERA")**

The investment in 30% of Take 1 Technologies Group Limited ("Take 1"), a trader of vending machine located in Hong Kong, was originally made in April 2004 with details as follows:

In April 2004 the Company, through its subsidiary PacificNet Strategic Investment Holdings Limited, acquired 30% equity interest in Take 1. The aggregate consideration was $1,156,812, of which $385,604 was paid in cash and $771,208 was paid in 149,459 PacificNet shares at $5.16, and warrants within a duration of three years to purchase up to 80,000 PacificNet shares at 5-Day volume weighted average price immediately prior to the transaction. The warrants have been cancelled in the year 2005 because the warranted profit was not met. (See Note 5)

In 2005 both the Company and Take 1 have mutually agreed to a change to the original investment structure pursuant to the Securities Repurchase Agreements entered. Summarized below are the effects of these repurchase arrangements:

(i) PacificNet 's interest in Take 1 was reduced to 20% in the year 2005 from 30% in the prior year;
(ii) PacificNet repurchased 149,459 shares in PacificNet previously issued to the majority owner of Take 1 at nominal value;
(iii) In addition to PacificNet 's existing loan of $769,000 (or HKD$6,000,000), PacificNet will advance a new loan of $256,000 (or HKD$2,000,000) to Take 1 (collectively called `Convertible Loan'). The Convertible Loan is guaranteed personally and jointly by the two majority owners of Take 1. The term of the Convertible Loan shall be three years expiring on October 17, 2008 (referred as "Term") with 8% interest per annum or HK Six-Month Prime Rate, whichever is higher.
(iv) Conversion terms of the Convertible Loan provide PacificNet an option at any time during the Term to convert in part or in whole of the then outstanding loan principal up toS$1,794,000 (or HKD$8,000,000) into shares of Take 1 to reach 51% ownership of Take 1. The conversion rate will be based on a valuation of SIX (6) times the average annual net profits of 3 years ending December 31, 2007 audited by PacificNet 's auditors.

As a result, the original investment of Take 1 was reduced at cost to $385,604 as of December 31, 2005 due to the PacificNet shares repurchased under item (ii) above. The management intends to cancel these repurchased shares subsequent to the year end. As of December 31, 2005, the outstanding loan amount due to Take 1 was US$769,000.

**4. PROPERTY AND EQUIPMENT, NET**

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

| | 2005 | 2004 |
|---|---|---|
| Office furniture, fixtures and leasehold improvements | $531 | $16 |
| Computers and office equipment | 1054 | 624 |
| Motor Vehicles | 220 | 69 |
| Software | 568 | 235 |
| Electronic Equipment | 3520 | 13 |
| Other | 77 | 468 |
| Less: Accumulated depreciation | (1,670) | (307) |
| Net Property and Equipment | $4,300 | $1,118 |

For the years ended December 31, 2005 and 2004, the total depreciation and amortization expenses were $1,126,000, of which $833,000 was included in the cost of revenue, and $78,000, respectively.

**5. COMMITMENTS AND CONTINGENCIES**

OPERATING LEASES -The Company leases warehouse and office space under operating leases for two years with fixed monthly rentals that expire through 2005. None of the leases included contingent rentals. Lease expense charged to operations for 2005 amounted to $653,000 (2004: $397,854). Future minimum lease payments under non-cancelable operating leases are 2006: $870,000 and 2007: $806,000.

RESTRICTED CASH - The Company has a $163,000 pledged bank deposit for Epro which represents overdraft protections with certain financial institutions and a fixed deposit of $1,489,000 for Lion Zone utilized to provide guarantee for related party.

BANK LINE OF CREDIT (2005): As of December 31, 2005, the Company utilized $1,060,000 of the banking facility including $945,000 from Epro and $112,000 from Smartime, and the differences of the exchange rate of $3,000. Epro has an overdraft banking facility with certain major financial institutions in the aggregate amount of $1,218,000, which is secured by a pledge of its fixed deposits of $163,000, pursuant to the following terms: interest will be charged at the Hong Kong Prime Rate per annum and payable at the end of each calendar month or the date of settlement, whichever is earlier. For Smartime, there is no due date payment stipulated by Hong Kong Hang Seng Bank because its overdraft banking facility was borrowed directly from one of its directors personal fixed deposit account as a mortgage. The detailed payment period is based on its funding condition.

BANK LINE OF CREDIT (2004): The Company has an overdraft banking facility with certain major bankers in the aggregate amount of $1,309,000, which is secured by a pledge of the Company's fixed deposits in the amount of $212,000, pursuant to the following terms: interest will be charged at the Hong Kong Prime Rate per annum and payable at the end of each calendar month or the date of settlement, which ever is earlier. As of December 31, 2004, the Company utilized $651,000 of the above-mentioned banking facility.

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

MINIMUM STATED CAPITAL REQUIREMENTS. Guangzhou Dianxun Co, Limited (DE) ("Dianxun"), a subsidiary of the Group, is carrying on business as a telecommunication value added service provider in the People's Republic of China ("PRC"). Initially, Dianxun obtained a certificate (the "Certificate") from the PRC authority to transact business and according to the PRC Telecommunication Rules, all telecommunication value added service providers can only carry on business if the Certificate is granted and if the Company maintains a minimum capital requirement of at least RMB10,000,000.

In order to satisfy the capital requirement of RMB 10,000,000, the shareholders of Dianxun had contributed relevant asset equivalent to RMB9,000,000 on behalf of Dianxun and such assets were verified by an independent professional accountant. Subsequently, such assets were returned back to the shareholders. In the opinion of the directors, even though the capital requirement is not fulfilled, Dianxun can continue to carry on business. No provision for any loss arising from the consequential actions that may be taken by the authority in the PRC and any potential penalties or claims for the Company not maintaining the minimum stated capital requirements of the PRC have been made in these financial statements.

Dianxun's contribution to consolidated revenues and net profit for 2005 was approximately 1.5% and 5.6%, respectively. Upon demand by the PRC authorities, PacificNet has agreed to loan Clickcom the remaining balance of the registration capital to provide the stated capital in accordance with PRC laws.

**6. OTHER CURRENT ASSETS**

Other current assets is represented in Consolidated Balance Sheets which include the following at December 31 (in thousands):

| | 2005 | 2004 |
|---|---|---|
| Deposit | $707 | $870 |
| Prepayment | 1,294 | 354 |
| Other receivables | 5,972 | 3,101 |
| Total | $7,973 | $4,325 |

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**7. BANK LOANS**

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

| | 2005 | 2004 |
|---|---|---|
| Secured [1] | $108 | $860 |
| Unsecured | 86 | 536 |
| Less: current portion | (188) | (1,327) |
| Non current portion | $6 | $69 |

Bank Loans are generated by one of the Company's subsidiaries, PacificNet Epro Holdings Limited, a company incorporated in the Hong Kong Special Administrative Region of the PRC, primarily engaged in the business of providing call center and customer relationship management (CRM) services as well as other business outsourcing services.

[1] The loans were secured by the following: joint and several personal guarantees executed by certain directors of the subsidiary of the Company; corporate guarantee executed by a subsidiary of the Company; second legal charge over a property owned by a subsidiary of the Company; and pledged bank deposits of $163,000 (2004: $212,000) of a subsidiary of the Company.

Aggregate future maturities of borrowing for the next five years are as follows: 2006: $188,000 and 2007: $6,000).

8. CAPITAL LEASE OBLIGATIONS

The Company leases various equipments under capital leases expiring in various years through 2005. The assets and liabilities under capital leases are recorded at the lower of the present value of the minimum lease payments or the fair value of the asset. The assets are depreciated over the lesser of their related lease terms or their estimated productive lives and are secured by the assets themselves. Depreciation of assets under capital leases is included in depreciation expense for 2005 and 2004

Aggregate minimum future lease payments under capital leases as of December 31, 2005 for each of the next five years are as follows: (2006: $126,000; 2007: $57,000; and 2008: $21,000)

Capital lease obligations represent the following at December 31, 2005 (in thousands):

| | 2005 | 2004 |
|---|---|---|
| Total minimum lease payments | $216 | $225 |
| Interest expense relating to future periods | (12) | (16) |
| Present value of the minimum lease payments | 204 | 209 |
| Less: current portion | (126) | (80) |

| | | |
|---|---|---|
| Non current portion | $78 | $129 |

Following is a summary of fixed assets held under capital leases at December 31 (in thousands):

| | 2005 | 2004 |
|---|---|---|
| Computers and office equipment | $441 | $268 |
| Less: accumulated depreciation | (286) | (246) |
| | $155 | $22 |

**9. ACCRUED EXPENSES**

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

| | 2005 | 2004 |
|---|---|---|
| Deposits and advance payments received | $3,312 | $31 |
| Payroll payable | 713 | 21 |
| Other | 595 | 76 |
| Total | $4,620 | $128 |

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**10. SUBSCRIPTION PAYABLE**

In December 2005, the Company executed agreements and acquired controlling interests in Shenzhen GuHaiGuanChao Investment Consultant Company Limited ("ChinaGoHi"), a wholly owned foreign enterprise (WOFE) registered in China and a provider of DRTV infomercial marketing company for financial advisory services in China.

According to the agreement for the acquisition of ChinaGoHi, the total purchase consideration at the acquisition date approximated $10,200,000, which included the following:

(1) Cash for original shareholders of ChinaGoHi: $2,100,000 (payable in installments based on the terms and conditions; the payable amount is $775,000 at December 31, 2005);
(2) PACT common stock for original shareholders of ChinaGoHi: $6,600,000 (825,000 x $8 per share); and
(3) Cash for registered capital of ChinaGoHi: $1,500,000.

Accordingly, subscription payable of $775,000 represents the installment payment in cash due under the terms and conditions of the Sale and Purchase Agreement at December 31, 2005.

See note 2 for details regarding the acquisitions.

**11. SUNDRY INCOME**

Sundry income for the years ended December 31, 2005 and 2004, consists of the following on the consolidated income statements (in thousands):

| | 2005 | 2004 |
|---|---|---|
| Consulting service income | $116 | $380 |
| Investment income | 113 | -- |
| Leasehold income | 75 | -- |
| Software service income | 375 | -- |
| Others | 151 | 42 |
| TOTAL | $830 | $422 |

**12. STOCKHOLDERS' EQUITY**

a) COMMON STOCK

For the year ended December 31, 2005, the Company had the following equity transactions (i) 700,000 shares as a result of exercise of stock options and warrants with cash consideration of $1,014,000; (ii) 515,900 shares for acquisition of subsidiaries valued at $3,971,000;(iii) 20,000 shares at $3.10 per share, or $63,000 for investor relations services rendered based on the fair market value of the services rendered; and (iv) cancellation of 149,459 shares with a market value of $771,000 related to affiliated company (see Note 3 for details).

For the year ended December 31, 2004, the Company had the following equity transactions (i) 352,364 shares as a result of exercise of stock options and warrants with cash consideration of $716,000; (ii) 1,756,240 shares for acquisition of subsidiaries valued at $8,866,000; and (iii) 2,205,697 shares for cash proceeds of $11,773,000 (net of offering costs); and (iv) 149,459 shares with a market value of $771,000 for acquisition of affiliated company (see Note 3 for details).

b) STOCK OPTION PLAN

On December 23, 2003, stockholders of the Company adopted an amendment to the Stock Option Plan (the "Plan") to increase the number of shares reserved under the Plan from 1,666,667 to 2,000,000. On December 30, 2004, stockholders of the Company approved the new 2005 Stock Option Plan (the "2005 Option Plan"). The 2005 Option Plan provide for the grant to directors, officers, employees and consultants of the Company (including its subsidiaries) of options to purchase up to an aggregate of 2,000,000 shares of Common Stock. The 2005 Plan is administered by the Board of Directors or a committee of the Board of Directors (in either case, the "Committee"), which has complete discretion to select the optionees and to establish the terms and conditions of each option, subject to the provisions of the 2005 Option Plan. Options granted under the 2005 Plan are "incentive stock options" as defined in Section 422 of the Internal Revenue Code of 1986, as amended (the "Code"), or nonqualified options.

The purpose of the Plan is to attract and retain the best available personnel for positions of responsibility and to provide incentives to such personnel to promote the success of the business. The Plan provides for the grant to directors, officers, employees and consultants of the Company (including its subsidiaries) of options to purchase shares of common stock. Options granted under the Plan may be "incentive stock options" as defined in Section 422 of the Internal Revenue Code of 1986, as amended (the "Code"), or non-qualified options. To date, all options granted have been nonqualified options. The exercise price of incentive stock options may not be less than 100% of the fair market value of the common stock as of the date of grant. The number of options outstanding and the exercise price thereof are subject to adjustment in the case of certain transactions such as mergers, recapitalizations, stock splits or stock dividends. Options granted under the Plan fully vest through June 2005.

The status of the Stock Option Plan as of December 31, 2005, is as follows:

| | OPTIONS | WEIGHTED AVERAGE EXERCISE PRICE |
|---|---|---|
| OUTSTANDING, DECEMBER 31, 2002 | 312,600 | $1.13 |
| Granted | 963,000 | $2.97 |
| Exercised | (350,000) | $1.13 |
| OUTSTANDING, DECEMBER 31, 2003 | 925,600 | $2.87 |
| Granted | 600,000 | $ 2.00 |
| Cancelled | (400,000) | $4.25 |
| Exercised | (321,500) | $ 2.11 |
| OUTSTANDING, DECEMBER 31, 2004 | 804,100 | $ 1.90 |
| Granted | 680,000 | $ 6.57 |
| Cancelled | -- | -- |
| Exercised | (100,000) | $ 1.99 |
| OUTSTANDING, DECEMBER 31, 2005 | 1,384,100 | $3.99 |

Additional information on options outstanding as of December 31, 2005 is as follows:

| | WEIGHTED AVERAGE EXERCISE PRICE | OPTIONS | AVERAGE REMAINING CONTRACTUAL LIFE |
|---|---|---|---|
| Options outstanding | $3.99 | 1,384,100 | 3.50 years |
| Options exercisable | $2.06 | 529,000 | 1.50 years |

c) WARRANTS

At December 31, 2005, the Company had outstanding and exercisable warrants to purchase an aggregate of 591,138 shares of common stock. The weighted average remaining life is 3.74 years and the weighted average price per share is $9.50 per share as follows:

| Shares of common stock | EXERCISE PRICE PER SHARE | EXPIRATION DATE OF WARRANTS |
|---|---|---|
| 123,456 | $7.15 | January 15, 2009 |
| 117,682 | $3.89 | November 15, 2009 |
| 350,000 | $12.21 | December 9, 2009 |
| --------------------- | | |
| 591,138 | | |

The Company believes 330,000 warrants issued in connection with certain acquisition agreements (Note 2) with the following subsidiaries, Yueshen: 50,000, Cheer Era: 80,000, Smartime: 50,000, Clickcom: 50,000, and Guangzhou3G:100,000 are no longer part of the purchase consideration as more fully described in Note 5 and therefore are not considered outstanding.

During 2005, 200,000 unexercised warrants (Excel Harbour warrants) expired, and 600,000 warrants were exercised by Sino Mart Management Ltd, a related party, at an exercise price of $1.45 per share for total proceeds of $870,000. For the year ended December 31, 2004, 30,864 warrants were exercised at an exercise price of $7.15 per share for total proceeds of $220,678.

d) TREASURY STOCK

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

| | Number of shares | Remarks |
|---|---|---|
| Balance, December 31, 2003 | 800,000 | |
| Repurchase in the open market | 36,154 | |
| Balance, December 31, 2004 | 836,154 | |
| Repurchase in the open market | 2,000 | |
| Repurchase of shares from Take 1 | 149,459 | See note 3 to the F/S |
| Cancellation of former employee shares | 45,000 | |
| Holdback shares as contingent consideration due to performance targets not yet met | 298,550 | Including 24,200 shares relating to Yueshen, 196,350 hares to 3G and 78,000 shares to Clickcom |
| Share consideration for acquisition of ChinaGoHi deemed issued under Sale and Purchase Agreement | (137,500) | Due to share issuance in progress; actual share certificate delivered after the year end |
| Options exercised but shares deemed issued | (24,000) | Share issuance in progress prior to year end |
| Balance, December 31, 2005: | 1,169,663 | |
| Shares outstanding at December 31, 2005 | 10,831,024 | |
| Shares issued at December 31, 2005 | 12,000,687 | |

**13. INCOME TAXES**

The Company is registered in the State of Delaware and has operations in primarily three tax jurisdictions - the PRC, Hong Kong and the United States. For certain operations in the United States of America, Hong Kong and the PRC, the Company has incurred net accumulated operating losses for income tax purposes. The Company believes that it is more likely than not that these net accumulated operating losses will not be utilized in the future. Therefore, the Company has provided full valuation allowance for the deferred tax assets arising from the losses at these locations as of December 31, 2005. Accordingly, the Company has no net deferred tax assets.

The components of income before income taxes are as follows:

| | 2005 | 2004 |
|---|---|---|
| In Income (loss) subject to PRC | $ 2,391,000 | $ 1,374,000 |
| Income (loss) subject to Hong Kong | 1,125,000 | 388,000 |

| | | | | |
|---|---|---|---|---|
| Income (loss) subject to United States | | (805,000) | | (915,000) |
| Income before taxes | $ | 2,711,000 | $ | 847,000 |

United States of America

As of December 31, 2005, the Company's subsidiary in the United States of America had approximately $4,900,000 in net operating loss carryforwards available to offset future taxable income. Federal net operating losses can generally be carried forward 20 years. The Tax Reform Act of 1986 limits the use of net operating loss and tax credit carryforwards in certain situations when changes occur in the stock ownership of a company. In the event the Company has a change in ownership, utilization of carryforwards could be restricted. The deferred tax assets for the United States entity at December 31, 2005 consists mainly of net operating loss carryforwards and were fully reserved as the management believes it is more likely than not that these assets will not be realized in the future.

The following table sets forth the significant components of the net deferred tax assets for operation in the United States of America as of December 31, 2005 and 2004.

| | | **2005** | **2004** |
|---|---|---|---|
| Net Operating Loss Carryforwards | $ | 1,732,300 | 1,501,000 |
| Total Deferred Tax Assets | | 1,732,300 | 1,501,000 |
| Less: Valuation Allowance | | (1,732,300) | (1,501,000) |
| Net Deferred Tax Assets | | - | - |

Hong Kong

As of December 31, 2005, the Company's Hong Kong subsidiary had net operating loss carryforwards which can be carried forward indefinitely to offset future taxable income. The deferred tax assets for the Hong Kong subsidiary at December 31, 2005 consists mainly of net operating loss carryforwards and were fully reserved as the management believes it is more likely than not that these assets will not be realized in the future. The amounts were immaterial.

China

Pursuant to the PRC Income Tax Laws, the Company's subsidiaries and VIEs are generally subject to Enterprise Income Taxes ("EIT") at a statutory rate of 33%, which comprises 30% national income tax and 3% local income tax. Some of these subsidiaries and VIEs are qualified new technology enterprises and under PRC Income Tax Laws, they are subject to preferential tax rates. Additionally, As of December 31, 2005 and 2004, the Company had accumulated net operating loss carryforwards for Chinese tax purposes of approximately $447,000 and $118,500, respectively. Realization of the Chinese tax net operating loss carryforwards is dependent on future profitable operations, as well as a maximum five-year carryforward period. Accordingly, management has recorded a valuation allowance to reduce the deferred tax associated with the net operating loss carryforwards to zero.

The following table sets forth the significant components of the net deferred tax assets for operation in the PRC as of December 31, 2005 and 2004.

| | | **2005** | **2004** |
|---|---|---|---|
| Net Operating Loss Carryforwards | $ | 86,000 | 20,000 |
| Total Deferred Tax Assets | | 86,000 | 20,000 |
| Less: Valuation Allowance | | (86,000) | (20,000) |
| Net Deferred Tax Assets | | - | - |

***Aggregate net deferred tax assets***

The following table sets forth the significant components of the aggregate net deferred tax assets of the Company as of December 31, 2005 and 2004:

| | | **2005** | **2005** |
|---|---|---|---|
| Total Deferred Tax Assets | | 1,818,300 | 1,521,000 |
| Less: Valuation Allowance | | (1,818,300) | (1,521,000) |
| Net Deferred Tax Assets | | - | - |

Income tax payable was approximately $296,000 at December 31, 2005 (2004: $10).

## 14. RELATED PARTY TRANSACTIONS

Employment Agreement

The Company has an employment agreement with its Chief Executive Officer (CEO) and President. The employment agreement with the CEO provides for $100,000 cash compensation plus $60,000 annual share compensation until April 1, 2005. The CEO is also eligible for an annual bonus for each fiscal year of the Company during the term based on performance standards as the Board or compensation committee designates. The CEO is entitled to receive a monthly housing allowance of $2,500, monthly automobile allowance of $500, Tax Preparation expenses of $2,000 per year, and Cash Bonus based on net profit of the Company. During 2004, under the Company's stock option plan, the CEO was granted an option to acquire 65,000 shares at an exercise price per share of $2.00 (at market price) which has not been exercised. During 2004, under the Company's stock option plan, the President was granted an option to acquire 73,000 shares at an exercise price per share of $2.00 (at market price) which has not been exercised.

Lease Agreement

In November 2004, the Company entered a lease agreement with EPRO for rental space in the amount of $1,923 per month. The term of the lease was one year and renewable by either party.

LOAN DUE TO AND FROM RELATED PARTIES

As of December 31, 2005, there was a total loan receivable of approximately. $2,520,000 due from related parties while the loan due to related party was $369,000.

As at the year end, the related party loan receivables included $769,000 due from Take 1, an affiliated company that is 20% owned by PacificNet, $1,751,000 due from shareholder and directors of PacificNet's subsidiaries. The loans receivable from shareholders and directors of PacificNet's subsidiaries comprised of $1,215,000 due from a shareholder of Yueshen, $80,000 due from a shareholder of EPRO, $199,000 due from a director of Soluteck, and $257,000 due from a director of Clickcom. The terms of these three related parties loan receivables and payables are summarized below:

LOAN TO TAKE 1 (CHEER ERA)

Please refer to Note 3 of the Consolidated Financial Statements for detailed discussion on the change of investment structure of this affiliated company which is now 20% owned by PacificNet. As of December 31, 2005, there was a Convertible Loan of $769,000 outstanding from Take 1. The purpose of the Convertible Loan was a working capital loan to finance the expansion of Take 1's business in Europe and North America.

LOAN TO YUESHEN'S SHAREHOLDER

As of December 31, 2005, there was $1,215,000 loan receivable due from the shareholder of Yueshen, a subsidiary of the Shanghai Classic. The purpose of the loan was to repay the working capital loan owed by the predecessor of Yueshen prior to PacificNet's acquisition and to finance Yueshen shareholder's other projects. This loan is collateralized with 106,240 PacificNet shares owned by the shareholder of Yueshen.

LOAN TO SOLUTEK'S DIRECTOR

As of December 31, 2005, there was a loan outstanding of $199,000 receivable from a director of Solutek, payable in three equal installments of $72,314 each, being principal plus interest, due on December 14 for three consecutive years ending 2007. The interest rate for the loan is 8% per annum plus 5% penalty interest in case it has not been timely paid. The loan is collateralized with 100,000 PacificNet's shares owned by the borrowing director and Ms Iris Lo, and the remaining assets of Smartime Holding Ltd.

LOAN TO DIRECTOR OF CLICKCOM

As of December 31, 2005, there was a loan of $257,000 receivable from the shareholders of Clickcom VIE. The loan was advanced by the Company to Clickcom VIE which in turn loaned to the shareholders of Clickcom VIE to finance the development of new projects. Pursuant to the loan agreement signed between the Company and Clickcom VIE, this loan has a two year term due on August 30, 2007 and bears a 2% interest rate and is personally and jointly guaranteed by all the three shareholders of Clickcom VIE on top of the pledged shares up to 130,000 PacificNet's shares and all remaining assets and equity ownership of Clickcom BVI.

LOAN TO SHAREHOLDER OF EPRO

As of December 31, 2005, a net loan receivable of $80,000 was due from a shareholder of Epro. The loan is unsecured, interest-free and repayable on demand.

LOAN PAYABLE TO RELATED PARTY

As of December 31, 2005, a loan of $369,000 was payable to a shareholder of EPRO. The loan was advanced to Epro for working capital purpose expiring by August 4, 2010 at Hong Kong Prime lending rate approximately 6.5% interest per annum prevailing in the year 2005.

**15. SEGMENT INFORMATION**

SFAS No. 131, DISCLOSURE ABOUT SEGMENTS OF AN ENTERPRISE AND RELATED INFORMATION ("SFAS 131"), establishes standards for reporting information about operating segments and for related disclosures about products, services and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision-maker, or decision-making group, in making decisions regarding allocation of resources and assessing performance. PacificNet's chief decision-makers, as defined under SFAS 131, is the Chief Executive Officer and Chairman. During 2005 and 2004, PacificNet had four operating segments.

The Company's reportable segments are operating units, which represent the operations of the Company's significant business operations. Summarized financial information concerning the Company's reportable segments is shown in the following table. The "Other" column includes the Company's other insignificant services and corporate related items, and, as it relates to segment profit (loss), income and expense not allocated to reportable segments.

| FOR THE YEAR ENDED DECEMBER 31, 2005 | Group 1. Outsourcing Business ($) | Group 2. VAS Business ($) | Group 3. Communications Distribution Business ($) | Group 4. Other Business ($) | Total ($) |
|---|---|---|---|---|---|
| Revenues | 13,505,000 | 13,834,000 | 16,201,000 | 801,000 | 44,341,000 |
| (% of Total Rev) | (30.5%) | (31.2%) | (36.5%) | (1.8%) | (100%) |
| Earnings / (Loss) from | | | | | |
| Operations | 1,360,000 | 3,899,000 | 558,000 | (1,248,000) | 4,569,000 |
| (% of Total Profit) | (29.8%) | (85.3%) | (12.2%) | (-27.3%) | (100%) |
| Total Assets | 7,335,000 | 19,363,000 | 9,493,000 | 15,012,000 | 51,203,000 |
| (% of Total Assets) | (14.3%) | (37.8%) | (18.6%) | (29.3%) | (100%) |
| Goodwill | 3,936,000 | 9,788,000 | 1,100,000 | - | 14,824,000 |
| Geographic Area | HK, PRC | HK, PRC | HK, PRC | HK,PRC | |

| For the year ended December 31, 2004 | 1.Outsourcing Business ($) | 2. VAS Business ($) | 3. Communications Distribution Business($) | 4. Other Business ($) | Total ($) |
|---|---|---|---|---|---|
| Revenues | 9,385,000 | 5,724,000 | 11,790,000 | 2,810,000 | 29,709,000 |
| (% of Total Rev) | (31.5%) | (19.27%) | (39.68%) | (9.55%) | (100%) |
| Earnings / (Loss) from | | | | | |
| Operations | 1,000,000 | 1,859,000 | 85,000 | (1,007,000) | 1,937,000 |
| (% of Total Profit) | (51.6%) | (96%) | (4.4%) | (-52%) | (100%) |
| Total Assets | 6,017,000 | 2,600,000 | 5,018,000 | 19,615,000 | 33,250,000 |
| (% of Total Assets) | (18.1%) | (7.8%) | (15.1%) | (59%) | (100%) |
| Goodwill | 3,936,000 | 4,473,000 | 1,100,000 | - | 9,509,000 |

| | | | | | |
|---|---|---|---|---|---|
| Geographic Area | HK, PRC | HK, PRC | HK, PRC | HK,PRC | |

The Company identifies and classifies its operating segments based on reporting entities that exhibit similar long-term financial performance based on the nature of the products and services with similar economic characteristics such as margins, business practices and target market. The operating segments are classified into four major segments which are summarized as follows:

(1) Outsourcing Services - involves human voice services such as Business Process Outsourcing, CRM, call center, IT Outsourcing and software development services. These types of services are conducted through our subsidiaries EPRO, Smartime/Soluteck and PacificNet Solution Ltd.

(2) Value-Added Telecom Ser vices (VAS) - primarily involves machine voice services such as Interactive Voice Response, SMS and related VAS, which are conducted through our subsidiaries such as ChinaGoHi, Linkhead, Clickcom and Guangzhou 3G/Sunroom. For example, Linkhead is a master reseller of NMS hardware and software platforms in China, and its voice cards are used as an integral part of voice hardware using CPCI industry control machines, and also by Media Servers to support access from PSTN and VoIP, softswitch and 3G networks.

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(3) Communication Products Distribution Services Group - primarily involves voice products distribution such as distribution of calling cards and other products, which are conducted through our subsidiary Yueshen and PacificNet Communication. These calling cards differ from the phone cards in the VAS business as these cards are geared towards the end user, and include prepaid calling cards, IDD long distance calling cards, internet access cards, bundledcross-selling insurance cards, and shopping discount cards.

(4) Other Business -other administrative, financial and investment services and non-core businesses such as PacificNet Power Limited (PacPower), Pacific Financial Services Limited, PacificNet Games, etc.

Product and service revenues classified by major geographic areas are as follows (in thousands):

| | Hong Kong | PRC | United States | Total |
|---|---|---|---|---|
| Product revenue | $20,131 | $ 3,216 | $- | $ 23,347 |
| Service revenue | $10,640 | $10,354 | $- | $ 20,994 |

**16. RESTATEMENT AND CORRECTION OF ERROR**

**Consolidated Income Statement and Consolidated Statement of Cash Flows**

The 2004 consolidated income statement has been restated to present separately revenues and costs of revenues from product sales and services in accordance with Rule 5-03 of Regulation S-X. There was no effect on previously reported total revenues, total costs of revenues, net earnings or earnings per share amounts.

The 2004 consolidated statement of cash flows has been restated to properly reflect the changes in the balance sheet accounts resulting from minority interests accounting. The restatement had no effect on previously reported net increase in cash and cash equivalents or cash balances.

The restatement for the year ended December 31, 2004 can be summarized as follows:

| | As Previously Reported | As Restated |
|---|---|---|
| Cash Flows from operating activities | | |
| Net earnings | $774 | $774 |
| Adjustment to reconcile net earnings to net cash provided by (used in) | | |
| operating activities: | | |
| Equity loss (earnings) of associated company | - | (32) |
| Minority Interest | 2,506 | 1,623 |
| Depreciation and amortization | 78 | 78 |
| Changes in current assets and liabilities net of effects from | | |
| purchase of subsidiaries: | | |
| Accounts receivable and other current assets | (7,793) | (3,567) |
| Inventories | (1,221) | (1,221) |
| Accounts payable and other accrued expenses | 1,921 | (2,069) |
| Net cash provided by (used in) operating activities | (3,718) | (4,431) |
| Cash flows from investing activities | | |

| | | |
|---|---|---|
| DECREASE IN RESTRICTED CASH | (3,289) | (3,289) |
| Increase in purchase of marketable securities | (46) | (46) |
| Acquisition of property and equipment | (730) | (206) |
| Acquisition of subsidiaries and affiliated companies | (640) | (724) |
| Net cash used in investing activities | (4,705) | (4,265) |
| CASH FLOWS PROVIDED BY FINANCING ACTIVITIES: | | |
| Repayments on under bank line of credit | (548) | (548) |
| Advances (repayments) of amount borrowed under capital lease obligations | (92) | (92) |
| Repayments on bank loans | (386) | (130) |
| Proceeds from sale of common stock | 11,773 | 11,773 |
| Repurchase of treasury shares | (99) | (99) |
| Proceeds from exercise of stock options and warrants | 716 | 716 |
| Net cash provided by (used in) financing activities | 11,364 | 11,620 |
| Effect of Exhange Rate (Range on Cash and Cash Equivalents | -- | 17 |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 2,941 | 2,941 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR | 3,823 | 3,823 |
| CASH AND CASH EQUIVALENTS, END OF YEAR | $6,764 | $6,764 |

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The 2005 consolidated statement of cash flows has been restated for the following reasons:

1. Reclassification of loan receivables from financing activities to investing activities.

2. Reclassification of certain reconciling items that have no cash or net earnings effect from operating activities to a separate line labeled “Effect of exchange rate on cash and cash equivalents.”

3. Reclassification of “Other current assets” balance of $4.325 million that was incorrectly included in the net change in “Decrease in Loans Receivable” balance of $ 2,753 in the financing activities section of the statement of cash flows while changes in “Accounts receivable and other current assets” amounted to $2,732 and was presented in the operating activities section of the balance sheet as originally reported. The restatements had no effect on previously reported net increase in cash and cash equivalents or cash balances.

The restatement for the year ended December 31, 2005 can be summarized as follows:

| | reported 2005 | restated 2005 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Net earnings | $ 2,489 | $ 2,489 |
| Adjustment to reconcile net earnings to net cash used in operating activities: | | |
| Equity loss (profit) of associated company | 8 | 8 |
| Common stock issued for services rendered | 63 | 63 |
| Unrealized exchange gain due to foreign currency translation | (271) | - |
| Minority Interest | 2,926 | 2,926 |
| Unrealized losses on marketable equity securities | 11 | - |
| Depreciation and amortization | 1,126 | 1,126 |
| **Changes in current assets & liabilities net of effects from purchase of subsidiaries:** | | |
| Accounts receivable and other current assets | 2,732 | 7,057 |
| Inventories | (539) | (539) |
| Accounts payable and accrued expenses | (3,880) | (3,880) |
| **Net cash provided (used in) operating activities** | **4,665** | **9,250** |
| | | |
| **CASH FLOWS FROM INVESTMENT ACTIVITIES** | | |
| Decrease in restricted cash | 1,849 | 1,849 |
| Increase in purchase of marketable securities | (521) | (521) |
| Acquisition of property and equipment | (2,252) | (2,252) |
| Acquisition of subsidiaries and affiliated companies | (1,183) | (1,183) |
| Decrease in loan receivables | | (1,572) |
| Decrease in loans receivables from related parties | | (2,520) |
| **Net cash used in investing activities** | **(2,107)** | **(6,199)** |
| | | |
| **CASH FLOWS PROVIDED BY FINANCING ACTIVITIES:** | | |
| Decrease in loan receivables | 2,753 | |
| Decrease in loans receivables from related parties | (2,520) | |
| Increase in loans payable to related parties | 369 | 369 |
| Advances (repayments) under bank line of credit | 409 | 409 |
| Advances under bank loans | (1,201) | (1,201) |
| Increase (repayment) of amount borrowed under capital lease obligations | (5) | (5) |
| Proceeds from sales of common stock | - | - |
| Repurchase of treasury shares | (15) | (15) |

| | | |
|---|---|---|
| Proceeds from exercise of stock options and warrants | 1,014 | 1,014 |
| Payment of certain PIPE related expenses | (547) | (547) |
| **Net cash provided by financing activities** | **257** | **24** |
| **Effect of exchange rate change on cash and cash equivalents** | | (260) |
| **NET DECREASE IN CASH AND CASH EQUIVALENTS** | **2,815** | **2,815** |
| **CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD** | 6,764 | 6,764 |
| **CASH AND CASH EQUIVALENTS, END OF PERIOD** | 9,579 | 9,579 |
| **CASH PAID (RECEIVED) FOR:** | | |
| Interest | 229 | 229 |
| Income taxes | (53) | (53) |
| **NONCASH INVESTING AND FINANCING ACTIVITIES:** | | |
| Issuance of option shares through increase in subscription receivable | 63 | 63 |
| Investment in subsidiary acquired through increase in subscription receivable | 775 | 775 |
| Repurchase of shares issued to Cheer Era | 771 | 771 |
| Investment in subsidiaries acquired through issuance of common stock | 3,971 | 3,971 |

**2005 Quarterly Reviews (unaudited)**

As discussed in Note 1, the Company accounts for its VIEs in accordance with U.S. generally accepted accounting principles which requires the consolidation of VIEs from the date of acquisition. During 2005, the Company's quarterly consolidated financial condition, results of operations, and reported cash flow did not properly reflect VIE accounting. As a result, the quarterly financial statements have been restated.

The restatements for the interim periods ended March 31, 2005, June 30, 2005 and September 30, 2005 are summarized as follows:

| | March 31, 2005 | | June 30, 2005 | | September 30, 2005 | |
|---|---|---|---|---|---|---|
| | Previously reported | As restated | Previously reported | As restated | Previously reported | As restated |
| BALANCE SHEET- | | | | | | |
| Total assets | 31,012 | 31,927 | 38,986 | 43,017 | 40,232 | 43,365 |
| Minority interest | 2,198 | 2,319 | 3,207 | 4,957 | 3,718 | 5,316 |
| Total liabilities | 3,682 | 3,879 | 7,109 | 8,793 | 6,423 | 7,361 |
| Additional paid-in capital | 53,919 | 53,919 | 56,865 | 56,865 | 57,653 | 57,653 |
| Retained earnings | (28,660) | (28,063) | (28,068) | (27,471) | (27,457) | (26,860) |
| Total stockholders' equity | 25,132 | 25,729 | 28,670 | 29,267 | 30,091 | 30,688 |
| Total liabilities and stockholders equity | 31,012 | 31,927 | 38,986 | 43,017 | 40,232 | 43,365 |
| INCOME STATEMENT: | | | | | | |
| Revenue | 9,133 | 9,212 | 19,885 | 21,492 | 30,607 | 32,593 |
| Minority Interest | (443) | (417) | (1,185) | (1,304) | (1,949) | (1,916) |
| Net income | 415 | 415 | 1,008 | 1,008 | 1,619 | 1,619 |
| Earnings per share | | | | | | |
| Basic | 0.04 | 0.04 | 0.10 | 0.10 | 0.16 | 0.16 |
| Diluted | 0.04 | 0.04 | 0.10 | 0.10 | 0.15 | 0.15 |

| | Three months ended March 31, 2005 | | Six months ended June 30, 2005 | | Nine months ended September 30, 2005 | |
|---|---|---|---|---|---|---|
| | Previously reported | As restated | Previously reported | As restated | Previously reported | As restated |
| Statement of Cash Flows | | | | | | |
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | | | | | |
| Net earnings | 415 | 415 | 1,008 | 1,008 | 1,619 | 1,619 |
| Adjustment to reconcile net earnings to net cash used in operating activities: | | | | | | |
| Equity loss (profit) of associated company | | - | (4) | (4) | (12) | (12) |
| Provision for income tax | (10) | - | 57 | 64 | 43 | 51 |
| Minority Interest | (198) | 417 | 811 | 1,304 | 1,322 | 1,916 |
| Depreciation and amortization | 43 | 43 | 141 | 141 | 274 | 274 |
| **Changes in current assets and liabilities net of effects from purchase of subsidiaries:** | | | | | | |
| Decrease in restricted cash* | | | 2,796 | | | |
| Increase in loan receivables* | | | (3,238) | | | |
| Accounts receivable and other current assets | (1976) | (2,153) | (975) | (2,027) | (2,832) | (3,029) |
| Inventories | (430) | (430) | (891) | (891) | (452) | (452) |
| Accounts payable and accrued expenses | (1482) | (2,137) | 221 | 295 | 338 | (234) |
| **Net cash used in operating activities** | **(3,638)** | **(3,845)** | **(74)** | **(110)** | **300** | **133** |
| | | | | | | |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | | | | | |
| Decrease in restricted cash | | - | | 2,796 | 3,132 | 3,132 |
| Increase in purchase of marketable securities | (36) | (36) | (421) | (421) | (409) | (409) |
| Acquisition of property and equipment | 63 | 63 | (1,200) | (1,341) | (1,346) | (1,844) |
| Acquisition of subsidiaries and affiliated companies | (233) | (233) | (3,984) | (1,183) | (2,238) | (1,183) |
| Increase in loan receivables from third parties | | | | (2,081) | | (1,597) |
| Increase in loan receivable from related parties | | | | (1,157) | | (1,349) |

| | | | | | | |
|---|---|---|---|---|---|---|
| **Net cash used in investing activities** | **(206)** | **(206)** | **(5,605)** | **(3,387)** | **(861)** | **(3,250)** |
| | | | | | | |
| **CASH FLOWS FROM FINANCING ACTIVITIES:** | | | | | | |
| Dividend paid to minority interest shareholders* | (339) | | | | | |
| Increase in loan receivables from third party* | | | | | (1,597) | |
| Increase in loan receivable from related parties* | | | | | (1,349) | |
| Increase in loan payable to related parties | 467 | 467 | 390 | 390 | 513 | 513 |
| Advances (repayments) under bank line of credit | (836) | (582) | 142 | 142 | (7) | (7) |
| Increase (repayment) of amount borrowed under capital lease obligations | | 30 | 62 | 62 | 29 | 29 |
| Increase in share consideration post acquisition of subsidiaries* | | | 1,977 | | | |
| Proceeds from exercise of stock options and warrants | 111 | 111 | 981 | 981 | 981 | 981 |
| Advances under bank loans | | (284) | 727 | 727 | 5 | 5 |
| **Net cash provided by financing activities** | **(597)** | **(258)** | **4,279** | **2,302** | **(1,425)** | **1,521** |
| | | | | | | |
| **NET DECREASE IN CASH AND CASH EQUIVALENTS** | **(4,441)** | **(4,309)** | **(1,400)** | **(1,195)** | **(1,986)** | **(1,596)** |
| | | | | | | |
| **CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD** | 6,764 | 6,764 | 6,764 | 6,764 | 6,764 | 6,764 |
| **CASH AND CASH EQUIVALENTS, END OF PERIOD** | 2,323 | 2,455 | 5,364 | 5,569 | 4,778 | 5,168 |
| | | | | | | |
| | | | | | | |
| **CASH PAID (RECEIVED) FOR:** | | | | | | |
| Interest | 45 | 45 | 127 | 127 | 182 | 182 |
| Income taxes | 34 | 34 | - | 34 | 34 | 34 |
| | | | | | | |
| **NONCASH INVESTING AND FINANCING ACTIVITIES:** | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Investment in subsidiaries acquired through issuance of common stock | | | 1,977 | 1,977 | 2,762 | 2,871 |

The nature of the revisions of the statements of cash flows can be classified into three categories:

1. The effect of consolidating two variable interest entities was included per FIN 46(R) in the Statement of Cash Flows.
2. Reclassification of change in restricted cash from operating activities to investing activities.
3. Reclassification of loan receivables from financing activities to investing activities.

**17. STATEMENTS OF CASH FLOWS SUPPLEMENTARY INFORMATION IN YEAR 2005:**

During 2005, PACT made investments for approximately $8,196,000 in subsidiary companies in form of cash, subscription payable and equity consideration of $1,950,000, $2,275,000 and $3,971,000 respectively. This amount represents equity interests in ChinaGoHi (51%), Clickcom (51%) and Sunroom 3G (51%). The details of these acquisitions are separately disclosed in the notes of the consolidated financial statement under Note 2 "BUSINESS ACQUISITIONS". As the consideration for these acquisition transactions are part cash and part non-cash, the breakdown below is the cash portion paid or payable for the subsidiaries acquired:

| | 2005 | |
|---|---|---|
| | In US$000s | Remark |
| ChinaGoHi - subsidiary | $2,275 | |
| Clickcom - subsidiary | 268 | -- |
| Sunroom 3G - subsidiary | 1,683 | -- |
| Subtotal: | 4,226 | |
| Cash still contained within the group on consolidation Less cash acquired in subsidiaries | (768) | |
| Less: subscription payable | (2,275) | Note (a) |
| Net cash paid for the acquisition: | $1,183 | |

**Note (a) of which $1,500 was eliminated due to inter-company payable**

**IN YEAR 2004:**

During 2004, PACT made investments for approximately US$11,325,000 in subsidiary and affiliated companies in form of cash and equity consideration of US$1,688,000 and US$9,637,000 respectively. This amount represents equity interests in EPRO (50%), LINKHEAD (51%), SHANGHAI CLASSIC (YUESHEN) (51%), SMARTIME (51%) and TAKE1 (CHEER ERA) (30%). The details of these acquisitions are separately disclosed in the notes of the consolidated financial statement under Note 2 "BUSINESS ACQUISITIONS". As the consideration for these acquisition transactions are part cash and part non-cash, the breakdown below is the cash portion paid for the subsidiaries and affiliated company acquired:

| | 2004 | |
|---|---|---|
| | In US$000s | Reference |
| EPRO - subsidiary | $500.0 | (a) below |
| LINKHEAD - subsidiary | 222.5 | (b) below |
| SHANGHAI CLASSIC (YUESHEN) - subsidiary | 579.9 | (c) below |
| SMARTIME - subsidiary | -- | |
| CHEER ERA - affiliated | 385.6 | |
| Subtotal: | 1,688 | |
| Less cash acquired in subsidiaries (a+b+c) less US$3383 paid to selling shareholder of YUESHEN | (964) | Cash still contained within the group on |

| | | |
|---|---|---|
| | | consolidation |
| NET CASH PAID FOR THE ACQUISITION: | $724 | |

**18. EVENTS SUBSEQUENT TO DECEMBER 31, 2005 (UNAUDITED)**

SALE OF CONVERTIBLE DEBENTURES On March 13, 2006, the Registrant consummated a private offering of $8,000,000 principal amount variable debentures due March 2009 (the Debentures) at an initial fixed conversion price of $10.00, and warrants to purchase up to 400,000 shares of the Registrants common stock exercisable for a period of 5 years at an exercise price of $12.20 per share (the Warrants) with several institutional investors, which included Whalehaven Capital Fund Limited, DKR Soundshore Oasis Holding Fund Ltd., Basso Fund Ltd., Basso Multi-Strategy Holding Fund Ltd., Basso Private Opportunities Holding Fund Ltd., Iroquois Master Fund Ltd., C.E. Unterberg, Towbin Capital Partners I, LP and Alpha Capital AG. C.E. Unterberg, Towbin advised the Registrant and acted as lead placement agent.

The Registrant has agreed to file a registration statement covering the resale of the shares underlying the Debentures and the Warrants under the Securities Act of 1933, as amended, on the earlier of (i) April 30, 2006, or (ii) the 30th calendar day following the date the Registrant files its Form 10-KSB with the Securities and Exchange Commission.

The Debentures and Warrants were sold in a transaction not involving a public offering and were issued without registration in reliance upon the exemption from registration afforded by Section 4(2) of the Securities Act of 1933, as amended and Regulation D promulgated there under.

**BUSINESS ACQUISITIONS**

On Jan 31, 2006, the Company, through its subsidiary PacificNet Strategic Investment Holdings Limited, consummated the acquisition of a 51% controlling interest in Guangzhou Wanrong Information Technology Co. Limited (Guangzhou Wanrong), one of the leading value-added telecom service providers in China, located in PRC Guangzhou, The purchase consideration for 51% of the equity interest of Guangzhou Wanrong was approximately US$1.75million, payable 21% in cash and 79% in restricted shares of PacificNet common stock valued at $8 per share, or about 173,000 restricted shares. Under the purchase agreement, Guangzhou Wanrong has made a guarantee to generate US$500,000 in annual net income. In the event of a shortfall, the purchase price will be adjusted accordingly. PacificNet will also invest approximately RMB 3 million (or about US$370,000) in Guangzhou Wanrong for general corporate purposes. The purchase price is payable upon achievement of certain quarterly earn-out targets based on net income

On February 26, 2006, entered into an agreement to acquire a 51% majority interest in PacificNet iMobile (Beijing) Technology Co., Ltd ("iMobile"), one of the leading Internet information portal and e-commerce distributors for mobile phone a and accessories and mobile related value-added service providers in China. iMobile operates its e-commerce business via two Internet portals, "http://www.iMobile.com.cn" and "http://www.18900.com" and one WAP portal "17wap.com" for mobile phone browsing. In addition, iMobile's 18900.com operation is the designated Internet distributor for Motorola, Nokia, and NEC's mobile products in China.

The purchase consideration for 51% of the equity interest of iMobile is approximately US$1.8 million, which represents approximately seven times the anticipated future annual net income of iMobile. The purchase consideration is payable 14% in cash and 86% in restricted shares of PacificNet valued at $8 per share, or about 191,875 restricted shares. Under the purchase agreement, iMobile has committed to generate US$500,000 in annual net income. In the event of a shortfall, the purchase price will be adjusted accordingly. PacificNet will also invest approximately RMB2 million (about US$250,000) in iMobile for general corporate and working capital purposes to support growth. The purchase price is payable upon achievement of certain quarterly earn-out targets based on net income.