

PACIFICNET INC  
Form 10-K/A  
July 03, 2008

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U.S. SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
Amendment No. 1  
FORM 10-K/A

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

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

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

COMMISSION FILE NUMBER: 000-24985

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

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

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

Registrant's Telephone Number: 0086-10-59225000

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

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

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

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

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

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the

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Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days YES x NO o

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

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

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

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

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

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Explanatory Note:

This Annual Report on Form 10K/A ("Form 10K/A") is being filed as Amendment No. 1 to our Annual Report on Form 10K/A for the year ended December 31, 2007, which was originally filed with the Securities and Exchange Commission (the "SEC") on May 13, 2008. We are amending the following items in this Amendment No. 1:

- (i) Part II. Item 6. Selected Financial Data
- (ii) Part II. Item 7. Management Discussion and Analysis of Financial Condition and Results of Operations
- (iii) Part IV. Item 15. Exhibits and Financial Statements Schedules

[Missing Graphic Reference]

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15.

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

## PART II

## ITEM 6. SELECTED FINANCIAL DATA.

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

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

|  | For the Years Ended December 31, |            |            |           |           |
|--|----------------------------------|------------|------------|-----------|-----------|
|  | 2007                             | 2006       | 2005       | 2004      | 2003      |
|  | Audited                          | restated   | restated   | restated  | restated  |
| Statement of Operations Data:                        |                                  |            |            |           |           |
| Total revenue  | \$ 18,994                        | \$ 29,073  | \$ 7,081   | \$ 10,857 | \$ 1,217  |
| Cost of revenues                                     | 15,292                           | 25,529     | 5,722      | (7,887)   | 698       |
| Operating expenses                                   | 20,129                           | 10,979     | 7,578      | 9,212     | 3,042     |
| Loss from operations                                 | (16,427)                         | (7,435)    | (6,219)    | (6,242)   | (2,523)   |
| Loss available to common stockholders                | (14,195)                         | (12,415)   | (5,145)    | (5,446)   | (1,878)   |
| Basic & Diluted Loss Per Share                       | \$ ( 1.19)                       | \$ (1.08)  | \$ (0.21)  | \$ (0.78) | \$ (0.36) |
| Shares used in computing earnings:                   |                                  |            |            |           |           |
| Weighted average number of shares-Basic & Diluted    |                                  |            |            |           |           |
|  | 11,895,525                       | 11,538,664 | 21,695,473 | 7,015,907 | 5,234,744 |
| Balance Sheet Data:                                  |                                  |            |            |           |           |
| Cash and cash equivalents (excludes restricted cash) |                                  |            |            |           |           |
|  | \$ 3,750                         | \$ 1,778   | \$ 3,331   | \$ 9,433  | \$ 3,823  |
| Working capital                                      | 3,178                            | 6,925      | 7,965      | 12,711    | 1,442     |
| Total assets   | 24,720                           | 32,671     | 25,225     | 29,442    | 7,173     |
| Total stockholders' equity                           | \$ 2,792                         | \$ 13,977  | \$ 23,205  | \$ 24,108 | \$ 1,912  |

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

**FORWARD-LOOKING STATEMENTS** This annual report on Form 10-K, contains forward-looking statements within the meaning of the federal securities laws. These include statements about our expectations, beliefs, intentions or strategies for the future, which we indicate by words or phrases such as "anticipate," "expect," "intend," "plan," "will," "we believe," "management believes" and similar language. The forward-looking statements are based on our current expectations and are subject to certain risks, uncertainties and assumptions, including those set forth in the

discussion under "Description of Business," including the "Risk Factors" described in that section, and "Management's Discussion and Analysis or Plan of Operation." Our actual results may differ materially from results anticipated in these forward-looking statements.

## FACTORS THAT COULD AFFECT FUTURE RESULTS

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

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

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

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

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

### Allowance for Doubtful Accounts

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

possibility of this occurrence.

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

#### Inventory

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

#### Income Taxes

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

#### Contingencies

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

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

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



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

## Convertible debt

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

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

## RECENT ACCOUNTING PRONOUNCEMENTS

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

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

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

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

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

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

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

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

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

## RESULTS OF OPERATIONS

### REVENUES

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

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

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

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

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

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|  | Group 1.<br>Outsourcing<br>Services | Group 2.<br>Telecom<br>Value-Added<br>Services | Group 3.<br>Products<br>(Telecom &<br>Gaming) | Group 4.<br>Other<br>Business | Total            |
|--|-------------------------------------|--|---|-------------------------------|------------------|
| For the year ended December<br>31, 2006 (in<br>thousands of US Dollars,<br>except percentages) | Restated<br>(\$)                    | Restated<br>(\$)                               | Restated<br>(\$)                              | Restated<br>(\$)              | Restated<br>(\$) |
| Revenues   | 1,813                               | 2,784  | 23,385  | 1,091                         | 29,073           |
| (% of Total Revenues)  | 6%                                  | 5%   | 77%   | 12%                           | 100%             |
| Earnings / (Loss) from<br>Operations   | (67)                                | (1,054)  | (1,345)                                       | (4,969)                       | (7,435)          |

#### (1) OUTSOURCING SERVICES

Revenues for the year ended December 31, 2007 were \$2,310,000, a significant year-over-year increase of 28% as compared to \$1,813,000 for the year ended December 31, 2006. Outsourcing services revenues made up 12% of the Company's total revenues for the FY 2007 which was mainly derived from software development, R&D, and project management services.

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

Revenues for the year ended December 31, 2007 were \$1,839,000, a year-over-year increase of 34% as compared to \$2,784,000 for the same period last year. The increase was mainly due to the sales revenues from WAP-based mobile phone games and traditional SP businesses, from which revenues accounted for 10% of the Company's total VAS revenues for FY2007.

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

Revenues for the year ended December 31, 2007 were \$14,528,000, a year-over-year decrease of 38% from \$23,385,000 for the year ended December 31, 2006. Decrease in Products revenues, which accounted for 76 % of the Company's total revenues for FY2007, is largely due to contraction of the Company's mobile phone wholesaling and distribution businesses in Greater China.

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

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

#### (4) OTHER BUSINESS

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

#### COST OF REVENUES

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

**(1) OUTSOURCING SERVICES**

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

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

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

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

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

**GROSS PROFIT**

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

**SELLING, GENERAL AND ADMINISTRATIVE EXPENSES**

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

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

**(1) OUTSOURCING SERVICES**

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





SELLING, GENERAL AND ADMINISTRATIVE  
EXPENSES

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

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

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

SELLING, GENERAL AND ADMINISTRATIVE  
EXPENSES

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

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

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

SELLING, GENERAL AND ADMINISTRATIVE  
EXPENSES

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

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

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## (4) OTHER BUSINESS

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

## SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

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

## DEPRECIATION AND AMORTIZATION EXPENSES

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

## Depreciation

| (in thousands of US Dollars, except percentages) | For the year ended        |                            | Percentage Change |
|--|---------------------------|----------------------------|-------------------|
|  | December 31, 2007 Audited | December 31, 2006 Restated |                   |
| Group 1. Outsourcing Services                    | \$ (2)                    | \$ 6                       | % (137)           |
| Group 2. Telecom Value-Added Services            | 167                       | 268                        | (38)              |
| Group 3. Products (Telecom & Gaming)             | 116                       | 38                         | 205               |
| Group 4. Other Business                          | 159                       | 89                         | 79                |
| Total  | \$ 440                    | \$ 401                     | % 10              |

## Amortization

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

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

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## LOSS FROM OPERATIONS

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

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

## INTEREST INCOME / (EXPENSES), NET

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

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

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

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

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## SUNDRY INCOME/EXPENSE

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

For the year ended December 31, 2007, the non-operating income or sundry income of \$1,339,000 included in Statement of Operations was mainly derived from the investment income of \$561,000, leasehold income \$65,000, software service income \$78,000 and various other income totaling \$635,000 .

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

| Sundry Income (Net)<br>(in thousands of US Dollars, except percentages) | For the year<br>ended<br>December 31,<br>2007<br>Audited | For the year<br>ended<br>December 31,<br>2006<br>Restated | Percentage<br>Change |       |
|---|--|---|----------------------|-------|
|   |  |   |                      |       |
| Group 1. Outsourcing Services   | \$ 1   | \$ -  | %                    | n/a   |
| Group 2. Telecom Value-Added Services                                   | 42   | -   |                      | n/a   |
| Group 3. Products (Telecom & Gaming)                                    | 115  | -   |                      | n/a   |
| Group 4. Other Business   | 1,181  | 108   |                      | 994   |
| Total   | \$ 1,339   | \$ 108  | %                    | 1,140 |

## SHARE OF PROFIT OF ASSOCIATED COMPANIES

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

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

## INCOME TAXES

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



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

MINORITY INTERESTS

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

NET LOSS

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

| (in thousands of<br>US Dollars, except<br>percentages)                    | Group 1.<br>Outsourcing<br>Services<br>(\$) | Group 2.<br>Telecom<br>Value-Added<br>Services<br>(\$) | Group 3.<br>Products<br>&<br>Gaming)<br>(\$) | Group 4.<br>Other<br>Business<br>(\$) | For the<br>year<br>ended<br>December<br>31, 2007<br>(\$) | For the<br>year<br>ended<br>December<br>31, 2006<br>(\$) | Percentage<br>Change<br>(%) |
|---|---|--|--|---------------------------------------|--|--|-----------------------------|
| Operating profits<br>(Loss)   | (544)                                       | 737  | (6,133)                                      | (10,487)                              | (16,427)   | (7,435)  | 121                         |
| Interest income /<br>(expenses), net                                      | (6)   | 1  | (430)  | (387)                                 | (822)  | (896)  | (8)                         |
| Loss in change in<br>fair value of<br>warrants                            | -   | -  | -  | -                                     | -  | (214)  | (100)                       |
| Liquidated<br>damages   | -   | -  | -  | -                                     | -  | (3,817)  | (100)                       |
| Sundry income   | 1   | 42   | 115  | 1,181                                 | 1,339  | 108  | 1,140                       |
| Shares of earning<br>from investment<br>on equity method                  |   |  | (77)   |                                       | (77)   | 17   | (553)                       |
| Earnings before<br>Income Taxes,<br>Minority Interest<br>and Discontinued | (549)                                       | 780  | (6,525)                                      | ( 9,693)                              | ( 15,987)  | (12,237)   | 31                          |

Operations

CONTRACTUAL OBLIGATIONS

CONTRACTUAL OBLIGATIONS

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

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## Payments Due by Period

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

## OFF-BALANCE SHEET ARRANGEMENTS

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

## LIQUIDITY AND CAPITAL RESOURCES

## OVERVIEW

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

Significant components of cash flows from operations are as follows:

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

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

## WORKING CAPITAL

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

## ISSUANCE OF COMMON STOCK

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

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

## CAPITAL RESOURCES

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

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

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

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

EXHIBITS

The following exhibits are filed as part of this report:

EXHIBIT

NUMBER DESCRIPTION

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

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

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

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

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

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

10.18+ Tony Tong Employment Agreement

10.19+ Victor Tong Employment Agreement

10.20 Consulting Service Agreement with Daniel Howing Lui (14)

14 Code of Ethics (8)

21 List of Subsidiaries (Included in Exhibit 99.1)

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

+ Filed herewith.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

SIGNATURES

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

PACIFICNET INC.

Date: July 3, 2008      BY: /S/ TONY TONG  
 Tony Tong  
 Chief Executive Officer  
 (Principal Executive Officer)

Date: July 3, 2008      BY: /S/ PHILLIP WONG  
 Phillip Wong  
 Chief Financial Officer  
 (Principal Financial Officer)

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

| NAME                                   | TITLE                      | DATE         |
|--|----------------------------|--------------|
| /s/ TONY TONG<br>Tony Tong             | Director, Chairman and CEO | July 3, 2008 |
| /s/ VICTOR TONG<br>Victor Tong         | Director, President        | July 3, 2008 |
| /s/ PHILLIP WONG<br>Phillip Wong       | Chief Financial Officer    | July 3, 2008 |
| /s/ SHAO JIAN WANG<br>Shao Jian Wang   | Director                   | July 3, 2008 |
| /S/ SU GUO JING<br>Su Guo Jing         | Director                   | July 3, 2008 |
| /S/ TAO JIN<br>Tao Jin                 | Director                   | July 3, 2008 |
| /S/ JEREMY GOODWIN<br>Jeremy Goodwin   | Director                   | July 3, 2008 |
| /S/ STEPHEN CRYSTAL<br>Stephen Crystal | Director                   | July 3, 2008 |





INDEX TO EXHIBITS

EXHIBITS

EXHIBIT

NUMBER DESCRIPTION

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| 10.13   | Agreements of Consulting, Pledge, and Power of Attorney of Clickcom and Sunroom (11)  |
| 10.14   | Agreement for the Sale and Purchase of Shares in Lion Zone Holdings (12)  |
| 10.15   | Form of Lock-Up Agreement, dated March 13, 2006(5)  |
| 10.16   | Form of Voting Agreement, dated March 13, 2006(5)   |
| 10.17   |   |

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

- 10.18+ Tony Tong Employment Agreement
- 10.19+ Victor Tong Employment Agreement
- 10.20 Consulting Service Agreement with Daniel Howing Lui (14)
- 14 Code of Ethics (8)
- 21 List of Subsidiaries (Included in Exhibit 99.1)
- 99.1+ Corporate structure chart of our corporate and share ownership structure

+ Filed herewith.

- (1) Incorporated by reference to the Amendment to Registration Statement on Form S-3 on Form SB-2/A (Registration No. 333-113209) filed on April 21, 2004.
- (2) Incorporated by reference to the Registration Statement on Form S-3 filed on March 2, 2004
- (3) Incorporated by reference to the Form SB-2 Registration Statement filed on December 31, 2004.
- (4) Incorporated by reference to the Company's Form 8-K filed on March 6, 2006
- (5) Incorporated by reference to the Company's Form 10-KSB/A filed on November 3, 2006.
- (6) Incorporated by reference to the Company's Form SB-2 filed on October 21, 1998.
- (7) Incorporated by reference to the Company's 10-KSB filed on March 31, 2003.
- (8) Incorporated by referenced to the Company's Form 10-KSB filed on April 2, 2004.
- (9) Incorporated by reference to the Company's Form 8-K filed on April 19, 2004.
- (10) Incorporated by reference to the Company's Definitive Proxy Statement filed on October 26, 2006.
- (11) Incorporated by reference to the Company's Form 10-KSB filed on April 19, 2005.
- (12) Incorporated by reference to the Company's Form 8-K filed on December 20, 2005.
- (13) Incorporated by reference to the Company's Form 8-K filed on November 27, 2006.
- (14) Incorporated by reference to the Company's Form 8-K filed on February 23, 2007.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

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

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

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

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

/s/ KABANI & COMPANY, INC.

LOS ANGELES, CA  
April 28, 2008



## PACIFICNET INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

AS AT DECEMBER 31, 2007 AND 2006

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

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

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

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

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

|   | For The Years Ended December 31, |                  |                  |
|---|----------------------------------|------------------|------------------|
|   | 2007                             | 2006<br>Restated | 2005<br>Restated |
| Net Revenues  |                                  |                  |                  |
| Services  | \$ 4,466                         | \$ 5,720         | \$ 4,242         |
| Product sales   | 14,528                           | 23,353           | 2,839            |
| Total net revenue   | 18,994                           | 29,073           | 7,081            |
| Cost of Revenues  |                                  |                  |                  |
| Services  | 2,754                            | 3,562            | 3,160            |
| Product sales   | 12,538                           | 21,967           | 2,562            |
| Total cost of revenue   | 15,292                           | 25,529           | 5,722            |
| Gross Profit  | 3,702                            | 3,544            | 1,359            |
| Operating expenses:   |                                  |                  |                  |
| Selling, General and Administrative expenses                              | 13,480                           | 7,968            | 3,576            |
| Stock-based compensation expenses   | 51                               | 242              | 282              |
| Depreciation and amortization   | 752                              | 1,536            | 31               |
| Impairment of Goodwill  | 5,461                            | -                | 3,689            |
| Impairment of Investment  | 385                              | 1,233            | -                |
| Total Operating expenses  | 20,129                           | 10,979           | 7,578            |
| Loss from continued operations  | (16,427)                         | (7,435)          | (6,219)          |
| Other income (expenses):  |                                  |                  |                  |
| Interest income /(expense), net   | (822)                            | (896)            | 194              |
| Gain / (Loss) in change in fair value of derivatives                      | -                                | (214)            | -                |
| Liquidated damages expense  | -                                | (3,817)          | -                |
| Share of earnings from investment on equity method                        | (77)                             | 17               | 855              |
| Sundry income, net  | 1,339                            | 108              | 266              |
| Total other income (expense)  | 440                              | (4,803)          | 1,315            |
| Loss from continued operations before Income Taxes and Minority Interests | (15,987)                         | (12,238)         | (4,904)          |
| Provision for income taxes  | (7)                              | (18)             | (28)             |
| Minority Interests  | 37                               | (58)             | (1,203)          |
| Loss from continued operations  | (15,957)                         | (12,314)         | (6,135)          |
| Income / (Loss) from discontinued operations:                             |                                  |                  |                  |
| Net gain on disposal  | 2,181                            | -                | -                |
| Net loss on disposal  | -                                | 26               | -                |

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|   |             |             |            |
|---|-------------|-------------|------------|
| Income / (Loss) from discontinued operations        | (419)       | (127)       | 989        |
| Total income / (Loss) from discontinued operations  | 1,762       | (101)       | 989        |
| NET LOSS  | (14,195)    | (12,415)    | (5,145)    |
| Other comprehensive income (loss):                  |             |             |            |
| Foreign exchange gain (loss)                        | 242         | (27)        | 7          |
| Net comprehensive loss                              | \$ (13,953) | \$ (12,442) | \$ (5,138) |
| BASIC & DILUTED LOSS PER COMMON SHARE:              |             |             |            |
| Loss per share-Continued Operations                 | \$ (1.34)   | \$ (1.07)   | \$ (0.28)  |
| Loss per share-Discontinued Operations              | \$ 0.15     | \$ (0.01)   | \$ 0.07    |
| Basic & Diluted Loss Per Share                      | \$ (1.19)   | \$ (1.08)   | \$ (0.21)  |
| * Weighted average number of shares-Basic & Diluted | 11,895,525  | 11,538,664  | 21,695,473 |

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

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

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

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

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|  |            |      |            |          |       |      |          |           |       |            |
|--|------------|------|------------|----------|-------|------|----------|-----------|-------|------------|
| BALANCE AT<br>DECEMBER 31,<br>2005 - Restated                            | 10,809,562 | 1    | 61,980     | -        | -     | (15) | (38,627) | 1,191,125 | (134) | \$ 23,205  |
| Exercise of stock<br>options for cash and<br>receivable                  | 418,000    | -    | 834        | -        | -     | -    | -        | -         | -     | 834        |
| Issuance of common<br>stock for acquisition<br>of subsidiaries           | 618,112    | -    | 4,346      | -        | -     | -    | -        | 1,142,798 | -     | 4,346      |
| Cancellation of<br>common stock for<br>acquisition of<br>subsidiaries    | (275,000)  | \$ - | \$ (1,672) | \$ -     | \$ -  | \$ - | \$ -     | 275,000   | \$ -  | \$ (1,672) |
| Repurchase of<br>common shares -<br>Treasury shares                      | (29,472)   | -    | -          | -        | -     | -    | -        | 29,472    | (138) | (138)      |
| Foreign<br>currency translation<br>gain/(loss)                           | -          | -    | -          | -        | -     | (27) | -        | -         | -     | (27)       |
| Issuance of stock<br>options   | -          | -    | 242        | -        | -     | -    | -        | -         | -     | 242        |
| Issuance of warrants<br>for issuing fee of<br>convertible debts          | -          | -    | 28         | -        | -     | -    | -        | -         | -     | 28         |
| Stock subscription<br>receivable   | -          | -    | -          | -        | (377) | -    | -        | -         | -     | (377)      |
| Goodwill opening<br>balance adjust                                       | -          | -    | -          | -        | -     | -    | (48)     | -         | -     | (48)       |
| Net income/(loss)  | -          | -    | -          | -        | -     | -    | (12,415) | -         | -     | (12,415)   |
| BALANCE AT<br>DECEMBER 31,<br>2006 - Restated                            | 11,541,202 | 1    | 65,758     | -        | (377) | (42) | (51,090) | 2,614,395 | (272) | 13,978     |
| Cumulative effect of<br>change in accounting<br>principle                | -          | -    | 690        | -        | -     | -    | 213      | -         | -     | 903        |
| Issuance of common<br>stock for repayment<br>of convertible<br>debenture | 199,444    | -    | 1,091      | -        | -     | -    | -        | -         | -     | 1,091      |
| Sale of treasury<br>shares   | 41,426     | -    | 155        | -        | -     | -    | -        | (41,426)  | 127   | 282        |
| Issuance of common<br>stock in escrow -<br>restricted                    | 2,330,000  | -    | 10,974     | (10,974) | -     | -    | -        | -         | -     | -          |
| Exercise of stock<br>options for cash                                    | 202,000    | -    | 406        | -        | -     | -    | -        | -         | -     | 406        |
| Stock option expense   | -          | -    | 51         | -        | -     | -    | -        | -         | -     | 51         |
| Foreign<br>currency translation<br>gain/(loss)                           | -          | -    | -          | -        | -     | 242  | -        | -         | -     | 242        |
|  | -          | -    | -          | -        | 32    | -    | -        | -         | -     | 32         |

|                                  |            |      |           |             |       |        |             |           |          |          |  |
|----------------------------------|------------|------|-----------|-------------|-------|--------|-------------|-----------|----------|----------|--|
| Stock subscription<br>receivable |            |      |           |             |       |        |             |           |          |          |  |
| Net loss                         | -          | -    | -         | -           | -     | -      | (14,195)    | -         | -        | (14,195) |  |
| <b>BALANCE AT</b>                |            |      |           |             |       |        |             |           |          |          |  |
| December 31, 2007                | 14,314,072 | \$ 1 | \$ 79,125 | \$ (10,974) | (345) | \$ 200 | \$ (65,070) | 2,572,969 | \$ (145) | \$ 2,792 |  |

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

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

|  | For The Years Ended December 31, |                  |                  |
|--|----------------------------------|------------------|------------------|
|  | 2007                             | 2006<br>Restated | 2005<br>Restated |
| Cash Flows from operating activities   |                                  |                  |                  |
| Net Loss   | \$ (14,195)                      | \$ (12,415)      | \$ (5,145)       |
| Adjustment to reconcile net loss to net cash provided by (used in) operating activities: |                                  |                  |                  |
| Provision for allowance for doubtful accounts  | 5,319                            | 4,537            | 2,739            |
| Minority Interest  | (37)                             | 58               | 1,203            |
| Depreciation and amortization  | 752                              | 1,536            | 31               |
| Share of earnings from investment on equity method                                       | 77                               | (17)             | (855)            |
| Goodwill impairment  | 5,461                            | -                | 3,689            |
| Investment impairment  | 385                              | 1,233            | -                |
| Stock-based compensation   | 51                               | 242              | 282              |
| Issuance of shares for services  | -                                | -                | 63               |
| Change in fair value of derivatives  | -                                | 214              | -                |
| Amortization of interest discount  | -                                | 690              | -                |
| Liquidated damages expense   | -                                | 3,817            | -                |
| Changes in current assets & liabilities net of effects from purchase of subsidiaries:    |                                  |                  |                  |
| Accounts receivable and other current assets   | 1,544                            | (7,098)          | (297)            |
| Inventories  | (505)                            | 2                | (55)             |
| Accounts payable and other accrued expenses  | 1,345                            | (2,202)          | 3,526            |
| Net cash provided by (used in) operating activities of continued operations              | 197                              | (9,403)          | 5,182            |
| Net cash provided by (used in) operating activities of discontinued operations           | (1,276)                          | 28               | (988)            |
| Net cash provided by (used in) operating activities                                      | (1,079)                          | (9,375)          | 4,193            |
| Cash flows from investing activities:  |                                  |                  |                  |
| Increase in restricted cash  | -                                | (71)             | -                |
| Increase in purchase of marketable securities  | (529)                            | (19)             | 11               |
| Acquisition of property and equipment  | (1,033)                          | (2,608)          | (2,966)          |
| Acquisition of subsidiaries and affiliated companies                                     | -                                | (667)            | (3,958)          |
| Repurchase of treasury shares  | 282                              | (138)            | (15)             |
| Net cash used in investing activities of continued operations                            | (1,280)                          | (3,503)          | (6,928)          |
| Net cash provided by (used in) investing activities of discontinued operations           | 1,801                            | 1,408            | (2,678)          |
| Net cash provided by (used in) investing activities                                      | 521                              | (2,095)          | (9,606)          |
| Cash flows from financing activities:  |                                  |                  |                  |
| Loans receivable from third parties  | (237)                            | 934              | (1,024)          |

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

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

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

1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

NATURE OF OPERATIONS

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

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION AND BASIS OF PRESENTATION

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

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

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





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

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

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

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

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

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

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

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

acquisition.

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

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

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

## BUSINESS COMBINATIONS

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

## GOODWILL AND PURCHASED INTANGIBLE ASSETS

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

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

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

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

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

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

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

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

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

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

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

#### IMPAIRMENT OF LONG-LIVED ASSETS

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

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

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

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

#### INVESTMENTS IN AFFILIATED COMPANIES

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

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

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

#### COMPREHENSIVE INCOME (LOSS)

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

#### REVENUE RECOGNITION

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



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

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

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

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

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

#### ALLOWANCE FOR DOUBTFUL ACCOUNTS

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

#### PROPERTY AND EQUIPMENT

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

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

## INVENTORIES

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

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## INCOME TAXES

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

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

## RESEARCH AND DEVELOPMENT COSTS AND CAPITALIZED SOFTWARE COSTS

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

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

## STOCK-BASED COMPENSATION PLANS

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

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

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

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



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

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

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

#### ADVERTISING EXPENSES

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

#### CASH EQUIVALENTS

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

#### RELATED PARTY TRANSACTIONS

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

#### RECLASSIFICATION

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

#### FAIR VALUE OF FINANCIAL INSTRUMENTS

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

CONCENTRATION OF CREDIT RISK

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

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

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## SIGNIFICANT RELATIONSHIPS

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

## MARKETABLE EQUITY SECURITIES

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

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

## FOREIGN CURRENCY

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

## SEGMENT INFORMATION

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

## GOING CONCERN



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

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

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

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

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

On December 18, 2007, the Company entered into a definitive agreement to sell its 36% equity interest in PacificNet Clickcom Limited ("Clickcom") (See Note 14).

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

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

## RECENT PRONOUNCEMENTS

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

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

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

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

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

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

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

## 2. BUSINESS ACQUISITIONS

### TAKE 1 TECHNOLOGIES GROUP LIMITED

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

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

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

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

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

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

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

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

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

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

### 3. EARNINGS PER SHARE (EPS)

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

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

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

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

4. INVESTMENT IN AFFILIATED COMPANIES

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

Under Cost Method:

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

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

Under Equity Method:

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

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

## 5. PROPERTY AND EQUIPMENT, NET

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

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

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

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



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

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

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

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

## 6. OTHER CURRENT ASSETS

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

| (USD ' 000s)                           | 2007    | 2006<br>Restated |
|--|---------|------------------|
| Prepayment to suppliers                | \$ 346  | \$ 886           |
| Deposit                                | 237     | -                |
| Receivable from Lion Zone Holdings Ltd | -       | 485              |
| Loans to employees                     | 273     | 412              |
| Prepaid expenses                       | 129     | 347              |
| loan to Golden Charpel                 | 517     | -                |
| Others receivable                      | 525     | 361              |
| WeiDa for disposal Linkhead            | 150     | -                |
| Loan to Webplus                        | 237     | -                |
| loan to Mou Yi Liang                   | 244     | -                |
| loan to Bell-Pact Shanghai JV          | 102     | -                |
| loan to UASIT                          | 96      | -                |
| Advances to sales reps                 | -       | 228              |
| Provision for doubtful account         | (2,448) | -                |
| Total                                  | \$ 408  | \$ 2,719         |

## 7. BANK LOANS

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

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

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

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

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

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

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

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

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## 8. ACCRUED EXPENSES

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

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

## 9. STOCKHOLDERS' EQUITY

## a) COMMON STOCK

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

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

## b) STOCK OPTION PLAN

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

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

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

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

Following is a summary of the status of options outstanding at December 31, 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 |
|------------|---------------------------|---------------------------|---|---------------------------------------|--------------------|---------------------------------|
| 2007-8-13  | 33,000                    | \$0                       | 5.62                                    | \$4.31                                | -                  | \$4.31                          |

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

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

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

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

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

The information is as below:

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

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

#### c) WARRANTS

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



Following is a summary of the warrant activity:

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

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

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

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

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

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

#### d) TREASURY STOCK

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

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



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

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

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## 10. CONVERTIBLE DEBENTURES

### 10.1 Eight Million Convertible Debentures

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

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

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

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

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

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

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

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

#### EVENT OF DEFAULT

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

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

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

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

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

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

Following is the summary of convertible debenture:

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

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

## 10.2 Five Million Convertible Note

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

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

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

Following is the summary of convertible debenture:

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

## 11. INCOME TAXES

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

The components of income before income taxes are as follows:

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

### United States of America

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



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

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

#### Hong Kong

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

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

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

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

## 12. RELATED PARTY TRANSACTIONS

### LOAN DUE TO AND FROM RELATED PARTIES

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

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

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

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





#### LOAN TO POWER

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

#### LOAN TO MOABC

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

#### LOAN TO LINKHEAD

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

#### LOAN TO PACIFICNET AD

PACIFICNET AD is an affiliated company, 19% owned by PacificNet as of December 31, 2007. A convertible loan of \$15,000 is outstanding from AD and is received on March 2008.

#### LOAN TO PACIFICNET SOLUTION LIMITED (PacSo-HK)

PacSo-HK is an affiliated company, 15% owned by PacificNet, as of December 31, 2007. A convertible loan of \$150,000 is outstanding from PactSo-HK. The maturity date of loan was January 6 2007. The loan is currently due on demand, non-interest bearing and unsecured.

#### LOAN TO VICTOR CHOI SHAREHOLDER

As of December 31, 2007, there was a loan outstanding of \$115,000 receivable from the shareholder of Victor Choi. This loan is secured by 30,000 PacificNet shares. The maturity date of loan was August 31, 2007. The loan is currently due on demand and non-interest bearing.

#### LOAN TO SOLUTECK'S DIRECTOR

As of December 31, 2007, there was a loan outstanding of \$64,000 receivable from a director of Soluteck, due on January 17 for three consecutive years ending 2008. The interest rate for the loan is 8% per annum plus 5% penalty interest in case it has not been timely paid. The loan is collateralized with 100,000 PacificNet's shares owned by the borrowing director and Ms Iris Lo, and the remaining assets of Smartime Holding Ltd.

## LOAN PAYABLE TO RELATED PARTY

As of December 31, 2007, there was no outstanding loan payable to related parties.

As of December 31, 2006, a loan of \$282,000 was payable to a shareholder of Smartime. The loan was advanced to Smartime for working capital purposes.

## 13. SEGMENT INFORMATION

SFAS No. 131, DISCLOSURE ABOUT SEGMENTS OF AN ENTERPRISE AND RELATED INFORMATION ("SFAS 131"), establishes standards for reporting information about operating segments and for related disclosures about products, services and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision-maker, or decision-making group, in making decisions regarding allocation of resources and assessing performance. PacificNet's chief decision-makers, as defined under SFAS 131, are the Chief Executive Officer and Chairman. During 2007 and 2006, PacificNet had four operating segments.

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

| For the year ended<br>December 31, 2007<br>(in thousands of US<br>Dollars, except<br>percentages) | Group 1.<br>Outsourcing<br>Services | Group 2.<br>Telecom<br>Value-Added<br>Services | Group 3.<br>Products<br>(Telecom &<br>Gaming) | Group 4.<br>Other<br>Business | Total            |
|---|-------------------------------------|--|---|-------------------------------|------------------|
|   | (\$)                                | (\$)   | (\$)  | (\$)                          | (\$)             |
| Revenues  | 2,310                               | 1,839  | 14,528  | 317                           | 18,994           |
| (% of Total Revenues)   | 12%                                 | 10%  | 76%   | 2%                            | 100%             |
| Earnings / (Loss) from<br>Operations  | (544)                               | 737  | (6,133)                                       | (10,487)                      | (16,427)         |
| (% of Total Profit)   | 3%                                  | (4)%   | 37%   | 64%                           | 100%             |
| Total Assets  | 1,490                               | 2,516  | 16,512  | 4,202                         | 24,720           |
| (% of Total Assets)   | 6%                                  | 10%  | 67%   | 17%                           | 100%             |
| Goodwill  | -                                   | 461  | 409   | -                             | 870              |
| Geographic Area   | HK,PRC                              | HK, PRC  | HK,PRC,Macau                                  | HK,PRC                        |                  |
| For the year ended<br>December 31, 2006<br>(in thousands of US<br>Dollars, except<br>percentages) | Group 1.<br>Outsourcing<br>Services | Group 2.<br>Telecom<br>Value-Added<br>Services | Group 3.<br>Products<br>(Telecom &<br>Gaming) | Group 4.<br>Other<br>Business | Total            |
|   | Restated<br>(\$)                    | Restated<br>(\$)                               | Restated<br>(\$)                              | Restated<br>(\$)              | Restated<br>(\$) |
| Revenues  | 1,813                               | 2,784  | 23,385  | 1,091                         | 29,073           |
| (% of Total Revenues)   | 6%                                  | 10%  | 80%   | 4%                            | 100%             |
|   | (67)                                | (1,054)  | (1,345)                                       | (4,969)                       | (7,435)          |

Earnings / (Loss) from  
Operations

|                     |        |         |              |        |        |
|---------------------|--------|---------|--------------|--------|--------|
| (% of Total Profit) | 1%     | 14%     | 18%          | 67%    | 100%   |
| Total Assets        | 3,413  | 12,673  | (1,570)      | 18,155 | 32,671 |
| (% of Total Assets) | 10%    | 39%     | (5)%         | 56%    | 100%   |
| Goodwill            | 3,964  | 461     | 1,176        | -      | 5,601  |
| Geographic Area     | HK,PRC | HK, PRC | HK,PRC,Macau | HK,PRC |        |

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

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

(2) Telecom Value-Added Services (VAS) - Our subsidiary, Guangzhou Wanrong Information Technology Co., Ltd. ("Guangzhou Wanrong"), is one of the leading value-added telecom service providers in China. Since its inception in 2003, Guangzhou Wanrong has achieved strong growth in its VAS including SMS, WAP, JAVA, MMS, IVR, multimedia entertainment download services, media interactive products, mobile email services, life, sports, entertainment, and business information services.

(3) Product (Telecom & Gaming) Services Group - involves communication and gaming products, GSM/CDMA/3G Products, Multimedia Communication Kiosks. This Group includes the following subsidiaries: PacificNet Communications Limited, iMobile, Take1 and PacificNet Games. PacificNet Games Limited (PactGames) is a leading developer of Asian electronic gaming machines, multi-player electronic gaming technology solutions and gaming related maintenance, IT, and distribution services for the leading hotel and casino operators based in the Macau and other Asian gaming markets. Take1 Technologies (Take 1), is in the business of designing and manufacturing electronic multimedia entertainment kiosks, coin-op kiosks and machines, Electronic Gaming Machines (EGM), bingo and slot machines, AWP (Amusements With Prizes) games, server-based downloadable games systems, and Video Lottery Terminals (VLT) such as Keno and Bingo machines, including hardware, software, and cabinets.

(4) Other Business - other administrative, financial and investment services and non-core businesses.

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

|                                      | Hong Kong | PRC      | Macau    | United States | Total     |
|--------------------------------------|-----------|----------|----------|---------------|-----------|
| For the year ended December 31, 2007 |           |          |          |               |           |
| Product revenues                     | \$ 5,447  | \$ 6,770 | \$ 2,311 | \$ -          | \$ 14,528 |
| Service revenues                     | \$ 261    | \$ 4,205 | \$ -     | \$ -          | \$ 4,466  |

|                                      | Hong Kong | PRC      | Macau  | United States | Total     |
|--------------------------------------|-----------|----------|--------|---------------|-----------|
| For the year ended December 31, 2006 |           |          |        |               |           |
| Product revenues                     | \$ 17,071 | \$ 7,147 | \$ 364 | \$ -          | \$ 24,582 |
| Service revenues                     | \$ 1,228  | \$ 3,263 | \$ -   | \$ -          | \$ 4,491  |

#### 14. NET ASSETS HELD FOR DISPOSITION

Sale of Interest in Linkhead Technology Beijing Limited. ("Linkhead") and PacificNet Telecom Solutions Inc. ("PactTelso")

On May 20, 2007, the Company entered into a definitive agreement to sell its 36% equity interest in Linkhead, a PRC limited liability corporation engaged in the business of resale of VAS, IVR, NMS hardware and software platforms in China, to Mr. Mu Yingliang, a resident of People's Republic of China.

On May 20, 2007, the Company entered into a definitive agreement to sell its 36% equity interest in PactTelso, an intermediate holding company registered under the laws of British Virgin Islands, to Mr. Mu Yingliang, a resident of

People's Republic of China.

Consideration for the 36% interest of Linkhead and PactTelso was US\$500,000, to be paid in three installments. The Company's interest in Linkhead and PactTelso was decreased from 51% to 15% after the transaction. Absent any explicit closing conditions contained in the said agreement, the disposal was completed upon title transfer during the third quarter of 2007.

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Sale of Interest in PacificNet Solutions Limited ("PacSo-HK")

On May 18, 2007, the Company entered into a definitive agreement to sell its 45% equity interest in PacSo-HK, a company registered under the laws of Hong Kong SAR, China and engaged in systems integration, software application, and e-business solutions services, to Mr. Alex Au, a resident of Hong Kong SAR, China. Consideration for the 45% interest of PacSo-HK was HK\$4,500 (or US\$577), to be paid within 90 days after signing of the agreement. The Company's interest in PacSo-HK decreased from 60% to 15% after the transaction. Absent any explicit closing conditions contained in the said agreement, the disposal was completed upon title transfer during the third quarter of 2007.

Sale of Interest in PacificNet Power Limited ("PactPower")

On May 18, 2007, the Company entered into a definitive agreement to sell its 36% equity interest in PactPower, a company registered under the laws of Hong Kong SAR, China and engaged in power and energy saving contracting and consulting businesses, to Mr. Alex Au, a resident of Hong Kong SAR, China. Consideration for the 36% interest of PactPower was HK\$3,600 (or US\$462), to be paid within 90 days after signing of the agreement. The Company's interest in PactPower decreased from 51% to 15% after the transaction. Absent any explicit closing conditions contained in the said agreement, the disposal was completed upon title transfer during the third quarter of 2007.

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

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

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

On December 18, 2007, the Company entered into a definitive agreement to sell its 36% equity interest in PacificNet Clickcom Limited. ("Clickcom"), a leading Value-Added Services (VAS) company in China, to Mr. Ou Zhenbin, a Chinese resident. Consideration for the 36% interest of Clickcom was RMB10,000 (or US\$1,314), to be paid in cash within 90 days after the agreement signing. The Company's interest in Clickcom decreased from 51% to 15% after the transaction.

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

On April 30, 2007, through our wholly-owned subsidiary, PacificNet Strategic Investment Holdings Limited ("PSI Holdings"), we entered into a stock purchase and sale agreement with Heyspace International Limited to sell PSI Holdings' 51% interest in Guangzhou 3G's parent company, Pacific 3G Information & Technology Co. Limited. The purchase price is \$6,000,000 payable in installments over a six month period or earlier if Heyspace completes its initial public offering prior to October 31, 2007. Heyspace paid an initial purchase price of \$1,000,000 and the remaining balance to be paid by October 2007. Due to non payment of the remaining balance by Heyspace as per the agreement, the Company on November 25, 2007 entered into a memorandum of understanding ("MOU") with Heyspace. Pursuant to the MOU, we agreed with Heyspace that for a period commencing on November 25, 2007 through March 31, 2008, we are free to seek new buyers to purchase PSI Holdings' share ownership in Guangzhou 3G at a consideration and term which at a minimum will not cause any disposal loss to us. As at December 31, 2007, Heyspace owns Pacific 3G.





## Sale of Interest in PacificNet Epro Holdings Limited ("Epro")

On April 18, 2008, PacificNet, consummated the sale of the Company's subsidiary, PacificNet Epro Holdings Limited, a company incorporated in the Hong Kong Special Administrative Region of the PRC ("Epro"), which is primarily engaged in the business of providing call center telecom and customer relationship management services as well as other business outsourcing services in China. Pursuant to the terms of the Sales and Purchase Agreement (the "Agreement") entered into between the Company and Epro Group International Limited (the "Epro Group International"), PacificNet sold its entire share ownership of 7,766,993 shares in Epro for HK\$21 million. Upon execution of the Agreement, the Company received a payment of HK\$3 million. PacificNet shall receive the remaining purchase price in installments over the next twenty-four months. Pursuant to the terms of the Agreement, within sixty days of the closing, Epro shall repay PacificNet HK\$2 million for an interest bearing loan granted from PacificNet to Epro. As at December 31, 2007, PacificNet Epro Holdings is classified under 'Net Assets Held for Disposal' in the accompanying financial statements.

Information relating to the operations of the subsidiaries up to the periods of disposal/held for disposal during the year ended December 31, 2007 is as follows (in thousands of US Dollars)

| 2007 (In US\$ thousands)                             | Linkhead +PacTelso (\$) | Clickcom (\$) | Power (\$) | Solutions (\$) | 3G (\$) | EPRO (\$) | AD (\$) | Total (\$) |
|--|-------------------------|---------------|------------|----------------|---------|-----------|---------|------------|
| Income (loss) from discontinued operations           | (84)                    | (60)          | (478)      | (10)           | (228)   | 491       | (50)    | ( 419)     |
| Gain on disposal                                     | 244                     | 60            | 1,274      | 218            | 333     | -         | 53      | 2,181      |
| Net assets held for disposition (remaining interest) | -                       | -             | -          | -              | -       | 2,692     | -       | 2,692      |

## 15. LEGAL PROCEEDINGS

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

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

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

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

On February 13, 2007, the board instructed the Hong Kong legal counsel to issue a Defense and Counterclaim to JCHKL to counter-claim that ( i ) JCHKL's construction work has not complied with the applicable rules and

regulations of various government authorities in Hong Kong; (ii) the Chiller System provided by JCHKL was defective and merchantable unfit and JCHKL has failed and/or refused to rectify such defective works; and (iii) JCHKL shall return the work deposit in the amount of HK\$1,500,000 to PacificNet Power Limited and shall compensate and keep PacificNet Power Limited indemnified against all the loss and damages suffered as a result of any claims from the China Weal Property Management Ltd..

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

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

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

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

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

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

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

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

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

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

On September 20, 2007, PacificNet Inc. filed a claim against its former auditors HLB Hodgson Impey Cheng (HLB), a firm of Chartered Accountants and Certified Public Accountants, in the High Court of the Hong Kong Special Administrative Region seeking refund of the professional fees, compensation of professional fees and expenses for Company to engage and deploy new auditors to take over the incomplete audit works from the Defendant and

returning and/or providing all relevant accounting records, vouchers, audit program and working papers retained by the Defendant and losses and damages incurred.

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

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

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

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

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

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

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

#### 16. CURRENT VULNERABILITY DUE TO CERTAIN CONCENTRATIONS

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

#### 17. EVENTS SUBSEQUENT TO DECEMBER 31, 2007

##### 1) STATUS OF ACQUISITION OF OCTAVIAN INTERNATIONAL LIMITED ("OCTAVIAN")

On January 22 2008, PacificNet Inc. (NASDAQ:PACT) (the "Company" or "PacificNet"), announced the acquisition of Octavian International Limited ("Octavian"), a worldwide supplier of gaming technology, solutions and systems. The Company had previously reported on a Form 8-K filed with the Securities and Exchange Commission on December 13, 2007, the execution of definitive agreements, including that certain Agreement among, PacificNet Games International Corporation, Octavian, Emperor Holdings Limited, Ziria Enterprises Limited and the Company on December 7, 2007, for the acquisition of 100% of Octavian (the "Agreement"). PacificNet, through its wholly-owned subsidiary, Pacificnet Games International Corporation, signed an agreement to acquire from Ziria Enterprises Limited, a company incorporated in Cyprus (the "Seller"), 100% of the issued and outstanding shares (the "Shares") of Emperor Holdings Limited, a company incorporated in Cyprus (the "Holding Company"), which is the parent company of Octavian.

Up to April 14, 2008, Ziria Enterprises Limited did not deliver to PacificNet the share certificates of Emperor Holdings Limited, the legal owner of Octavian International Limited. As a result of Ziria's failure to deliver the share certificates, which was a condition to closing the acquisition of Octavian, on May 21, 2008, the Company, Ziria, PacificNet Games International Corporation, Octavian and Emperor Holdings Limited terminated the agreement to

acquire Octavian. Under the acquisition agreement, if the transaction had been consummated, PacificNet was obligated to issue, in the aggregate, 2,330,000 restricted shares of PACT representing approximately 19.5% of PacificNet's outstanding shares and cash of up to \$18,900,000, which would have been paid upon the completion of certain net profit performance targets.

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All parties involved have agreed not to complete the merger but will remain distribution partners of complimentary products in each others respective markets.

As a result of the failure of the Octavian acquisition to be consummated and the termination of the acquisition agreement, on May 21, 2008, Mr. Harmen Brenninkmeijer, Chief Executive Officer of Octavian, resigned as a member of the Board of Directors of PacificNet. It was a condition to the closing of the acquisition of Octavian that Mr. Brenninkmeijer was appointed to the Board of Directors. There was no disagreement between Mr. Brenninkmeijer and PacificNet on any matter relating to PacificNet's operations, policies or practices.

## 2) SALE OF INTEREST IN EPRO. ("EPRO")

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

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

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

## 3) SALE OF GUANGZHOU 3G

PacificNet and Heyspace entered into a Supplement Agreement for 3G's deal on 20th March, 2008. According to this supplement agreement, PacificNet will apply \$500,000 received as of December 31, 2007 against the 5% ownership interest and the remaining \$500,000 will be served as a collateral along with the transfer of the share certificates of 46% shares to PacificNet from Heyspace. If Heyspace fails to pay the remaining USD\$5,000,000 on or before 31 March, 2009, PacificNet has right to reclaim for the unpaid 46% shares of Pacific 3G Information & Technology Co., Limited, and demand for an annual interest rate of 12% (See note 14 for details). As at December 31, 2007, Company has made a provision of \$3.5 million against receivable from Heyspace and the net amount is included under other receivables in the accompanied financial statements.