INC Research Holdings, Inc.
Form 10-K
February 25, 2016
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K
(Mark One)
ý ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2015
or
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _______ to ______

Commission File Number: 001-36730

INC RESEARCH HOLDINGS, INC.
(Exact name of registrant as specified in its charter)

Delaware	27-3403111
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3201 Beechleaf Court, Suite 600 Raleigh, North Carolina	27604-1547
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (919) 876-9300

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Class A Common Stock, par value $0.01 per share	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No ý
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or section 15(d) of the Exchange Act. Yes ¨ No ý
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes ý No ¨
Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ý
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant, based on the closing sale price of on June 30, 2015 (based on the closing sale price of $40.12 on that date), was approximately $718,968,173. Common stock held by each officer and director and by each person known to the registrant who owned 10% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of February 18, 2016, there were approximately 53,976,093 shares of the registrant's common stock outstanding.

Portions of the registrant's Proxy Statement for its 2016 Annual Meeting of Stockholders are incorporated by reference into Part III hereof.

INC RESEARCH HOLDINGS, INC.
FORM 10-K
For the Fiscal Year Ended December 31, 2015

TABLE OF CONTENTS

		Page
	PART I	
Item 1.	Business	2
Item 1A.	Risk Factors	19
Item 1B.	Unresolved Staff Comments	41
Item 2.	Properties	41
Item 3.	Legal Proceedings	41
Item 4.	Mine Safety Disclosures	41
	PART II	
Item 5.	Market for Registrants' Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	42
Item 6	Selected Financial Data	45
Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations	51
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	68
Item 8.	Financial Statements and Supplementary Data	69
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	110
Item 9A.	Controls and Procedures	111
Item 9B.	Other Information	111
	PART III	
Item 10.	Directors, Executive Officers and Corporate Governance	112
Item 11.	Executive Compensation	112
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	112
Item 13.	Certain Relationships and Related Transactions and Director Independence	113
Item 14.	Principal Accountant Fees and Services	113
	Part IV	
Item 15.	Exhibits and Financial Statement Schedules	114
	Signatures	118
	Exhibit Index	119

PART I

FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. Such forward-looking statements reflect, among other things, our current expectations and anticipated results of operations, all of which are subject to known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements, market trends, or industry results to differ materially from those expressed or implied by such forward-looking statements. Therefore, any statements contained herein that are not statements of historical fact may be forward-looking statements and should be evaluated as such. Without limiting the foregoing, the words “anticipates,” “believes,” "can," "continue," "could," “estimates,” “expects,” “intend “may,” "might," “plans,” “projects,” “should,” "would," “targets,” “will” and the negative thereof and similar words and expressions are intended to identify forward-looking statements. These forward-looking statements are subject to a number of risks, uncertainties and assumptions, including those described in “Risk Factors” in Part I, Item 1A of this report. Unless legally required, we assume no obligation to update any such forward-looking information to reflect actual results or changes in the factors affecting such forward-looking information.

As used in this report, the terms "INC Research Holdings, Inc.," "Company," "we," "us," and "our" mean INC Research Holdings, Inc. and its subsidiaries unless the context indicates otherwise.

Item 1. Business.

Overview

We are a leading global contract research organization ("CRO") based on revenues and are exclusively focused on Phase I to Phase IV clinical development services for the biopharmaceutical and medical device industries. We provide our customers highly differentiated therapeutic alignment and expertise, with a particular strength in complex therapeutic areas, such as central nervous system ("CNS"), oncology and other complex diseases. We consistently and predictably deliver clinical development services in a complex environment and offer a proprietary, operational approach to clinical trials through our Trusted Process® methodology. Our service offerings focus on optimizing the development of, and therefore, the commercial potential for, our customers' new biopharmaceutical compounds, enhancing returns on their research and development ("R&D") investments, and reducing their overhead by offering an attractive variable cost alternative to fixed cost, in-house resources.

Founded more than two decades ago as an academic central nervous system research organization, we have translated that expertise into a global organization with a number of therapeutic specialties, as well as full data services and regulatory capabilities. Over the past decade, we have built our scale and capabilities to become a leading global provider of Phase I to Phase IV clinical development services, with approximately 6,400 employees in over 50 countries across six continents as of December 31, 2015. Our broad global reach has enabled us to provide clinical development services in over 110 countries. Our global footprint provides our customers with broad access to diverse markets and patient populations, local regulatory expertise and local market knowledge.

We provide clinical development services through specialized therapeutic teams that have deep scientific expertise and are strategically aligned with the largest and fastest growing areas of our customers' R&D investments. We believe our therapeutic focus and proprietary methodology have set us apart within our industry. We were named the "Best Contract Research Organization" at the 11th Annual Scrip Awards ceremony in December 2015. The annual Scrip awards competition is organized by Scrip Intelligence to celebrate the contributions of the pharmaceutical, biotech and other allied industries to improving human health worldwide. The Company was selected from among several leading global CROs after being judged based on full range of services provided and quality of relationships built with clients by a distinguished panel of life science industry executives.

We have also developed industry-leading relationships with principal investigators and clinical research sites, as demonstrated by being named the "Top CRO to Work With" among large global CROs in the 2015 CenterWatch Global Investigative Site Relationship Survey (the "2015 CenterWatch Survey") conducted by CenterWatch, a third-party leading publisher in the clinical trials industry. The 2015 CenterWatch Survey covered responses from over 1,900 sites globally that evaluated 11 CROs, including the top five by revenue, across 38 specific relationship attributes. We ranked in the top 3 on 33 out of the 38 specific relationship attributes. We believe the Company's ranking as "Top CRO to Work With" for a second straight time demonstrates the effectiveness of our business model and our ability to deliver high-quality clinical trial results on time and on budget for our customers.

Our extensive range of services supports the entire drug development process from Phase I to Phase IV and allows us to offer our customers an integrated suite of investigative site support and clinical development services. We offer these services across a wide variety of therapeutic areas with deep clinical expertise, with a primary focus on Phase I to Phase IV clinical trials. We provide total biopharmaceutical program development while also providing discrete services for any part of a trial. Our combination of service area experts and depth of clinical capability allows for enhanced protocol design and actionable trial data.

We have two reportable segments: Clinical Development Services and Phase I Services. Clinical Development Services offers a variety of clinical development services, including full-service global studies, as well as ancillary services such as clinical monitoring, investigator recruitment, patient recruitment, data management, study reports to assist customers with their drug development process, quality assurance audits and specialized consulting services. Phase I Services focuses on clinical development services for Phase I trials, which include scientific exploratory medicine, first-in-human studies through proof-of-concept stages and support for Phase I studies in established compounds. For further information about the Company's reportable segments, please see "Note 12 - Segment Information" in our consolidated financial statements included in Part II, Item 8 of this Annual Report on Form 10-K. For financial information about geographic areas of our revenue and long-lived assets, please see "Note 13 - Operations by Geographic Location" in our consolidated financial statements included in Part II, Item 8 of this Annual Report on Form 10-K. International operations expose us to risks that differ from those applicable to operating in the United States, including foreign currency translation and transaction risks, risks of changes in tax laws and other risks described further in Part I, Item 1A "Risk Factors" of this Annual Report on Form 10-K.

For the year ended December 31, 2015, we had total net service revenue of $914.7 million, net income of $117.0 million, Adjusted Net Income of $120.2 million, and Adjusted EBITDA of $221.4 million. For important disclosures about our non-GAAP measures and a reconciliation of Adjusted Net Income and Adjusted EBITDA to our GAAP net income (loss), see Part II, Item 6, "Selected Financial Data" of this Annual Report on Form 10-K. For further information about our consolidated revenues and earnings, see our consolidated financial statements included in Part II, Item 8 "Financial Statements and Supplementary Data" and Part II, Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Annual Report on Form 10-K.

Our diversified customer base includes a mix of many of the world's largest biopharmaceutical companies as well as high-growth, small and mid-sized biopharmaceutical companies. We deliver high quality service through our internally developed, metrics-driven Trusted Process®, which is our proprietary methodology designed to reduce operational risk and variability by standardizing clinical development services and implement quality controls throughout the clinical development process. We believe our Trusted Process® leads our customers to faster, better-informed drug development decisions.

We were originally founded in 1998 as INC Research, and our headquarters are located in Raleigh, North Carolina. As a result of a corporate reorganization in connection with a business combination transaction, INC Research Holdings, Inc., was incorporated in Delaware in August 2010.

Our Market

The market for our services includes biopharmaceutical companies that outsource clinical development services. We believe we are well-positioned to benefit from the following market trends:

Trends in late-stage clinical development outsourcing. Within the clinical development market, we primarily focus on Phase II to Phase IV clinical trials. Biopharmaceutical companies continue to prioritize the outsourcing of Phase II to Phase IV clinical trials, particularly in complex, high-growth therapeutic areas such as CNS, oncology and other complex diseases. Additionally, small and mid-sized biopharmaceutical companies typically have limited infrastructure and therefore have a particular proclivity to outsource their clinical development to CROs. We estimate, based on industry sources, including analyst reports, and management's knowledge, that the market for CRO services for Phase II to Phase IV clinical development services will grow at a rate of 7% to 8% annually through 2020, driven by a combination of increased development spend and further outsourcing penetration. In addition, we estimate that total biopharmaceutical spending on drug development in 2015 was approximately $75.4 billion, of which the clinical development market, which is the market for drug development following pre-clinical research, was approximately $65.1 billion. Of the $65.1 billion, we estimate our total addressable market to be $52.5 billion, after excluding $12.6 billion of indirect fees paid to principal investigators and clinical research sites, which are not a part of the CRO market. We estimate that total biopharmaceutical spending on clinical development will grow at a rate of 3% to 4% annually through 2020. In 2015, we estimate biopharmaceutical companies outsourced approximately $26.0 billion of clinical development spend to CROs, representing an 8% increase compared to 2014 and a penetration rate of 49% of our total addressable market. We estimate that this penetration rate will increase to approximately 59% of our total addressable market by 2020. We believe that CROs with deep therapeutic expertise, global reach and capabilities, the ability to conduct increasingly complex clinical trials and maintain strong principal investigator and clinical research site relationships will be well-positioned to benefit from these industry trends.

Optimization of biopharmaceutical R&D efficiency. Market forces and healthcare reform, including the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act (collectively, the "Affordable Care Act") and other governmental initiatives, place significant pressure on biopharmaceutical companies to improve cost efficiency. Companies need to demonstrate the relative improvement in quality, safety, and effectiveness of new therapies as compared to existing approved therapies as early as possible in the development process. CROs can help biopharmaceutical companies deploy capital more efficiently, especially because many biopharmaceutical companies do not have adequate in-house development resources. In response to high clinical trial costs, particularly in therapeutic areas such as CNS and oncology, which we believe present the highest mean cost per patient across all clinical trials, biopharmaceutical companies are streamlining operations and shifting development to external providers in order to lower their fixed costs. Based on efficiencies gained through experience, we estimate that CROs have shortened clinical testing timelines by as much as 30%. Full service CROs can deliver operational efficiencies, provide high visibility into trial conduct, and allow biopharmaceutical companies to focus internal resources on their core competencies related to drug discovery and commercialization.

Globalization of clinical trials. Clinical trials have become increasingly global as biopharmaceutical companies seek to accelerate patient recruitment, particularly within protocol-eligible, treatment-naïve patient populations without co-morbidities that could skew clinical outcomes. Additionally, biopharmaceutical companies increasingly seek to expand the commercial potential of their products by applying for regulatory approvals in multiple countries, including in areas of the world with fast-growing economies and middle classes that are spending more on healthcare. As part of the approval process for biopharmaceutical products in newer markets, especially in certain Asian and emerging markets, regulators often require trials to include specific percentages or numbers of people from local populations. Thus, clinical studies to support marketing approval applications frequently include a combination of multinational and domestic trials. These trends emphasize the importance of global experience and geographic coverage, local market knowledge and coordination throughout the development process.

Management of increasingly complex trials. The biopharmaceutical industry operates in an increasingly sophisticated and highly regulated environment and has responded to the demands of novel therapeutics by adapting efficient drug development processes. Complex trial design expertise has emerged as a significant competitive advantage for select CROs that have a track record of successfully navigating country-specific regulatory, trial protocol and patient enrollment barriers, including sometimes subjective, evolving clinical endpoints. Measures of clinical trial complexity significantly increased over the last decade, as evidenced by total procedures per trial protocol increasing by 57% between 2000 and 2011. In addition, the therapeutic areas where we have a particular focus, including CNS, oncology and other complex diseases, often require more complicated testing protocols than other disease indications. For

example, studies related to complex

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therapeutic areas often require treatment-naïve patients, and sometimes have subjective endpoints, which can be difficult to measure. In addition, many of these studies have longer periods of duration due to these factors and have been increasing in duration over the last 24 months. For example, our average study duration has increased from approximately 30 months as of December 31, 2013 to slightly over 40 months as of December 31, 2015. As a result of these factors, these therapeutic areas demand greater clinical trial proficiency and therapeutic expertise, particularly in light of new methods of testing, such as the use of biomarkers and gene therapy.

Our Competitive Strengths

We believe that we are well positioned to capitalize on positive trends in the CRO industry and provide differentiated solutions to our customers based on our key competitive strengths set forth below:

Deep and long-standing expertise in the largest and fastest growing therapeutic areas. Since our inception in 1998, we have focused on building world-class therapeutic expertise to better serve our customers. We provide a broad offering of therapeutic expertise, with our core focus in the largest and fastest growing therapeutic areas, including our complex therapeutic areas, which collectively constitute approximately 66% of our backlog as of December 31, 2015. Based on industry data, we estimate that these complex therapeutic areas together represent over 60% of total Phase III drugs under development. We believe we have been growing faster than the market, resulting in market share gains in our key therapeutic areas. In 2015, our net service revenue grew by 13% and our net service revenue for our complex therapeutic areas grew by 18%. Our therapeutic expertise is managed by our senior leadership and delivered by our senior scientific and medical staff and our clinical research associates ("CRAs") within our various therapeutic areas. Industry analysts have reported that therapeutic expertise is the most influential factor for small to mid-cap as well as large sponsors of clinical trials in selecting a CRO. We believe that our expertise in managing complex clinical trials differentiates us from our competitors and has played a key role in our revenue growth, our ability to win new clinical trials and our successful relationship development with principal investigators and clinical research sites.

Clinical development focus and innovative operating model. We derive approximately 98% of our net service revenue from clinical development services without distraction from lower growth, lower margin non-clinical business. Since 2006, we have conducted our clinical trials using our innovative Trusted Process® operating model, which standardizes methodologies, increases the predictability of the delivery of our services and reduces operational risk. Since initiation of the Trusted Process®, we have reduced median study start-up time (defined as the period from finalized protocol to first patient enrolled) on new projects. Based on industry sources for the median study start-up time for the biopharmaceutical industry, we believe we achieve this milestone for our customers at a faster pace than industry medians, due in part to our proprietary Trusted Process® operating model. In addition to the absolute reduction of cycle times in critical path milestones, we provide greater operating efficiency, more predictable project schedules and a reduction in overall project timelines. We were named the "Best Contract Research Organization" at the 11th Annual Scrip Awards in December 2015, which we believe is directly attributable to our innovative business model.

Unmatched, industry-leading principal investigator and clinical research site relationships. We have extensive relationships with principal investigators and clinical research sites. We believe these quality relationships are critical for delivering clinical trial results on time and on budget for our customers. Motivated and engaged investigative sites can facilitate faster patient recruitment, increase retention, maintain safety, ensure compliance with protocols as well as with local and international regulations, and streamline reporting. The ability to recruit and retain principal investigators and patients is an integral part of the clinical trial process. We have dedicated personnel focused on enhancing clinical research site relationships; we work with these sites in collaborative partnerships to improve cycle times and standardize start-up activities to drive efficiency. Our focus on principal investigator and clinical research site relationships is unmatched in the industry, as demonstrated by being named "Best Contract Research Organization" in December 2015 by an independent panel for Scrip Intelligence and our ranking as the "Top CRO to Work With" among large global CROs in the 2015 CenterWatch Survey. In the 2015 CenterWatch Survey, we ranked in the top 3 on 33 out of 38 attributes and received an average of 83% of "excellent" or "good" ratings across all attributes, up from approximately 80% in 2013. In addition, we are a top-three ranked CRO on four of the five attributes rated by sites as most important to study conduct success and the number one-ranked CRO for providing professional

5

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medical staff in clinical operations. We also participate at the highest level of membership within the Society for Clinical Research Sites ("SCRS") as a Global Impact Partner ("GIP").

Broad global reach with in-depth local market knowledge. We believe that we are one of a few CROs with the scale, expertise, systems and agility necessary to conduct global clinical trials. We offer our services through a highly skilled staff of approximately 6,400 employees in over 50 countries as of December 31, 2015 and have conducted work in over 110 countries. We continue to have a presence in high-growth international markets such as Asia-Pacific, Latin America, the Middle East and North Africa. Our comprehensive regulatory expertise and extensive local knowledge facilitate timely patient recruitment for complex clinical trials and improved access to treatment-naïve patients and to emerging markets, thereby reducing the time and cost of these trials for our customers while also optimizing the commercialization potential for new therapies.

Diversified, loyal and growing customer base. We have a well-diversified, loyal customer base of over 300 customers that includes many of the world's largest biopharmaceutical companies as well as high-growth, small and mid-sized biopharmaceutical companies. We have several customers with whom we have achieved "preferred provider" or strategic alliance relationships. We define these customer relationships to include ones where we have executed master service agreements in addition to regularly scheduled strategy meetings to discuss the status of our relationship, and for which we serve as a preferred supplier of services. We believe these relationships provide us enhanced opportunities for more business, although they are not a guarantee of future business. In addition, many of our customers are diversified across multiple projects and compounds. Our top five customers represented approximately 71 compounds in 47 indications across 200 active projects and accounted for approximately 34% of our net service revenue in 2015. Our customer base is geographically diverse with well-established relationships in the United States, Europe and Asia. We believe the breadth of our footprint reduces our exposure to potential U.S. and European biopharmaceutical industry consolidation. We believe that the tenure of our customer relationships as well as the depth of penetration of our services reflect our strong reputation and track record. While 86% of our new business awards in 2015 were from repeat customers and our top ten customers have worked with us for an average of more than 10 years, we were also awarded clinical trials from 72 new customers in 2015, with particularly strong growth among small to mid-sized biopharmaceutical companies. We have also increased our penetration in the large biopharmaceutical market, which we define as the top 50 biopharmaceutical companies measured by annual drug revenue, with 59% of our net service revenue in 2015 coming from large biopharmaceutical companies. We believe we have increased our market share in recent years and are well positioned to continue growing our customer base.

Outstanding financial performance. We have achieved significant revenue and EBITDA growth over the past several years. For example, during 2015, we increased our net service revenue, Adjusted EBITDA and Adjusted Net Income by 13%, 52%, and 169%, respectively, as compared to 2014, and ended the year with net income of $117.0 million, compared to that of a net loss of $23.5 million in 2014. The momentum in our business is also reflected in the growth in our backlog and new business awards (which is the value of future net service revenue supported by contracts or pre-contract written communications from customers for projects that have received appropriate internal funding approval, are not contingent upon completion of another trial or event and are expected to commence within the next 12 months, minus the value of cancellations in the same period). Backlog and new business awards are not necessarily predictive of future financial performance because they will likely be impacted by a number of factors, including the size and duration of projects (which can be performed over several years), project change orders resulting in increases or decreases in project scope, and cancellations. For the period from December 31, 2014 to December 31, 2015, our backlog increased by 14% and net new business awards grew by 24%. We believe our outstanding financial profile and strong momentum demonstrate the quality of the platform we have built to position ourselves for continued future growth.

Highly experienced management team with a deep-rooted culture of quality and innovation. We are led by a dedicated and experienced senior management team with significant industry experience and knowledge focused on clinical development. Each of the members of our senior management has 20 years or more of relevant experience, including significant experience across the CRO and biopharmaceutical industries. Our management team has successfully grown our company into a leading CRO through a combination of organic growth and acquisitions and believes we are well positioned to further capitalize on industry growth trends.

6

Business Strategy
The key elements of our business strategy include:
Focus on attractive, high-growth late-stage clinical development services market. We believe outsourcing late-stage clinical development services to CROs optimizes returns on invested R&D for biopharmaceutical companies. As development spend and outsourcing penetration rates continue to increase, we estimate that the late-stage clinical development services market will grow at a rate of 7% to 8% annually through 2020 and is poised to realize incremental growth relative to the overall CRO market. We believe that our core focus on the late-stage clinical development services market ideally positions us to benefit from this growth trend. Additionally, we believe that our differentiated approach of investing in highly experienced people, making better use of enabling technology and improving the process of clinical development, will allow our customers to generate superior returns.
Leverage our expertise in complex clinical trials. We intend to continue to develop and leverage our therapeutic expertise in complex clinical trials. We believe that our focus on and deep expertise in complex therapeutic areas such as CNS, oncology and other complex diseases better position us to win new clinical trials in these fast growing and large therapeutic areas. This is enhanced by the use of our proprietary Trusted Process® methodology that reduces operational risk and variability by standardizing processes and minimizing delays, instills quality throughout the clinical development process and leads customers to more confident, better-informed drug development decisions.
Capitalize on our geographic scale. We intend to leverage our global breadth and scale to drive continued growth. We have built our presence across key markets over time, developing strong relationships with principal investigators and clinical research sites around the world. We have expanded our patient recruitment capabilities, principal investigator relationships and local regulatory knowledge, which should continue to position us well for new customer wins in a wide array of markets. We have added geographic reach through both acquisitions and organic growth in areas such as Asia-Pacific, Latin America and the Middle East and North Africa, which we believe is critical to obtaining larger new business awards from large and mid-sized biopharmaceutical companies. Our long-term growth opportunities are enhanced by our strong reputation in emerging markets and our track record of efficiently managing trials in accordance with regional regulatory requirements.
Continue to enhance our Trusted Process® methodology to deliver superior outcomes. We intend to continue the development and enhancement of our Trusted Process® methodology, which has delivered measurable, beneficial results for our customers and improved drug development decisions. We believe our Trusted Process® will continue to lead to high levels of customer satisfaction. Our Trusted Process® is subject to continual refinement based on feedback from therapeutic leadership, staff and customers as well as the market factors of an evolving regulatory environment and technology innovation. Our Trusted Process® uses best-in-class and industry-leading third-party technology solutions. We expect that through continuous enhancement of our Trusted Process® methodology, we will achieve better alignment of best-in-class technology to enable increased visibility into critical processes, management and controls in the drug development process. We intend to continue to position ourselves to quickly adopt best-in-class technology through effective third-party collaborations without the need for high capital investments and maintenance costs, driving attractive returns on capital.
Continue proven track record of identifying and successfully integrating selective acquisitions to augment our organic growth. Over the past decade, we have developed a systematic approach for integrating acquisitions. We have successfully acquired and integrated ten companies. These strategic acquisitions have increased our size, scale and reach, complementing our organic growth profile as we have become a leading provider of CRO services. Our acquisitions have enabled us to expand our global service offerings across all four phases of biopharmaceutical clinical development while also allowing us to achieve significant synergies and cost reductions. For example, in March 2014 we completed the acquisition of MEK Consulting, which expanded our presence in the high-growth Middle East and North Africa market. We will continue to evaluate opportunities to acquire and integrate selective tuck-in acquisitions within the CRO sector in order to strengthen our competitive position and realize attractive returns on our investments.
Drive our human capital asset base to grow existing relationships. As a clinical service provider, our employees are critical to our ability to deliver our innovative operational model by engaging with customers,

delivering clinical development services in a complex environment, and supporting and executing our growth strategy. All employees undergo comprehensive initial orientation and ongoing training, including a focus on our Trusted Process® methodology. Our recruiting and retention efforts are geared toward maintaining and growing a stable work force focused on delivering results for customers. We have a successful track record of integrating talent from prior acquisitions and believe we have a best-in-class pool of highly experienced project management professionals and CRAs.

Our Services

Our extensive range of services supports the entire clinical development process from Phase I to Phase IV and allows us to offer our customers an integrated suite of investigative site support and clinical development services. We offer these services across a wide variety of therapeutic areas with deep clinical expertise with a primary focus on Phase II to Phase IV clinical trials. We provide total biopharmaceutical program development while also providing discrete services for any part of a trial. The combination of service area experts and the depth of clinical capability allows for enhanced protocol design and actionable trial data. Our comprehensive suite of clinical development services includes, but is not limited to:

Clinical Development Services

Clinical Trial Management	Data Services	Strategic and Regulatory Services	Post-Approval Services
• Patient recruitment and retention • Project management • Clinical monitoring • Drug safety / pharmacovigilance • Medical affairs • Quality assurance • Regulatory and medical writing • Functional service	• Clinical data management • Electronic data capture • Biostatistics	• Strategic development services • Regulatory consulting and submissions • Clinical operations optimization • Pricing and reimbursement planning	• Specialized support for patient registries • Safety surveillance studies, prospective observational studies • Health outcome research • Patient-reported outcomes • Phase IV effectiveness trials • Health economics studies and retrospective chart reviews

Clinical Trial Management

We offer a variety of select and stand-alone clinical trial services as well as full-service, global studies through our clinical development services. Our key clinical trial management services include the following:

- Patient Recruitment and Retention. Our patient recruitment services group helps identify and manage appropriate vendors, focuses on patient recruitment and retention strategies and acts as a liaison to media outlets and other vendors that we have validated.
- Project Management. Our project managers provide customer-focused leadership in managing clinical trials and are accountable for the successful execution of all assigned projects, where success includes on-time, on-budget, and high quality results that lead to satisfied customers. Project managers have the skills, education, experience and training to support the successful conduct of clinical studies.
- Clinical Monitoring. Our clinical monitors oversee the conduct of a clinical trial by working with and monitoring clinical research sites to assure the quality of the data. The clinical monitor ensures the trial is conducted according to Good Clinical Practice ("GCP"), International Conference on Harmonisation ("ICH") guidelines and local regulations, to meet the customers' and regulatory authorities' requirements according to the study protocol. CRAs engage with clinical research sites in site initiation, training and patient recruitment. We deploy and manage clinical monitoring

staff in all

8

regions of the globe. By maintaining a therapeutic focus, we attract CRAs who have a strong desire to dedicate themselves to working within a specific therapeutic area, providing an environment where they can further develop their expertise in their chosen area of interest.

- Drug Safety/Pharmacovigilance. Our drug safety teams are strategically located across the United States, Europe, Latin America and Asia-Pacific. We provide global drug safety expertise in all phases of clinical research for serious adverse event/adverse event collection, evaluation, classification, reporting, reconciliation, post-marketing safety and pharmacovigilance.
- Medical Affairs. We have in-house physicians who provide 24/7 medical monitoring, scientific and medical support for project management teams and clinical research sites. These in-house physicians consist of senior clinicians and former clinical researchers with patient care and trial management expertise.
- Quality Assurance. Quality control steps are built into all of our processes. We have an independent quality assurance department that, in addition to conducting independent audits of all ongoing projects and processes as part of our internal quality assurance program, offers contracted quality assurance services to customers, including audits of clinical research sites and of various vendors to the clinical research industry; 'mock' regulatory inspections and clinical research site inspection-readiness training; standard operating procedure development; and quality assurance program development/consultation. Our customers also engage us to conduct third-party audits on behalf of their studies.
- Regulatory and Medical Writing. We also offer regulatory and medical writing expertise across the entire biopharmaceutical product lifecycle. Our team has hands-on regulatory and medical writing knowledge gained through experience from working in large biopharmaceutical companies, as well as high-growth, small and mid-sized biopharmaceutical companies, CROs and the United States Food and Drug Administration ("FDA"). Additionally, each member is trained in FDA regulations, including GCP/standard operating practice compliance guidelines and guidelines established by the ICH.
- Functional Services. Our functional service provider ("FSP") offering is a tool to help sponsors review their approach to key functional areas of clinical research, specifically those areas not core to their clinical development business. The aim of implementing an FSP approach is greater predictability and more consistent delivery of services across all protocols. We currently operate FSP hubs in North America, South America, Europe and Asia.

Data Services

Our data services include the following:

- Clinical Data Management. Our clinical data management services allow us to confirm that the clinical trial database is ready, accurately populated and locked in an expeditious manner, with verification and validation procedures throughout every phase of a clinical trial. This processing is done in synchronization with the clinical team, utilizing the information provided from the trial to help ensure efficient processes are employed, regardless of the data collection method used.
- Electronic Data Capture. To compete in today's changing global drug and device development environment, companies must collect and distribute data faster than ever before. We have the ability to manage electronic data capture ("EDC") to help our customers take advantage of the efficiencies available through EDC, which include improved access to data, reduced cycle time, increased productivity and improved relationships with customers, vendors and other parties. We utilize three leading EDC platforms: Medidata Rave, Oracle Clinical Remote Data Capture and Oracle Health Sciences InForm products. Our ability to design, build and deliver high quality databases in all three platforms enables our team to deliver effective EDC solutions.
- Biostatistics. Our biostatistics team has a depth of experience with the FDA and European Medicines Agency ("EMA") which allows our teams to provide customers with guidance on building a statistical plan to meet regulatory and safety requirements as well as a careful analysis of the resulting study data. In addition, we provide support for independent drug safety monitoring boards and a full range

of related services. Our biostatisticians are also heavily involved in our Trusted Process® methodology, so that protocol and project development can be grounded in advanced statistical methodology. As part of a project team, our biostatisticians can provide data oversight throughout a clinical trial and address any data or data handling issues that may arise.

Strategic and Regulatory Services

Strategic Services. Our strategic consulting group focuses on maximizing the value of scientific knowledge, intellectual property and portfolio content. The key areas of advisory services include strategic drug development, clinical development plans, registration strategies, exit strategies, transitional clarity, good clinical practice compliance strategies, clinical operations optimization, pricing and reimbursement, and due diligence. Strategic consultants include senior personnel from medical and regulatory affairs, clinical research, biostatistics and data management. These individuals provide expertise gained through hands-on experience as former executives from biopharmaceutical companies, CROs and regulatory agencies.

Regulatory Services. We offer regulatory expertise across the entire biopharmaceutical product lifecycle. Our regulatory affairs practice has a global presence with offices in North America, Europe and Asia-Pacific. In addition, subject matter experts are located worldwide to provide global regulatory coverage. Global regulatory services include worldwide regulatory submissions, regulatory strategy and agency meetings, early development consultancy, data safety monitoring board and data review committee management, chemistry manufacturing and controls, contemporary regulatory interpretation, investigational new drug ("IND"), applications and clinical trial authorizations.

Post-Approval Services

Our post-approval services are focused on efficient delivery of studies and support programs. These studies and programs include specialized support for patient registries, safety surveillance studies, prospective observational studies, health outcome research, patient reported outcomes, Phase IV effectiveness trials, health economics studies and retrospective chart reviews. Our proprietary post-approval study management system provides real-time support for sites and up-to-date status reports for sponsors.

Our Trusted Process® Methodology

We perform each of these service offerings through our proprietary, operational approach to clinical trials. Our Trusted Process® is a metrics-driven methodology that we employ to deliver superior results to our customers. We developed this process to improve reliability and predictability of clinical trial project management. Our Trusted Process® methodology has allowed us to reduce operational risk and variability as well as provide faster cycle times. This has resulted in greater operating efficiency, highly predictable project timelines and enhanced customer satisIN-RIGHT: 0pt" align="left">**CONSOLIDATED STATEMENTS OF OPERATIONS**

(Unaudited. In thousands of United States dollars, except earnings per share and share amounts)

	FOR THE THREE MONTH PERIODS ENDED JUNE 30		FOR THE SIX MONTH PERIODS ENDED JUNE 30	
	2007	2006 (restated)	2007	2006 (restated)
Net revenues				
Services	$ 4,299	$ 4,300	$ 8,864	$ 8,035
Product sales	4,722	8,914	9,424	11,851
Total net revenues	9,021	13,214	18,288	19,886
Cost of revenues				
Services	(2,832)	(2,909)	(6,185)	(5,486)
Product sales	(3,828)	(8,528)	(7,203)	(11,271)
Total cost of revenues	(6,660)	(11,437)	(13,388)	(16,757)
Gross Profit	2,361	1,777	4,900	3,129

Operating expense:				
Selling, general and administrative expenses	(1,798)	(1,416)	(3,365)	(2,495)
Stock-based compensation expenses		(60)		(242)
Depreciation and amortization	(216)	(129)	(388)	(158)
Total operating expenses	(2,014)	(1,605)	(3,753)	(2,895)
Income from continued operations	347	172	1,147	234
Other income (expenses)				
Interest expense, net	(232)	(341)	(432)	(393)
Gain/(loss) in change in fair value of derivatives	20	208	81	208
Sundry income, net	27	48	46	63
Total other expenses	(185)	(85)	(305)	(122)
Income from continued operations before income taxes, minority interests	162	86	842	111
Provision for income taxes	22	(13)	(46)	(30)
Share of earnings of associated companies	-	52		49
Minority interests	(340)	(179)	(874)	(265)
Income/(loss) from continued operations	(156)	(53)	(78)	(134)
Gain (loss) from discontinued operations (including income (loss) from discontinued operations)	400	850	630	1,732
Net income	244	796	552	1,597
Other comprehensive income/(loss):				
Foreign exchange gain/(loss)	(126)	0	(97)	(20)
Net comprehensive income	$ 118	$ 796	$ 455	$ 1,577
Basic earnings per share	$ 0.02	$ 0.07	$ 0.05	$ 0.15
Diluted earnings per share	$ 0.02	$ 0.07	$ 0.05	$ 0.13
Weighted average number of shares - Basic	11,808,993	11,022,984	11,764,329	10,939,834
Weighted average number of shares - Diluted	12,085,566	11,879,697	12,040,902	11,902,019

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

4

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

	FOR THE SIX MONTH PERIOD ENDED June 30, 2007	2006 (Restated)
Cash Flows from operating activities		
Net income	$ 552	$ 1,597
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Equity income of associated company	-	(49)
Provision for income tax	-	33
Provision for doubtful accounts	(691)	28
Minority Interest	874	265
Depreciation and amortization	646	975
(Gain) loss from discontinued operations	(630)	(1,732)
Stock-based compensation	-	242
Change in fair value of derivatives	(81)	(208)
Amortization of interest discount	-	154
Changes in current assets and liabilities net of effects from purchase of subsidiaries:		
Accounts receivable and other current assets	(479)	(5,284)
Inventories	(190)	(117)
Accounts payable and other accrued expenses	994	(1,170)
Net cash provided by (used in) operating activities	995	(5,266)
Cash flows from investing activities		
Increase in purchase of marketable securities	(17)	-
Acquisition of property and equipment	(1,343)	(3,141)
Acquisition of subsidiaries and affiliated companies	-	(836)
Proceeds from disposition of discontinued operations	740	-
Loans receivable from third parties	(446)	562
Loans receivable from related party	(75)	(85)
Net cash used in investing activities	(1,141)	(3,500)
CASH FLOWS FROM FINANCING ACTIVITIES:		
(Decrease) increase in restricted cash	(3)	1,422
Loan payable to related party	(61)	201
Repayments under bank line of credit	(556)	(171)
Repayments of amount borrowed under capital lease obligations	(61)	(73)
(Purchase) sale of treasury shares	282	(124)
Proceeds from subscription received, exercise of stock options and warrants	209	86
Net proceeds from issuance of convertible debenture	2,671	8,000
Advances under bank loans	(192)	623
Net cash provided by financing activities	2,289	9,964
Effect of exchange rate change on cash and cash equivalents	(97)	54
	880	(2,121)

Net increase (decrease) in cash from subsidiaries held for disposition				
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS		2,926		(869)
CASH AND CASH EQUIVALENTS, BEGINNING OF THE PERIOD		1,799		3,487
CASH AND CASH EQUIVALENTS, END OF THE PERIOD	$	4,725	$	2,618
CASH PAID FOR:				
Interest	$	221	$	292
Income taxes				463
NON-CASH INVESTING AND FINANCING ACTIVITIES:				
Property & equipment acquired under banking loan	$	785	$	1,082
Options exercised for share receivable				522
Investments in subsidiaries acquired through the issuance of common stock	$	190	$	2,275

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

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

1. BASIS OF PRESENTATION

Description of Operations - PacificNet Inc. (referred to herein as "PacificNet" or the "Company") is a leading provider of gaming technology, e-commerce, and Customer Relationship Management (CRM) in China. Our gaming products are specially designed for the Chinese and Asian gamers, and we focus on integrating localized Chinese and Asian themes and content, advanced graphics, digital sound effects and popular domestic music, with secondary bonus games and jackpots. Our gaming products include: Multi-player Electronic Table Games - Baccarat, Sicbo, Fish-Prawn-Crab, and Roulette machines, server based games (SBG) with multiple client betting stations, slot and bingo machines, video lottery terminals (VLTs), amusement with prices (AWP) machines, gaming cabinet and client/server system designs, online i-gaming software design, and multimedia entertainment kiosks. PacificNet's gaming clients include the leading hotels, casinos, and gaming operators in Macau, Asia, and Europe, and our ecommerce and CRM clients include the leading telecom companies, banks, insurance, travel, marketing and business services companies and telecom consumers in Greater China such as China Telecom, China Mobile, Unicom, PCCW, Hutchison Telecom, Bell24, Motorola, Nokia, SONY, TCL, Huawei, American Express, Citibank, HSBC, Bank of China, Bank of East Asia, DBS, TNT, China and Hong Kong government. PacificNet employs about 1,200 staff in its various subsidiaries throughout China with offices in Hong Kong, Beijing, Shanghai, Shenzhen, Guangzhou, Macau and Zhuhai China, in the USA, and in the Philippines.

Consolidated Interim Financial Statements - The consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial reporting consistent in all material respects with those applied in the Company’s Annual Report on Form 10-K, as amended, for the year ended December 31, 2006, but do not include all disclosures required by GAAP. You should read these interim consolidated financial statements in conjunction with the audited financial statements, including the notes thereto, and the other information set forth in the Company’s Annual Report on Form 10-K, as amended, for the year ended December 31, 2006. The unaudited consolidated financial statements include the accounts of PacificNet Inc. and its subsidiaries and variable interest entities (“VIEs”) for which the Company is the primary beneficiary. All significant intercompany balances and transactions have been eliminated in consolidation. In the opinion of management, all material adjustments considered necessary for a fair presentation of the Company’s interim results have been reflected. PacificNet’s 2006 Annual Report on Form 10-K includes certain definitions and a summary of significant accounting policies and should be read in conjunction with this report. The results for interim periods are not necessarily indicative of annual results.

Use of Estimates - The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates, and such differences may be material to the financial statements. Certain prior year amounts have been reclassified to conform to the current year presentation.

Reclassification - Certain items in the accompanied consolidated financial statements have been re-classed for comparative purposes.

Going Concern

As shown in the accompanying consolidated financial statements, the Company incurred accumulated losses of $47.2 million and $47.7 million as of June 30, 2007 and December 31, 2006, respectively. These matters raise substantial

doubt about the Company's ability to continue as a going concern.

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

The Company has taken certain restructuring steps to provide the necessary capital to continue its operations. These steps included, but were not limited to: 1) accelerate disposal and spin-off of unprofitable or unfavorable return-on-investment non-gaming operations; 2) focus on execution of the new high potential gaming business initiatives; 3) acquisition of profitable and/or strategic operations through issuance of equity instruments; 4) formation of strategic relationship with key gaming operators in Asia; and 5) issuance and/or restructure of new long-term convertible debentures. In this regard, on April 30, 2007, the Company entered into a sale and purchase agreement to dispose of its interest in Guangzhou3G for a consideration of US$6 million, on May 5, 2007, the Company entered into a sale and purchase agreement to dispose of the real estate in HK for approximately US$1 million and on May 15 & 20, 2007, the Company entered into various definitive agreements to reduce its equity interests in certain unprofitable subsidiaries to 15%, namely: Linkhead, Clickcom, PacTelso, PacSo and PacPower.

6

2. RECENT PRONOUNCEMENTS

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

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

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

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

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

3. EARNINGS PER SHARE

Basic and diluted earnings or loss per share (EPS) amounts in the financial statements are computed in accordance with SFAS No. 128, "Earnings Per Share." Basic EPS is based on the weighted average number of common shares outstanding. Diluted EPS is based on the weighted average number of common shares outstanding plus dilutive common stock equivalents. Basic EPS is computed by dividing net income/loss available to common stockholders

(numerator) by the weighted average number of common shares outstanding (denominator) during the period Diluted EPS is calculated by dividing net earnings by the weighted average number of common shares outstanding and other dilutive securities. Dilutive earnings per share for the period ended June 30, 2007 exclude the potential dilutive effect of 889,456 warrants because their impact would be anti-dilutive based on current market prices. 581,817 convertible debentures are tested by using if-converted method. The result shows when convertible debentures are included in the computation, diluted EPS increases. According to SFAS No.128, those convertible debentures are ignored in the computation of diluted EPS. All per share and per share information are adjusted retroactively to reflect stock splits and changes in par value.

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

	Three Months Ended June 30 2007	Three Months Ended June 30 2006	Six Months Ended June 30 2007	Six Months Ended June 30 2006
	(IN THOUSANDS OF UNITED STATES DOLLARS, EXCEPT WEIGHTED SHARES AND PER SHARE AMOUNTS)		(IN THOUSANDS OF UNITED STATES DOLLARS, EXCEPT WEIGHTED SHARES AND PER SHARE AMOUNTS)	
Numerator: earnings	$ 244	$ 796	$ 552	$ 1,597
Denominator:				
Weighted-average shares used to compute basic EPS	11,808,993	11,022,984	11,764,329	10,939,834
Dilutive potential from assumed exercise of stock options and warrants	276,573	856,713	276,573	962,185
Weighted-average shares used to compute diluted EPS	12,085,566	11,879,697	12,040,902	11,902,019
Basic earnings per common share:	$ 0.02	$ 0.07	$ 0.05	$ 0.15
Diluted earnings per common share:	$ 0.02	$ 0.07	$ 0.05	$ 0.13

4. GOODWILL AND BUSINESS ACQUISITIONS

The changes in the carrying amount of goodwill for the following reporting periods are summarized below:

(US$000s)	Group 1. Outsourcing Services	Group 2. Telecom Value-Added Services	Group 3. Products (Gaming and Technology)	Total goodwill on the balance sheet	Goodwill reclassified to net assets for disposal/ to be sold
Balance as of December 31, 2005	$ 3,936	$ -	$ 979	$ 4,915	$ 9,909
Goodwill acquired during the year	--	461	1,176	1,637	
Balance as of December 31, 2006	$ 3,936	$ 461	$ 2,155	$ 6,552	$ 3,655
Goodwill acquired during the first quarter			848		
Balance as of March 31, 2007	$ 3,936	$ 461	$ 3,003	$ 7,400	$ 3,655
Goodwill acquired during the second quarter					
Balance as of June 30, 2007	$ 3,936	$ 461	$ 3,003	$ 7,400	$ 0

5. STOCKHOLDERS' EQUITY

a) COMMON STOCK

For the six month period ended March 31, 2007, the Company had the following equity transactions: (i) 199,444 shares of common stock were issued as the monthly principal redemption shares for 8 million convertible debentures from January to March. Such shares are valued at $ 1,090,914.; (ii) 29,459 shares of common stock were released from escrow (PACT treasury shares) for acquiring additional 31% Ownership in Take 1 Technologies Group Limited valued at $190,305.(iii) 41,426 treasury shares were sold to the open market with total consideration $282,845.

b) STOCK OPTION PLAN

Prior to January 1, 2006, PacificNet accounted for awards granted under stock-based compensation plans following the recognition and measurement principles of APB 25, *Accounting for Stock Issued to Employees*, and related interpretations. Accordingly, compensation expense was recognized for awards granted at an exercise price less than fair market value of the underlying common stock on the date of grant. Effective January 1, 2006, PacificNet adopted the fair value recognition provisions of SFAS 123(R). See Note 2 for a description of the Company's adoption of SFAS 123R. The fair value of stock options is determined using the Black-Scholes option pricing model, which is consistent with the valuation techniques previously utilized for options in footnote disclosures required under SFAS 123, as amended by FASB Statement No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure." The determination of the fair value of stock-based compensation awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables, including the expected volatility of the Company's stock price over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rate and expected dividends. The valuation provisions of SFAS 123(R) apply to new grants and unvested grants that were outstanding as of the effective date. For the three months ended June 30, 2007, no new options were granted and no options were vested, thus the compensation costs is zero. PacificNet elected the modified prospective method and therefore has not restated results for prior periods due to 123R.

The status of the Stock Option Plan as of June 30, 2007, is as follows:

	OPTIONS OUTSTANDING		WEIGHTED AVERAGE EXERCISE PRICE
OUTSTANDING, DECEMBER 31, 2005	**1,444,500**	$	4.29
Granted	500,000	$	4.75
Cancelled	(1,180,000)	$	5.80
Exercised	(394,000)	$	2.12
OUTSTANDING, DECEMBER 31, 2006	**370,500**	$	2.00
Granted	**-**		-
Cancelled	**-**		-
Exercised	**-**		-
OUTSTANDING MARCH 31, 2007	**370,500**	$	2.00
Granted	**-**		-
Cancelled	**-**		-
Exercised	**-**		-
OUTSTANDING JUNE 30, 2007	**370,500**	$	2.00

Following is a summary of the status of options outstanding at June 30, 2007:

Grant Date	Total Options Outstanding	Aggregate Intrinsic Value	Weighted Average Remaining Life (Years)	Total Weighted Average Exercise Price	Option Exercisable	Weighted Average Exercise Price
2004-7-26	370,500	$1,063,335	0.07	$2.00	370,500	$2.00

9

The 370,500 outstanding options, which were granted during 2004, will be expired on July 26, 2007. Those options were vested from July 1, 2005 with a 10 month vesting period, and the corresponding compensation costs have been recorded within the vesting period. The weighted-average fair value of such options was $1.41.The assumptions used in calculating the fair value of options granted using the Black-Scholes option- pricing model are as follows:

Risk-free interest rate	2.75%
Expected life of the options	1.65 years
Expected volatility	61.33%
Expected dividend yield	0%

No options were granted, cancelled, exercised and vested during the six month period ended June 30, 2007.

c) WARRANTS

At June 30, 2007, the Company had outstanding and exercisable warrants to purchase an aggregate of 1,007,138 shares of common stock. The weighted average remaining life is 2.84 years and the weighted average exercise price per share is $10.61 per share.

Following is a summary of the warrant activity:

	Warrants outstanding	WEIGHTED AVERAGE EXERCISE PRICE	Aggregate Intrinsic Value
OUTSTANDING, DECEMBER 31, 2005	**591,138**	$ 9.5	$ -
Granted	416,000	-	-
Forfeited	-	-	-
Exercised	-	-	-
OUTSTANDING, DECEMBER 31, 2006	**1,007,138**	$ 10.61	$ -
Granted	-	-	-
Forfeited	-	-	-
Exercised	-	-	-
OUTSTANDING, MARCH 31, 2007	**1,007,138**	$ 10.61	$ -
Granted	-	-	-
Forfeited	-	-	-
Exercised	-	-	-
OUTSTANDING, JUNE 30, 2007	**1,007,138**	$ 10.61	$ -

Following is a summary of the status of warrants outstanding at June 30, 2007:

Grant Date	Total warrants Outstanding	Weighted Average Remaining Life (Years)	Total Weighted Average Exercise Price	Warrants Exercisable	Weighted Average Exercise Price
2004-1-15	123,456	1.54	$7.15	123,456	$7.15
2004-11-15	117,682	2.38	$3.89	117,682	$3.89
2004-12-9	350,000	2.44	$12.21	350,000	$12.21
2006-3-13	416,000	3.7	$12.20	416,000	$12.20

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

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

No warrants were granted, cancelled and exercised during the six month period ended June 30, 2007.

d) TREASURY STOCK

The following is a summary of the movement of the Company's shares held as treasury stock as at June 30, 2007:

	Number of shares
Escrowed shares returned to treasury in 2003	800,000
Shares purchased in the open market	2,000
Repurchase of shares from Yueshen	24,200
Cancellation of former employee shares	45,000
Termination with ChinaGoHi - Returned shares plus Escrow shares	825,000
Incomplete acquisition of Allink	200,000
Holdback shares as contingent consideration due to performance targets not yet met - Includes shares related to Clickcom (78,000); Guangzhou Wanrong (138,348); iMobile (153,500); Games (160,000); and Take 1 (120,000)	649,848
Balance, June 30, 2007	**2,546,048**
Shares outstanding at June 30, 2007	11,808,993
Shares issued at June 30, 2007	14,355,041

From January 24, 2007 to January 30, 2007, we sold 41,426 treasury shares to the open market for total consideration of $282,845.

On February 4, 2007 (30 days after deal closing), we released 29,459 shares of common stock from escrow (PACT treasury shares) for acquiring an additional 31% ownership in Take 1 Technologies Group Limited. The remaining 120,000 shares are treated as holdback shares and will be released to Take 1 once they meet their future performance targets.

6. CONVERTIBLE DEBENTURES

6.1 Eight Million Convertible Debentures

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

we may force the holders to convert up to 50% of the then outstanding principal amount of the debentures, subject to certain trading conditions being met. If any event of default occurs under the debentures or other related documents, the holders may elect to accelerate the payment of the outstanding principal amount of the debenture, plus accrued, but unpaid interest, liquidated damages and penalties, which shall become immediately due and payable.

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

In February 2007, upon reaching an agreement on the amount and payment of accrued liquidated damages, the Company signed a Settlement and Release Agreement with each of the investors. Under the terms of the Settlement and Release Agreements, the Company paid an aggregate $140,000 in cash as satisfaction in full of liquidated damages owed to Basso Fund Ltd., Basso Multi-Strategy Holding Fund Ltd., and Basso Private Opportunities Holding Fund Ltd. Partial liquidated damages owed to Whalehaven Capital Fund Ltd. were paid in the amount of $35,000 in cash, with the remaining liquidated damages in the amount of $105,000 paid in the form of a new convertible debenture due February 2009, on substantially the same terms as the original debentures, except that interest only is paid on the new debentures until October 2008 and beginning in November 2008 until February 2009, when the new debentures are due, the monthly redemption amount under the new debentures shall be equal to $315,000. The remaining investors also agreed to accept the aggregate $840,000 in liquidated damages owed to them in the form of the new convertible debentures for the amount of their respective portion of the liquidated damages. The Company also agreed to amend the original debentures to shorten the term for payment of the original principal amount to a 22 month term. As a result the monthly redemption amount for the original debenture increased from $320,000 to $ 363,638. All other terms and conditions of the original debenture remain in full force and effect. The outstanding original principal amount as at June 30, 2007 is $5,977,273.

C.E. Unterberg, Towbin L.L.C. acted as placement agent and received a negotiated cash fee in the amount of $449,500 and a warrant to purchase up to 16,000 shares at an exercise price of $12.20 per share, which expire five years from the date of issuance. The fair value of these warrants totaled $28,141. Such amount was charged to other assets, net, and credited to additional paid-in capital and will be amortized over the life of the debentures. Maxim Group also acted as Placement Agent and received a cash fee in the amount of $50,000.

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

The gross proceeds of $8,000,000 are recorded as a current debenture liability. In addition, fair values attributed to the Investors' warrants in accordance with EITF issue No. 00-19 "Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company's Own Stock" are recorded as liabilities. The initial value related to the Investors' warrants is $690,642. An aggregate gain of $20,071 and $80,765 representing the change in fair value of warrants recognized during the three and six months ended June 30, 2007, respectively.

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

PROBABLE EVENT OF DEFAULT

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

a) "If, during the Effectiveness Period, either the effectiveness of the Registration Statement lapses for any reason or the Holder shall not be permitted to resell Registrable Securities under the Registration Statement for a period of more than 20 consecutive Trading Days or 60 non-consecutive Trading Days during any 12 month period, the Company has to pay 'Mandatory Default Amount' as the sum of (i) the greater of (A) 130% of the outstanding principal amount of this Debenture, plus all accrued and unpaid interest hereon, or (B) the outstanding principal amount of this Debenture, plus all accrued and unpaid interest hereon, divided by the Conversion Price on the date the Mandatory Default Amount is either (a) demanded (if demand or notice is required to create an Event of Default) or otherwise due or (b) paid in full, whichever has a lower Conversion Price, multiplied by the VWAP on the date the Mandatory Default Amount is either (x) demanded or otherwise due or (y) paid in full, whichever has a higher VWAP, and (ii) all other amounts, costs, expenses and liquidated damages due in respect of this Debenture."

b) "If any Event of Default occurs, the outstanding principal amount of this Debenture plus accrued but unpaid interest, liquidated damages and other amounts owing in respect thereof through the date of acceleration, shall become, at the Holder's selection, immediately due and payable in cash at the Mandatory Default Amount. Commencing 5 days after the occurrence of any Event of Default that results in the eventual acceleration of this Debenture, the interest rate on this Debenture shall accrue at an interest rate equal to the lesser of 18% per annum or the maximum rate permitted under applicable law."

Due to the provisions mentioned above and as per the terms of the Debenture, the Company has reclassified the principal amount of the Debenture of $8,000,000 and the principal amount of the new Debenture of $945,000 and the interest accrued thereon to current liabilities.

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

($,000)	June 30, 2007	
Liquidated damages	2%	$ 450
Mandatory default	30%	2,247
Total		$ 2,697

Such amounts have been recorded as liquidated damages liability as of June 30, 2007.

6.2 Five Million Convertible Note

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

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

In connection with the issuance of the note, PacGames incurred issuance costs of $204,121, which primarily consisted of investment banker fees, legal and other professional fees. These costs have been capitalized and will be amortized over three years, the life of the note.

7. SEGMENT INFORMATION

The Company has classified its operating segments in accordance with SFAS No. 131 "DISCLOSURES ABOUT SEGMENTS OF AN ENTERPRISE AND RELATED INFORMATION." Operating segments comprise 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 four operating segments are 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) Telecom Value-Added Services (VAS) - primarily involves machine voice services such as Interactive Voice Response, SMS and related VAS, which are conducted through our subsidiaries such as Wanrong, ChinaGoHi (discontinued), Linkhead (discontinued), Clickcom (discontinued) and Guangzhou 3G/Sunroom (discontinued). 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.

(3) Product (Telecom & Gaming) Services Group - involves communication and gaming products, GSM/CDMA/3G Products, Multimedia Communication Kiosks. This Group includes the following subsidiaries: PacificNet Communications Limited, iMobile, Allink, Take1 and PacificNet Games. PacificNet Games Limited (PacGames) is a leading developer of Asian electronic gaming machines, multi-player electronic gaming technology solutions and gaming related maintenance, IT, and distribution services for the leading hotel and casino operators based in the Macau and other Asian gaming markets.

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

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 earnings/(loss), income and expense not allocated to reportable segments.

For the three months ended June 30, 2007	Group 1.	Group 2.	Group 3.	Group 4.	Total
(in thousands, except percentages)	Outsourcing Services ($)	Telecom Value-Added Services ($)	Products (Telecom & Gaming) ($)	Other Business ($)	($)
Revenues	3,767	432	4,722	100	9,021
(% of Total Revenues)	42%	5%	52%	1%	100%
Earnings / (Loss) from Operations	241	353	378	(625)	347
(% of Total Profit)	69%	102%	109%	(180%)	100%
Total Assets	7,851	2,189	19,373	14,338	43,751
(% of Total Assets)	18%	5%	44%	33%	100%
Goodwill	3,936	461	3,003	-	7,400
Geographic Area	HK, PRC	HK, PRC	HK, PRC, Macau	HK,PRC	

For the three months ended June 30, 2006	Group 1.	Group 2.	Group 3.	Group 4.	Total
(in thousands, except percentages)	Outsourcing Services ($)	Telecom Value-Added Services ($)	Products (Telecom & Gaming) ($)	Other Business ($)	($)
Revenues	3,538	344	8,914	418	13,214
(% of Total Revenues)	27%	3%	67%	3%	100%
Earnings / (Loss) from Operations	233	82	340	(483)	172
% of Total Profit)	135%	48%	198%	(281%)	100%
Total Assets	9,112	12,819	11,954	28,245	62,130
(% of Total Assets)	15%	21%	19%	45%	100%
Goodwill	3,704	2,102	-	-	5,806
Geographic Area	HK,PRC	HK,PRC	HK,PRC, Macau	HK,PRC	

For the six months ended June 30, 2007	Group 1.	Group 2.	Group 3.	Group 4.	Total
(in thousands, except percentages)	Outsourcing Services	Telecom Value-Added Services	Products (Telecom & Gaming)	Other Business	
	($)	($)	($)	($)	($)
Revenues	7,729	959	9,424	176	18,288
(% of Total Revenues)	42%	5%	52%	1%	100%
Earnings / (Loss) from Operations	641	349	1,623	(1,466)	1,147
(% of Total Profit)	56%	30%	141%	(128%)	100%
Total Assets	7,851	2,189	19,373	14,338	43,751
(% of Total Assets)	18%	5%	44%	33%	100%
Goodwill	3,936	461	3,003	-	7,400
Geographic Area	HK, PRC	HK, PRC	HK, PRC, Macau	HK,PRC	

For the six months ended June 30, 2006	Group 1.	Group 2.	Group 3.	Group 4.	Total
(in thousands, except percentages)	Outsourcing Services	Telecom Value-Added Services	Products (Telecom & Gaming)	Other Business	
	($)	($)	($)	($)	($)
Revenues	6,560	639	11,851	836	19,886
(% of Total Revenues)	33%	3%	60%	4%	100%
Earnings / (Loss) from operations	439	168	395	(768)	234
(% of Total Profit)	188%	72%	169%	(328%)	100%
Total Assets	9,112	12,819	11,954	28,245	62,130
(% of Total Assets)	15%	21%	19%	45%	100%
Goodwill	3,704	2,102	-	-	5,806
Geographic Area	HK,PRC	HK,PRC	HK,PRC, Macau	HK,PRC	

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

For the three months ended June 30, 2007	Hong Kong, Macau	PRC	United States	Total
Product revenues	3,338	1,384		4,722
Service revenues	3,371	928		4,299

For the three months ended June 30, 2006	Hong Kong, Macau	PRC	United States	Total (Restated)
Product revenues	7,684	1,230		8,914
Service revenues	3,490	810		4,300

		PRC		Total

For the six months ended June 30, 2007	Hong Kong, Macau		United States	
Product revenues	6,489	2,395		9,424
Service revenues	6,863	2,001		8,864

For the six months ended June 30, 2006	Hong Kong, Macau	PRC	United States	Total (Restated)
Product revenues	9,620	2,231		11,851
Service revenues	6,516	1,519		8,035

15

8. RELATED PARTY TRANSACTIONS

LEASE AGREEMENT

In November 2004, the Company entered into 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 FROM RELATED PARTIES

At June 30, 2007, there was a total loan receivable of approximately $2,351,000 due from related parties. Included in which were $324,000 from MOABC, $845,000 due from PACT Power , $150,000 due from PACT Solutions and $600,000 due from PACT Linkhead, which affiliated companies are 15% owned by PacificNet, and $431,000 from shareholders and directors of certain of the Company's subsidiaries in connection with the acquisition of those subsidiaries. The amounts due from shareholders and directors of subsidiaries are comprised of $251,000 due from a shareholder of Yueshen, $64,000 due from a director of Soluteck and $115,000 due from a director of PACT Communications. Terms of these related parties loan receivables and payables are summarized below:

LOAN TO MOABC

MOABC is an affiliated company, 15% owned by PacificNet, as of June 30, 2007. A convertible loan of $324,000 is outstanding from MOABC as of June 30, 2007. Terms of the convertible loan provide PacificNet an option at any time during the term of the loan to convert in part or in whole of the then outstanding loan principle into equity interest of MOABC, at $23,160 for each 1% of MOABC shares.

LOAN TO POWER

PacPower is an affiliated company, 15% owned by PacificNet, as of June 30, 2007. A convertible loan of $845,000 is outstanding from PacPower as of June 30, 2007.

LOAN TO SOLUTION

PacSo is an affiliated company, 15% owned by PacificNet, as of June 30, 2007. A convertible loan of $150,000 is outstanding from PacSo as of June 30, 2007.

LOAN TO LINKHEAD

Linkhead is an affiliated company, 15% owned by PacificNet, as of June 30, 2007. A convertible loan of $600,000 is outstanding from Linkhead as of June 30, 2007.

LOAN TO YUESHEN'S SHAREHOLDER

As of June 30, 2007, there was a loan outstanding of $251,000 receivable from the shareholder of Yueshen. This loan is secured by 106,240 PacificNet shares.

LOAN TO SOLUTECK'S DIRECTOR

As of June 30, 2007, there was a loan outstanding of $64,000 receivable from a director of Soluteck, 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 COMMUNICATIONS' DIRECTOR

As of June 30, 2007, there was a loan outstanding of $115,000 receivable from a director of Communications, due on August 31, 2007. The interest rate for the loan is 10% per annum plus 1% penalty interest per month in case of delinquency. The loan is secured by 30,000 PacificNet shares.

LOAN DUE TO RELATED PARTIES

As of June 30, 2007, there was an outstanding loan payable of $577,000 due to related parties. Included in which was a loan payable of $288,000 to a shareholder of EPRO. The loan was advanced to Epro by a shareholder of EPRO on behalf of the Company for working capital purposes. The loan is due on August 4, 2010. Interest is charged at Hong Kong prime lending rate.

As of June 30, 2007, a loan of $289,000 was payable to a shareholder of Smartime. The loan was advanced to Smartime by a shareholder of Smartime on behalf of the Company for working capital purposes.

9. COMMITMENTS AND CONTINGENCIES

OPERATING LEASES - The Company leases warehouse and office space under operating leases with fixed monthly rentals. None of the leases included contingent rentals. Lease expense charged to operations for 2007 Q2 amounted to $341,000 (2006 Q2: $255,000). Future minimum lease payments under non-cancelable operating leases are $610,000 for the period from July 2007 to June 2008, and $244,000 for the period from July 2008 to June 2011, respectively.

RESTRICTED CASH - Term deposit of $237,000 has been pledged to certain financial institutions for bank line overdraft protection of Epro.

BANK LINE OF CREDIT - As of June 30, 2007, the Company's outstanding bank line of credit were as follows:

(i) Epro has an overdraft banking facility of up to $170,000 with certain banking institutions, which is secured by a pledge of its fixed deposits of $237,000. Interest is charged at Hong Kong Prime Rate and payable at the end of each calendar month or the date of settlement, whichever is earlier.

(ii) Smartime has an overdraft banking facility of up to $129,000 with a Hong Kong banking institution. This overdraft facility is secured by a personal deposit account of a director of Smartime.

BANK LOANS - Tabulated below are bank loans outstanding (in thousands):

	June 30, 2007 (Unaudited)	December 31, 2006
Secured [1]	$ 865	$ 1,668
Unsecured	$ 1,939	$ 543
Less: Current portion	$ (642)	$ (576)
Noncurrent portion	$ 2,162	$ 1,635

[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 $237,000 (2006: $234,000) of a subsidiary of the Company.

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

(US$000s)	July 2007 to June 2008	July 2008 to June 2009	July 2009 to June 2010	July 2010 to June 2011	July 2011 to June 2012	Thereafter	TOTAL
Beijing PACT office mortgage (1)	53	55	58	62	65	757	1,049
Shenzhen PACT office mortgage (2)	22	24	25	27	29	639	766
Sub-total	75	79	83	89	94	1,396	1,816
Bank loan of Epro (3)	444	374	47	0	0	0	865
AR factoring loans (3)	123	0	0	0	0	0	123
Sub-total	567	374	47	0	0	0	988
TOTAL	642	453	130	89	94	1,396	2,804

(As at December 31, 2006, the aggregate future maturities of borrowing for the next five years were as follows: 2007: $576,000, 2008: $477,000, 2009: $268,000, 2010: $59,000, 2011: $62,000, thereafter: $769,000)

(1) Fixed mortgages expiring in 2012 at interest rate of 5.5% per annum.
(2) Fixed mortgage expiring in 2012 at interest rate of 6.2% per annum.
(3) Interest rates charged range from Hong Kong Prime Lending Rate to Prime + 2%.

CAPITAL LEASE OBLIGATIONS - The Company leases various equipments under capital leases expiring in 2009. Aggregate minimum future lease payments under capital leases for each of the next three years are as follows: first year: $100,000; second year: $77,000, and third year: $6,000. (As at December 31, 2006, aggregate minimum future lease payments under capital leases for the future years were as follows: 2007: $120,000; 2008: $83,000, 2009: $41,000, and thereafter: none).

Liquidated damages: Refer to Note 6 for details

10. OTHER CURRENT ASSETS

Other current assets comprises of the following (in thousands):

	June 30, 2007 (Unaudited)	December 31, 2006
Loans to employees	$ 8,141	$ 411
Advances to sales representatives	510	358
Receivable from Lion Zone Holdings	480	485
provision for bad debt-other receivables	(1,203)	
Prepayment	690	887
Deposit-utilities	1,042	1,292
Prepaid expense	225	408
Others	345	171
Total	$ 10,230	$ 4,012

11. INCOME TAXES

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

The income taxes expenses adjustment for the Company's subsidiaries were $22,000 for the 3-month period ended June 30, 2007. The provision of income taxes depends on the tax rate and tax exemption, thus is subject to adjustment from time to time. Pursuant to the PRC Income Tax Laws, the Company's subsidiaries and VIEs are generally subject to Enterprise Income Taxes ("EIT") at a statutory rate of 33%, which comprises 30% national income tax and 3% local income tax. Certain subsidiaries and VIEs are qualified for preferred high technology or software enterprise tax status, and they are subject to preferential tax rate of 15% under PRC Income Tax Rules.

For operations in the United States of America and Hong Kong the Company has incurred net accumulated operating loss for income tax purposes. The Company believes that it is more likely than not that these net accumulated operating loss 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 June 30, 2007. Accordingly, the Company has no net deferred tax assets as of June 30, 2007.

12. NET ASSETS HELD FOR DISPOSITION

Sale of Interest in Linkhead Technology Bejing Limited. ("Linkhead")
On May 20, 2007, the Company entered into a definitive agreement to sell its 36% equity interest in Linkhead, a PRC limited liability corporation engaged in the business of resaling of NMS hardware and software platforms in China, to Mr. Mu Yingliang, a resident of People's Republic of China. Consideration for the 36% interest of Linkhead was RMB10,000 (or US$1,295), to be paid within 90 days after signing of the agreement. The Company's interest in Linkhead decreased from 51% to 15% after the transaction.

Sale of Interest in PacificNet Telecom Solution Inc. ("PacTelso")
On May 20, 2007, the Company entered into a definitive agreement to sell its 36% equity interest in PacTelso, an intermediate holding company registered under the laws of British Virgin Islands, to Mr. Mu Yingliang, a resident of People's Republic of China. Consideration for the 36% interest of PacTelso was RMB10,000 (or US$1,295), to be paid within 90 days after signing of the agreement The Company's interest in PacTelso decreased from 51% to 15% after the transaction.

Sale of Interest in PacificNet Solutions Limited. ("PacSo")
On May 18, 2007, the Company entered into a definitive agreement to sell its 45% equity interest in PacSo, a company registered under the laws of Hong Kong SAR, China and engaged in systems integration, software application, and e-business solutions services, to Mr. Alex Au, a resident of Hong Kong SAR, China. Consideration for the 45% interest of PacSo was HK$4,500 (or US$583), to be paid within 90 days after signing of the agreement. The Company's interest in PacSo decreased from 60% to 15% after the transaction.

Sale of Interest in PacificNet Power Limited ("PacPower")
On May 18, 2007, the Company entered into a definitive agreement to sell its 36% equity interest in PacPower, a company registered under the laws of Hong Kong SAR, China and engaged in air-conditioning contracting and consulting businesses, to Mr. Alex Au, a resident of Hong Kong SAR, China. Consideration for the 36% interest of PacPower was HK$3,600 (or US$466), to be paid within 90 days after signing of the agreement. The Company's interest in PacPower decreased from 51% to 15% after the transaction.

Sale of Interest in MOABC.com ("MOABC")

On May 20, 2007, the Company entered into a definitive agreement to sell its 5% equity interest in MOABC, a PRC limited liability corporation engaged in the business of value-added services platform providing, to Mr. Jack Ou, a resident of People's Republic of China. Consideration for the 5% interest of MOABC was RMB5,000 (or US$647), to be paid within 90 days after signing of the agreement. The Company's interest in MOABC decreased from 20% to 15% after the transaction.

Sale of Interest in PacificNet Clickcom Limited ("Clickcom")

On May 15, 2007, the Company entered into a definitive agreement to sell its 36% entire interest in PacificNet Clickcom Limited. ("Clickcom"), a leading Value-Added Services (VAS) company in China, to Mr. Ou Zhenbin, a Chinese residence. Consideration for the 36% interest of Clickcom was RMB10,000, to be paid in cash within 90 days after the agreement signing. The Company's interest in Clickcom decreased from 51% to 15% after the transaction.

Sale of Interest in Guangzhou 3G Information Technology Co., Ltd. ("Guangzhou 3G")

On April 30, 2007, the Company entered into a definitive agreement to sell its 51% entire interest in Guangzhou 3G Information Technology Co., Ltd. ("Guangzhou 3G"), a leading provider of Customer Relationship Management (CRM), mobile internet, e-commerce and gaming technology in China, Consideration for the 51% interest of Guangzhou 3G was US$6 million, to be paid in cash in 5 installments over 7 months after the agreement signing. The Company acquired 51% controlling interest in Guangzhou 3G in March of 2005 for US$5.5 million consideration which was paid partially in cash and mostly in PACT stock. The Company's interest in Guangzhou 3G decreased from 51% to 0% after the transaction.

Information relating to the operations of the subsidiaries up to the periods of disposal during the three month period ended June 30, 2007 is as follows:

June 30, 2007

(In US$ thousands)	Linkhead	Clickcom	Power	Solutions	MOABC	T otal
Gain (loss) from discontinued operations (including income (loss) from discontinued operations)	241	(3)	336	79	(23)	630
Net assets held for disposition (remaining interest)	104	129	(140)	(26)	(42)	25

13. ACQUISITION

TAKE 1 TECHNOLOGIES GROUP LIMITED

On January 05, 2007, we entered into an agreement for PacificNet to exercise the option to acquire an additional 31% interest in Take 1. The completion date for the new Securities Subscription Agreement was January 05, 2007, with a consideration of $965,505 (paid entirely with shares of PacificNet: 149,459 PACT Shares, valued at $6.46 per share). As a result, PacificNet has become the majority and controlling shareholder of Take1 with our ownership percentage increasing from 20% to 51%.

An initial equity investment of 30% in Take 1 was made in April 2004 by the Company, through its subsidiary PacificNet Strategic Investment Holdings Limited, for a consideration of $1,156,812, comprising $385,604 in cash and $771,208 in 149,459 PacificNet shares at $5.16 per share. PacificNet's interest in Take 1 was reduced to 20% in the year 2005 from 30% as a result of PacificNet repurchasing an aggregate of 149,459 at nominal value.

Summarized below is the assets acquired and liabilities assumed for Take 1 in the acquisition:

Estimated fair values:		
Current Assets	$	106,422
Intangible asset	$	64,665
Total Assets Acquired	$	171,087
Liabilities assumed		($728,156)
Net assets acquired		($557,069)
Investment on equity method (20%)	$	385,604
Loss from Investment	$	(285,260)
Additional Consideration (31%)-partially paid	$	190,305
Goodwill	$	847,718

At June 30, 2007, goodwill of $847,718 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 is reported under reportable segment for Products (Telecom & Gaming)..

In accordance with SFAS 142, goodwill is not amortized but is tested for impairment at least annually. The purchase price allocation for Take 1 acquisition is based on a management's estimates and overall industry experience. Immediately after the signing of the definitive agreement, the Company obtained effective control over Take 1. Accordingly, the operating results of Take 1 have been consolidated with those of the Company starting January 05, 2007. Pursuant to SFAS 141 "Business Combinations", the earn-out consideration is considered contingent consideration, which will not become certain unless the audited combined after-tax profit of US$552,000 for the six

months ended June 30, 2007. Accordingly, the contingent consideration of 120,000 shares has not been reflected in the consolidated financial statements of the Company as of June 30, 2007.

UNAUDITED PRO FORMA CONSOLIDATED FINANCIAL INFORMATION DISCLOSURE FOR THE QUARTER ENDED June 30, 2007 AND 2006

The following is an un-audited pro forma consolidated financial information for the six month ended June 30, 2006 and 2007, as presented below, reflects the results of operations of the Company assuming the acquisition occurred on January 1, 2006 and 2007, respectively, and after giving effect to the purchase accounting adjustments. These pro forma results have been prepared for information purposes only and do not purport to be indicative of what operating results would have been had the acquisitions actually taken place on January 1, 2006 and 2007, respectively, and may not be indicative of future operating results.

	Six months ended June 30			
	2007		2006	
	(un-audited and in thousands of U.S. dollars except for earnings per share)			
Revenue	$	18,288	$	20,459
Operating income	$	1,147	$	480
Net profit	$	552	$	1,673
Earnings per share - basic	$	0.05	$	0.15
Earnings per share - diluted	$	0.05	$	0.14

Accordingly, PacificNet included the financial results of Take 1 in its consolidated 2007 financial results from January 5, 2007 through June 30, 2007.

14. INVESTMENTS IN AFFILIATED COMPANIES

Investments in affiliated companies consists of the following as of June 30, 2007:

(US$ thousands)	COLLATERAL/OWNERSHIP % AND BUSINESS DESCRIPTION		
INVESTMENTS IN AFFILIATED COMPANIES:	AMOUNT		DESCRIPTION
Glad Smart	$	30	15% ownership interest
Community Media Co.	$	4	5% ownership interest
Total	$	34	

15. LEGAL PROCEEDINGS.

1. Lawsuit between PacificNet Power Limited and Johnson Controls Hong Kong Limited (JCHKL), a subsidiary of Johnson Controls Inc. (NYSE:JCI) (www.jci.com)

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

In connection with the claim, PacificNet Power reviewed a letter from its client, China Weal Property Management Ltd., dated January 22, 2007 stating that the construction work by JCHKL had not been completed as of the date of

the letter, and that certain violations itemized in a letter issued by the Hong Kong Environment Protection Department (EPD) (Noise Abatement Notice No. N806030) addressed to JCHKL with respect to acoustic problems with JCHKL's equipment had not been abated. Further, JCHKL was to pay penalties between HK$100,000 and HK$200,000 assessed by the JCHKL for failing to fix the noise problem on the roof of Fortress Tower.

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

On February 7, 2007, we instructed our Hong Kong legal counsel to issue a Defense and Counterclaim to JCHKL to counter-claim that (i) JCHKL's construction work has not complied with the applicable rules and regulations of various government authorities in Hong Kong; (ii) the Chiller System provided by JCHKL was defective and merchantable unfit and JCHKL has failed and/or refused to rectify such defective works; and (iii) JCHKL shall return the work deposit in the amount of HK$1,500,000 to PacificNet Power Limited and shall compensate and keep PacificNet Power Limited indemnified against all the loss and damages suffered as a result of any claims from the China Weal Property Management Ltd, the employer and the potential tenants of Fortress Tower.

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

2. Lawsuit between PacificNet Power Limited and Johnson Controls Hong Kong Limited (JCHKL), a subsidiary of Johnson Controls Inc. (NYSE:JCI) (www.jci.com)

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

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

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

On April 23, 2007, we instructed our lawyers issued a letter to the Defendant requesting and demanding them, being the sub-contractor of the Construction and Replacement Works Contract, to take immediate rectification action within seven days from the date of the said letter to (i) rectify and complete all outstanding defective works of the Construction and Replacement Works Contract; (ii) replace the water-cooled chiller plant and/or equipments which are not conformed with the requirements of the tender documents previously submitted by the Defendant to the Employer; and (iii) improve the poor performance of energy saving of the new water-cooled chiller plant so that it would conform with their guarantee made on 21 December, 2005 to PKL and the employer.

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

On July 25, 2007, JCHKL issued a Defense and Counterclaim to PacificNet Power to counter-claim that: (i) a concrete base was discovered after the existing dismantled radiators was not indicated in tender drawings nor could it be revealed by site visit; (ii) JCHKL could not have carried out the works under the Contract without first demolishing the said concrete base; (iii) by a letter from JCHKL to PacificNet Power dated 22 May, 2007, PacificNet Power was

informed additional works had been carried out by JCHKL; (iv) a sum of HK$30,000 is still due and owing by PacificNet Power to JCHKL.

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

16. CURRENT VULNERABILITY DUE TO CERTAIN CONCENTRATIONS

The Company's operations are carried out in the PRC. Accordingly, the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environments in the PRC, by the general state of the PRC's economy. The Company's business may be influenced by changes in governmental policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation, among other things.

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

THE FOLLOWING DISCUSSION SHOULD BE READ IN CONJUNCTION WITH THE INFORMATION CONTAINED IN THE FINANCIAL STATEMENTS OF THE COMPANY AND THE NOTES THERETO APPEARING ELSEWHERE HEREIN AND IN CONJUNCTION WITH THE MANAGEMENT'S DISCUSSION AND ANALYSIS SET FORTH IN THE COMPANY'S ANNUAL REPORT ON FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 2006, AS AMENDED.

PRELIMINARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements contained in this Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These include statements about the Company's expectations, beliefs, intentions or strategies for the future, which are indicated by words or phrases such as "anticipate," "expect," "intend," "plan," "will," "the Company believes," "management believes" and similar words or phrases. The forward-looking statements are based on the Company's 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." The Company's actual results could differ materially from results anticipated in these forward-looking statements. All forward-looking statements included in this document are based on information available to the Company on the date hereof, and the Company assumes no obligation to update any such forward-looking statements.

FACTORS THAT COULD AFFECT FUTURE RESULTS

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

— the impact of competitive products;
— changes in laws and regulations;
— adequacy and availability of insurance coverage;
— limitations on future financing;

— increases in the cost of borrowings and unavailability of debt or equity capital;
— the inability of the Company to gain and/or hold market share;
— exposure to and expense of resolving and defending liability claims and other litigation;
— consumer acceptance of the Company's products;

— managing and maintaining growth;
— customer demands;
— market and industry conditions,
— the success of product development and new product introductions into the marketplace;

— the departure of key members of management, and
— the effect of the United States War on Terrorism, as well as other risks and uncertainties that are described from time to time in the Company's filings with the Securities and Exchange Commission.

Regarding one of our subsidiaries, for example, Epro is engaged in the business of providing outsourced call center services with over 15 years of field experience in Hong Kong and China. The factors that could affect current and future results are as follows:

— insufficient sales forces for business development & account servicing;
— lack of PRC management team in operation;
— less familiarity on partners' product knowledge;
— deployment costs of a new HR application and the costs to upgrade the call center computer system;

— increasing operations costs (cost of salaries, rent, interest rates & inflation) under rising economy in Hong Kong;
— insufficient brand awareness initiatives in the market;
— salary increases due to an active labor market in Hong Kong and GuangZhou; and
— increasing competition of call center solutions in the Hong Kong and PRC markets.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

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

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

Allowance For Doubtful Accounts

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

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

Inventory

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

Income Taxes

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

Contingencies

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

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

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

Convertible Debt

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

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

NATURE OF THE OPERATIONS OF THE COMPANY

NATURE OF BUSINESS.

PacificNet Inc. (http://www.PacificNet.com) is a leading provider of gaming technology, e-commerce, and Customer Relationship Management (CRM) in China. Our gaming products are specially designed for the Chinese and Asian gamers, and we focus on integrating localized Chinese and Asian themes and content, advanced graphics, digital

sound effects and popular domestic music, with secondary bonus games and jackpots. Our gaming products include: Multi-player Electronic Table Games - Baccarat, Sicbo, Fish-Prawn-Crab, and Roulette machines, server based games (SBG) with multiple client betting stations, slot and bingo machines, video lottery terminals (VLTs), amusement with prices (AWP) machines, gaming cabinet and client/server system designs, online i-gaming software design, and multimedia entertainment kiosks. PacificNet's gaming clients include the leading hotels, casinos, and gaming operators in Macau, Asia, and Europe, and our ecommerce and CRM clients include the leading telecom companies, banks, insurance, travel, marketing and business services companies and telecom consumers in Greater China such as China Telecom, China Mobile, Unicom, PCCW, Hutchison Telecom, Bell24, Motorola, Nokia, SONY, TCL, Huawei, American Express, Citibank, HSBC, Bank of China, Bank of East Asia, DBS, TNT, China and Hong Kong government. PacificNet employs about 1,200 staff in its various subsidiaries throughout China with offices in Hong Kong, Beijing, Shanghai, Shenzhen, Guangzhou, Macau and Zhuhai China, USA, and the Philippines.

25

PacificNet's Gaming Products:
Our gaming products are specially designed for the Chinese and Asian gamers, and we focus on integrating localized Chinese and Asian themes and content, advanced graphics, digital sound effects and popular domestic music, with secondary bonus games and jackpots. Our gaming products include:

• Multi-player Electronic Table Games: Baccarat, Sicbo, Fish-Prawn-Crab, and Roulette Machines, server based games (SBG) with multiple client betting stations.
• Slot Machines
• Bingo and Keno Machines
• Video Lottery Terminals (VLTs)
• Server-Based Gaming Machines (SBG)
• Amusement With Prices (AWP) Machines
• Online iGaming Software Development
• Client-Server Gaming Systems
• CMM Level 3 Certified Gaming Software Development Center in China with 200 Professional Software Developers
• Gaming Systems, Cabinet Design and Sales, Parts Sales, OEM Games. We design and sell gaming machine cabinets, replacement parts.

PacificNet's Business Units:
1. Gaming Technology: Electronic Gaming Machines, Mobile Games, i-Gaming Software.
2. Legacy Business: CRM, E-commerce and Telecom Products
Our goal is to take a leading role in providing customer relationship management (CRM) and gaming technology, which are rapidly expanding business sectors in Asia.

PaificNet's Major Operating Subsidiaries
— **PacificNet Games Limited (PacGames)**, is a leading provider of Asian multi-player electronic gaming machines, gaming technology solutions, gaming related maintenance, IT and distribution services for the leading hotel, casino and slot hall operators based in Macau, China and other Asian gaming markets.
— Take1 Technologies (www.take1technologies.com) , is in the business of designing and manufacturing electronic multimedia entertainment kiosks, coin-op kiosks and machines, electronic gaming machines (EGM), bingo and slot machines, AWP (Amusements With Prizes) games, server-based downloadable games systems, and Video Lottery Terminals (VLT) such as Keno and Bingo machines, including hardware, software, and cabinets.
— Pacific Solutions Technology, is a CMM Level 3 certified software development center with over 200 software programmers located in Shenzhen, China, and specializes in the development of client-server systems, internet e-commerce software, online and casino gaming systems and slot machines, banking and telecom applications using Microsoft Visual C++, Java, and other rapid application development tools.
— PacificNet Epro (www.EproTel.com.hk): CRM Call Center and Customer Services Outsourcing
— PacificNet Clickcom (www.clickcom.com.cn), MOABC.com : VAS,SP,(SMS, WAP)
— Guangzhou Wanrong (www.my2388.com) : VAS, SP, (SMS,MMS,IVR,WAP, Java Games)
— PacificNet Communications Limited,
— iMobile, (www.imobile.com.cn, www.18900.com, wap.17wap.com)

PacificNet Gaming Technology

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

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

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

4. Video Lottery Terminals: video gaming machines featured with localized Chinese and Asian themes and contents, advanced graphics, digital sound effects and music and incorporate many of the same features from our other gaming machines.

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

26

Gaming Market Overview on Macau, China

As of the end of 2006, Macau (a Special Administrative Region of the People's Republic of China) has become the largest and fastest-growing gaming market in the world, and surpassed the Las Vegas Strip in total revenues. According to statistics provided by Macau government, in 2006, Macau's gaming revenues exceeded US$7 billion (MOP 56.2 billion patacas), surpassing the Las Vegas Strip gaming revenues of US$6.6 billion. Macau borders Zhuhai City of Guangdong Province of China, one of the country's wealthiest and most developed regions and is an hour away from Hong Kong via ferry. In 2006, the number of tourists visiting Macau reached an all-time record of 22 million, an increase of 17 percent compared with 2005, of which 55% or 12 million visitors were from mainland China. At the end of 2006, there were 22 casinos, 83 hotels and similar establishments in Macau with close to 13,000 rooms. By 2010, the number of tourists is expected to nearly double to nearly 30 million visitors per year. Approximately one billion people live within a three-hour flight of Macau. Numerous hotel, gaming, and other projects are in the works in Macau which are expected to add over 10,000 guest rooms and over 20,000 live entertainment seats in eight separate venues. The number of hotel-casinos in operation and in development in Macau continues to grow, including well-known Chinese names such as Galaxy and Melco, and famous Las Vegas names such as the Sands, the Venetian, Wynn Resort and Crown Macau. With the disposable income of the average Chinese on the rise, Macau's gaming and entertainment market is expected to grow for years to come. Macau is the only area in China where gambling is legal.

RESULTS OF OPERATIONS

REVENUES. Revenues for the three and six months ended June 30, 2007 were amounted to $9,021,000 and $18,288,000, which represented a year-over-year decline of 32% and 8% from $13,214,000 and $19,886,000 for the three and six months ended June 30, 2006, respectively. The year-over-year decrease in revenues was mainly due to the Company’s Mobile phone wholesaling businesses in Greater China, which posted a year-over-year decrease of 21% and 79% for the second quarter and first half of the year, respectively. Segmented financial information of the three business operating groups is set out below followed by a brief discussion of each business group.

THREE AND SIX MONTHS ENDED JUNE 30, 2007 COMPARED TO THREE AND SIX MONTHS ENDED JUNE 30, 2006

For the three months ended June 30, 2007	Group 1.	Group 2.	Group 3.	Group 4.	Total
(in thousands, except percentages)	Outsourcing Services ($)	Telecom Value-Added Services ($)	Products (Telecom & Gaming) ($)	Other Business ($)	($)
Revenues	3,767	432	4,722	100	9,021
Earnings / (Loss) from Operations	241	353	378	(625)	347

For the three months ended June 30, 2006	Group 1.	Group 2.	Group 3.	Group 4.	Total
(in thousands, except percentages)	Outsourcing Services ($)	Telecom Value-Added Services ($)	Products (Telecom & Gaming) ($)	Other Business ($)	($)
Revenues	3,538	344	8,914	418	13,214
Earnings / (Loss) from Operations	233	82	340	(483)	172

For the six months ended June 30, 2007 (in thousands, except percentages)	Group 1. Outsourcing Services ($)	Group 2. Telecom Value-Added Services ($)	Group 3. Products (Telecom & Gaming) ($)	Group 4. Other Business ($)	Total ($)
Revenues	7,729	959	9,424	176	18,288
Earnings / (Loss) from Operations	641	349	1,623	(1,466)	1,147

For the six months ended June 30, 2006 (in thousands, except percentages)	Group 1. Outsourcing Services ($)	Group 2. Telecom Value-Added Services ($)	Group 3. Products (Telecom & Gaming) ($)	Group 4. Other Business ($)	Total ($)
Revenues	6,560	639	11,851	836	19,886
Earnings / (Loss) from operations	439	168	395	(768)	234

(1) Outsourcing services: Revenues for the three and six months ended June 30, 2007 were $3,767,000 and $7,729,000, which represent a year-over-year increase of 7% and 18% as compared to the same period of 2006. The increase was primarily due to the growth in outsourcing call center in Hong Kong. In spite of call volume growth (of 14%, 6%, 54% and 18%, respectively) in inbound and outbound calling lists, in-sourcing operators and sub-contract American Express and MetLife call centers, real revenue growth from outsourcing call center is held back by competitive pricing. Revenue from outsourcing software largely remained steady from prior periods. Outsourcing revenues accounted for 42% and 42% of the Company's total revenues for the second quarter and first half of FY2007.

(2) Telecom Value-added Services (VAS): Revenues for the three months and six months ended June 30, 2007 were $432,000 and $959,000 which represented a year-over-year increase of 26% and 50% as compared to the same periods of 2006. VAS revenues, mainly comprised of WAP based mobile phone games, accounted for 5% and 6% of the Company's total revenues for the second quarter and first half of FY2007.

(3) Products (Telecom & Gaming): Revenues for the three and six months ended June 30, 2007 were $4,722,000, and $9,424,000 which represented a year-over-year decrease of 47% and 20% as compared to the same periods of 2006, respectively. Products revenues accounted for 52% and 52% of the Company's total revenues for the second quarter and first half of FY2007.

Gaming technology revenues from selling to casino operators amounted to $491,000 and $1,506,000 for the three and six months ended June 30, 2007, representing 10% and 16% of product revenues. In light of the internet gaming license granted by First Cagavan and Cagavan Economic Zone Authority (CEZA) of the Philippines, the company is well positioned to emerge as a leading technology provider of the gaming industry, both online and land-based, in foreseeable future. Significant resources have been, and will continually be, invested in moving our highly successful land-based games online and negotiation of profit sharing model to make such gaming vision possible.

Revenues from sales of electronic slot machines amounted to $1,189,000 and $1,908,000 for the three and six months ended June 30, 2007, which accounted for 25% and 20% of the total product revenues. The company continued to take advantage of the new “amusement with prize” regulation change in entering the largest European slot market, Italy, as an exclusive supplier of electronic slot machines to various leading gaming operators’ slot halls.

As planned, the company continues to scale down its low-margin mobile phone wholesaling business and distribution business in Greater China. Revenues from sales of mobile phone in Hong Kong for the three and six months ended Jun 30, 2007, amounted to $1,658,000 and $3,077,000, a decline of 75% and $68% as compared to $6,683,000 and $9,619,000 for the same periods of 2006. Nevertheless, accessory revenue derived from becoming the approved maintenance and delivery services provider for mobile phone accessories of Motorola in China posted an increase of 42% to $260,000 for the quarter ended June 30, 2007 as compared to $ 183,000 for the same period of 2006.

COST OF REVENUES. Cost of revenues for the three and six months ended June 30, 2007 were $6,660,000 and $13,388,000, representing a decrease of 42% and 20% from $11,437,000 and $16,757,000 as compared to the same periods of 2006, respectively. Cost of revenues as a percentage of the corresponding revenues was approximately 74% and 73% for the second quarter and first half of FY2007, respectively.

(1) Outsourcing services: Cost of revenues from outsourcing services for the three and six months ended June 30, 2007 amounted to $2,880,000 and $5,859,000, an increase of 8% and 17% respectively, in each case compared with 2006; mainly due to increase of $40,000 in rental fees for two call centers in Hong Kong, increase of $225,000 for

additional 110 headcounts and increased of $29,000 in depreciation of newly acquired computers during the quarter;

(2) Telecom Value-added Services (VAS): Cost of revenues from VAS for the three and six months ended June 30, 2007 posted a reduction of 74% and 26% respectively, in each case compared with 2006. The decrease was mainly due to new WAP-based mobile phone games completed in Q1 for sales in Q2; and

(3) Products (Telecom & Gaming): Cost of revenues from Products for the three months ended June 30, 2007 amounted to $3,827,000 and $7,202,000, a reduction of 55% and 36% respectively, in each case compared with 2006. Decrease in cost of revenues, approximately 71% of the total product cost of revenues was mobile phone wholesaling related, was commensurate with smaller mobile phone wholesale revenue.

GROSS PROFIT. Gross profit for the three and six months ended June 30, 2007 was $2,361,000 and $4,900,000, a year-over-year increase of 33 % and 57%, respectively, as compared to the comparable period of 2006. Gross margin was 26% and 27% for the three and six months ended June 30, 2007, as compared to 13% and 16% for the same period of prior year, respectively. Quarterly improvement in gross margin, as well as the first half year, was attributed to higher margin gaming technology and electronic slot machine businesses.

Gross profit contribution, averaged approximately 59% and 54% respectively, from the Company's gaming technology business represented 12% and 17% of the total gross profit for the three and six months ended June 30, 2007 for the periods. Gross profit, averaged approximately 29% and 41% respectively, contribution from the Company's electronic slot machine business represented 15% and 16% of the total gross profit for three and six months ended June 30, 2007. Although rather insignificant, gross margin contribution from providing internet connection, maintenance and building website services reached 91% for the second quarter.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Selling, general and administrative expenses totaled $1,798,000 and $3,365,000 for the three and six months ended June 30, 2007, which represented year-over-year increases of 27% and 35%, respectively, for the same period of prior year; or a year-over-year increase from 11% to 20% as a percentage of revenue for the three months ended June 30, 2007. Selling, general and administrative expenses consist primarily of staff salaries, office rent, insurance, sales commissions, advertising expenditures and traveling costs.

(1) Outsourcing services: Selling, general and administrative expenses attributed to outsourcing services for the three and six months ended June 30, 2007 amounted to $623,000 and $1,191,000, an increase of 19% and 21% as compared to the same period of prior year. During the quarter, the increases were primarily due to $57,000 for traveling and entertainment fees driven by the increasing insourcing services, and $43,000 for labor cost including benefits and its traveling fees driven by the additional 10 headcounts working on market research for sub-contract software project;

(2) Telecom Value-added Services (VAS): Selling, general and administrative expenses attributed to VAS for the three and six months ended June 30, 2007 amounted to $96,000 and $219,000 from an increase of 268 % and 1,117% as compared to the same periods of prior year. Significant increase of labor costs were primarily derived from traveling, entertainment and other expenses relating to business development of WAP-based mobile phone games; and

(3) Products (Telecom & Gaming): Selling, general and administrative expenses attributed to Products for the three and six months ended June 30, 2007 amounted to $417,000 and $401,000, an increase of 154% and 37% as compared to the same periods of prior year. Included in the increase were remuneration of $143,000 for additional headcount dedicated to sustain our gaming technology growth, the salaries of $116,000 for the headcounts related to the sales of electronic slot machine, as well as the rental and utilities expenses of $44,000 and $3,000 for the new sales center in Macau and expansion of our gaming design center in Zhuhai. Expenses related to gaming technology, electronic slot machines and mobile phone products amounted to $340,000, $180,000 and $277,000 for the second quarter of FY2007, representing 19%, 10% and 15%, respectively of the total selling, general and administrative expenses for the second quarter of FY2007.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES (in US$ thousands, except percentages)	Three months ended June 30, 2007	Three months ended June 30, 2006	Percentage Change (%)
Remuneration	1,178	637	85
Office	345	226	53
Travel	172	83	107
Entertainment	58	39	49

Professional (legal and consultant)	70	137	(49)
Audit	116	119	(3)
Selling	75	84	(11)
Other	97	63	54
Recovery of provisions for doubtful accounts from subsequent collections	(313)	28	(1,218)
Total	1,798	1,416	27

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES (in US$ thousands, except percentages)	Six months ended June 30, 2007	Six months ended June 30, 2006	Percentage Change (%)
Remuneration	2,218	1,218	82
Office	645	440	47
Travel	264	122	116
Entertainment	98	55	79
Professional (legal and consultant)	360	201	79
Audit	136	138	(1)
Selling	185	136	36
Other	149	157	(5)
Recovery of provisions for doubtful accounts from subsequent collections	(691)	28	(2,568)
Total	3,365	2,495	35

INCOME / (LOSS) FROM OPERATIONS. On a quarter-over-quarter basis, income from operations increased 102% and 390% for the three and six months ended June 30, 2007 compared to the same period of 2006 respectively. Segmented operating income of $241,000, $353,000 and $378,000 for the three months ended June 30, 2007 were generated from the Company's three business groups: (1) Outsourcing Services, (2) Telecom Value-Added Services, and (3) Products (Telecom & Gaming) Services, respectively. This compared to operating income of $233,000, $82,000 and $340,000 from the same groups for the same period last year, respectively. Segmented operating incomes of $641,000, $349,000 and $1,623,000 for the six months ended June 30, 2007 were generated from the Company's three business groups, which increased 46%, 108% and 311% as compared to operating incomes of $439,000, $168,000 and $395,000 from the same groups for the same period of the prior year, respectively. Significant increase in high quality operating income derived from gaming related operations provides a clear confirmation to the company's newly adopted gaming technology strategy. Operating income from the gaming technology business accounted for 14% and 28% of the total operating income for the second quarter and first half of the year, respectively. Likewise, operating income from sale of electronic slot machines accounted for 53% and 50% of the total operating income for the respective period of the year.

INCOME TAXES. Management has made an income tax provision adjustment of $22,000 in the second quarter of FY2007, thus $(46,000) for the six months ended June 30, 2007, as compared to $(30,000) for the six months ended June 30, 2006. Interim income tax provisions are based upon management's estimate of taxable income and the resulting consolidated effective income tax rate for the full year. As a result, such interim estimates are subject to change as the year progresses and more information becomes available. We, however, expect our income taxes to increase as our net income increases and the tax holidays we have benefited from in Hong Kong and the PRC expire.

MINORITY INTERESTS. Minority interests for the three and six months ended June 30, 2007 totaled $(340,000) and $(874,000) compared with $(179,000) and $(265,000) for the same period of the prior year, respectively, representing minority ownership interests in subsidiaries consolidated in the Company's consolidated financial statements.

NET INCOME. On a year-over-year basis, net income recorded the decrease of 69% and 65% for the three and six months ended June 30, 2007, respectively. This was primarily due to diminishing income from discontinued operations as a result of the Company shifting from VAS businesses that are highly susceptible to adverse billing policy changes administered by China Mobile. Additionally, sales competition for mobile phones in Hong Kong market directly affected the sales for such business.

CASH

Net cash and cash equivalents at June 30, 2007 were approximately $4.73 million, an increase of approximately $2.93 million compared to December 31, 2006. This was primarily due to successful collection of certain doubtful debts of approximately $0.69 million and $2.67 million for the net proceeds from issuance of convertible debenture for the Company's gaming technology business, net of acquisition of property and equipment of approximately $1.34 million.

CONTRACTUAL OBLIGATIONS

Contractual obligations as of June 30, 2007 are detailed below:

Payments Due by Period

Contractual Obligations		Total		Less than 1 year		1-5 years		After 5 years
Line of credit (in thousands)	$	299	$	299			$	$
Bank Loans	$	2,804	$	642	$	766	$	1,396
Operating leases	$	854	$	610	$	244	$	
Capital leases	$	183	$	100	$	83	$	
Total cash contractual obligations	$	4,140	$	1,651	$	1,093	$	1,396

In addition to above, as previously disclosed in the paragraph under the sub-heading of PROBABLE EVENT OF DEFAULT under Item 1 - CONVERTIBLE DEBENTURES, the terms of the convertible note obligate the Company to pay monthly 2% of outstanding principal as liquidated damages and 30% of the outstanding principal as mandatory default amount from the date of ineffectiveness of registration statement. As of June 30, 2007, the Company has accrued three months of liquidated damages and mandatory default amount or approximately $2,697,000, although the Company may not have to pay the full amount of liquidated damages. The amount has been reflected in the consolidated financial statements as a separate line item on the consolidated balance sheet as “liquidated damages liability”.

OFF-BALANCE SHEET ARRANGEMENTS.

There were no off-balance sheet guarantees, interest rate swap transactions, foreign currency forward contracts or long term purchase commitments outstanding as of June 30, 2007. Further, the Company had not engaged in any non-exchange trading activities during second quarter of 2007.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Foreign Currency Exchange Rate Risk.
Fluctuations in the rate of exchange between the U.S. dollar and foreign currencies, primarily the Hong Dollar and the Chinese Renminbi, could adversely affect our financial results. During the quarter ended June 30, 2006, approximately all of our sales are denominated in foreign currencies. We expect that foreign currencies will continue to represent a similarly significant percentage of our sales in the future. Selling, marketing and administrative costs related to these sales are largely denominated in the same respective currency, thereby mitigating our transaction risk exposure. We therefore believe that the risk of a significant impact on our operating income from foreign currency fluctuations is not substantial. However, for sales not denominated in U.S. dollars, if there is an increase in the rate at which a foreign currency is exchanged for U.S. dollars, it will require more of the foreign currency to equal a specified amount of U.S. dollars than before the rate increase. In such cases and if we price our products in the foreign currency, we will receive less in US. dollars than we did before the rate increase went into effect. If we price our products in U.S. dollars and competitors price their products in local currency, an increase in the relative strength of the U.S. dollar could result in our price not being competitive in a market where business is transacted in the local currency. All of our sales denominated in foreign currencies are denominated in the Hong Dollar and the Chinese Renminbi. Our principal exchange rate risk therefore exists between the U.S. dollar and these two currencies. Fluctuations from the beginning to the end of any given reporting period result in the re-measurement of our foreign currency-denominated receivables and payables, generating currency transaction gains or losses that impact our non-operating income/expense levels in the respective period and are reported in other (income) expense, net in our combined consolidated financial statements. We do not currently hedge our exposure to foreign currency exchange

rate fluctuations. We may, however, hedge such exposure to foreign currency exchange rate fluctuations in the future.

All of our sales denominated in foreign currencies are denominated in the Hong Dollar and the Chinese Renminbi. Our principal exchange rate risk therefore exists between the U.S. dollar and these two currencies. Fluctuations from the beginning to the end of any given reporting period result in the re-measurement of our foreign currency-denominated receivables and payables, generating currency transaction gains or losses that impact our non-operating income/expense levels in the respective period and are reported in other (income) expense, net in our combined consolidated financial statements. We do not currently hedge our exposure to foreign currency exchange rate fluctuations. We may, however, hedge such exposure to foreign currency exchange rate fluctuations in the future.

31

Interest Rate Risk.

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

Inflation.

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

Currency Exchange Fluctuations.

All of the Company's revenues are denominated either in U.S. dollars or Hong Kong dollars, while its expenses are denominated primarily in Hong Kong dollars and Chinese renminbi ("RMB"). The value of the RMB-to-U.S. dollar or Hong Kong dollar-to-United States dollar and other currencies may fluctuate and is affected by, among other things, changes in political and economic conditions. Since 1994, the conversion of renminbi into foreign currencies, including U.S. dollars, has been based on rates set by the People's Bank of China, which are set daily based on the previous day's inter-bank foreign exchange market rates and current exchange rates on the world financial markets. Since 1994, the official exchange rate for the conversion of renminbi to U.S. dollars had generally been stable and the renminbi had appreciated slightly against the U.S. dollar. However, on July 21, 2005, the Chinese government changed its policy of pegging the value of Chinese renminbi to the U.S. dollar. Under the new policy, Chinese renminbi may fluctuate within a narrow and managed band against a basket of certain foreign currencies. Recently there has been increased political pressure on the Chinese government to decouple the renminbi from the United States dollar. At the recent quarterly regular meeting of People's Bank of China, its Currency Policy Committee affirmed the effects of the reform on Chinese renminbi exchange rate. Since February 2006, the new currency rate system has been operated; the currency rate of renminbi has become more flexible while basically maintaining stable and the expectation for a larger appreciation range is shrinking. Although a devaluation of the Hong Kong dollar or renminbi relative to the United States dollar would likely reduce the Company's expenses (as expressed in United States dollars), any material increase in the value of the Hong Kong dollar or renminbi relative to the United States dollar would increase the Company's expenses, and could have a material adverse effect on the Company's business, financial condition and results of operations. For fluctuations in period to period exchange rates, the translation adjustment is required to translate from local functional currency to the USD reporting currency (not RMB to HKD to USD). The Company has never engaged in currency hedging operations and has no present intention to do so.

Concentration of Credit Risk.

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

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

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

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

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

Seasonality and Quarterly Fluctuations.

Several of our businesses experience fluctuations in quarterly performance. Traditionally, the first quarter from January to March is a low season for our call center business due to the long Lunar New Year holidays in China Revenues and income from gaming products, call center and telecom value-added services tend to be higher in the fourth quarter due to special holiday promotions. Internet/Direct Commerce revenues also tend to be higher in the fourth quarter due to increased consumer spending during that period. Revenues from the gaming and VAS can vary from quarter to quarter due to new product launches and the seasonality of certain product lines.

Sales of our gaming machines to Macau and other Asian casinos and gaming operators are generally strongest in Q3 and Q4 and slowest in the Chinese New Year holiday season in Q1. In addition, quarterly revenues and net income may increase when we receive a larger number of approvals for new games from regulators and gaming operators than in other quarters, when a game or platform that achieves significant player appeal is introduced or if gaming is permitted in a significant new jurisdiction. In addition, as further technology advancements become available for the gaming industry, replacement or conversion of gaming machines will be impacted once any such advanced technology is approved by regulators.

ITEM 4. 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. Certain internal audit tests performed at the fiscal year-end of 2006 revealed that there were weaknesses inherent in the Company's internal control system. Among which it was noted that there were insufficient checks and balances in place for controlling the company's non-routine transactions, namely: accuracy and completeness of stock option expense calculation. Such weaknesses in our controls eventually led to prior period option expense restatements being charged to the Company's financial statements for the years ended December 31, 2003, 2004, and 2005 respectively. As a result, our chief executive officer and our former chief financial officer concluded that there was a material weakness in our disclosure controls and procedures.

As of the end of the quarter covered by this report, the company had taken various steps to maintain the accuracy of our financial disclosures, and improve company internal control. An internal control SOX implementation team led by senior managers had been set up to uncover potential significant deficiencies inherent in the internal control systems of the company, including but not limited to risk identification, control procedure setup, staff training, segregation of incompatible job duties, design of management reporting system, definition and delegation of signing authority, establishment of documentation system and implementation of a company-wide SOX compliant ERP system. Based on the current schedule, the Company is expected to be substantially SOX compliant by the end of FY2007.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

None.

ITEM 1A. RISK FACTORS.

In addition to the other information set forth in this report, you should carefully consider the factors discussed in "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2006, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing us Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

In July 2007, the Company failed to timely make scheduled principal payments under an Amended and Restated Variable Rate Convertible Debenture due March 2009 (the "Amended Debenture") in the aggregate amount of $8,000,000. Pursuant to the terms of the Amended Debenture, the Company was obligated to make monthly redemption payments commencing on January 1, 2007, until the Amended Debenture was redeemed in full. On August 1, 2007, the Company made the July monthly redemption and interest payments to all of the debenture holders.

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

None.

ITEM 5. OTHER INFORMATION.

None.

ITEM 6. EXHIBITS

The following exhibits are filed as part of this report:

EXHIBIT NUMBER	DESCRIPTION
31.1	Rule 13a-14(a) Certification of Chief Executive Officer (Principal Executive Officer)
31.2	Rule 13a-14(a) Certification of Chief Financial Officer (Principal Financial Officer)
32.1	18 U.S.C. Section 1350 Certifications

SIGNATURES

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

PACIFICNET INC.

Date: August 21, 2007	By:	/s/ TONY TONG Tony Tong Chief Executive Officer (Principal Executive Officer)
Date: August 21, 2007	By:	/s/ Daniel Lui Daniel Lui Chief Financial Officer (Principal Financial Officer)