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PACIFICNET INC
Form 10QSB
May 04, 2004

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

FORM 10-QSB

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2004

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

COMMISSION FILE NUMBER: 000-24985

PACIFICNET INC.

(Exact name of small business issuer in its charter)

DELAWARE

91-2118007

(State or other jurisdiction of
incorporation or organization)

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

UNIT 2710, HONG KONG PLAZA, 188 CONNAUGHT ROAD WEST,
HONG KONG

N/A
(Zip Code)

(Address of principal executive offices)

REGISTRANT'S TELEPHONE NUMBER: 011-852-2876-2900

PACIFICNET.COM INC., 7808 CREEKRIDGE CIRCLE, SUITE 101 BLOOMINGTON, MN 55439

(Former Name and Address)

Check whether the issuer (1) has filed all reports required to be filed by
Section 13 or 15(d) of the Securities Exchange Act of 1934 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 / /

There were 6,813,262 shares of the Company's common stock outstanding on April
30, 2004.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
PACIFICNET INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

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

| | MARCH 31, 2004 | DECEMBER 31, 2003 (AUDITED) |
|--|-------------------|-----------------------------------|
| | ----- | ----- |
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 4,124 | \$ 3,820 |
| Restricted cash - pledged bank deposit | 212 | 212 |
| Accounts Receivables (net of allowance for doubtful accounts of \$0 as of March 31, 2004 and \$0 as of December 31, 2003) | 3,224 | 1,897 |
| Inventories | 656 | 77 |
| Other Current Assets | 1,242 | 283 |
| | ----- | ----- |
| Total Current Assets | 9,458 | 6,289 |
| Property and Equipment, net | 527 | 462 |
| Goodwill | 3,930 | 422 |
| | ----- | ----- |
| TOTAL ASSETS | \$ 13,915 | \$ 7,173 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities: | | |
| Bank Line of Credit | \$ 143 | \$ 1,190 |
| Bank Loans-current portion | 1,338 | 1,400 |
| Capital Lease Obligations - current portion | 108 | 150 |
| Accounts Payable | 1,648 | 1,000 |
| Accrued Expenses | 527 | 360 |
| Subscription Payable | -- | 72 |
| | ----- | ----- |
| Total Current Liabilities | 3,764 | 4,842 |
| | ----- | ----- |

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| | | |
|--|-----------|---------|
| Long-term liabilities: | | |
| Bank Loans - non current portion | 379 | 37 |
| Capital Lease Obligations - non current portion | 147 | 14 |
| | ----- | ----- |
| Total Long-Term Liabilities | 526 | 52 |
| | ----- | ----- |
| Minority Interests in Consolidated Subsidiaries | 699 | (11) |
| Commitments and Contingencies | | |
| Stockholders' Equity: | | |
| Preferred stock, par value \$0.0001, Authorized - 5,000,000 shares | | |
| Issued and outstanding - none | -- | -- |
| Common Stock, par value \$0.0001, Authorized - 125,000,000 shares | | |
| Issued and outstanding: | | |
| March 31, 2004 - 8,363,262 issues; 6,813,262 outstanding | | |
| December 31, 2003 - 6,163,977 issued; 5,363,977 outstanding | 1 | |
| Treasury Stock, at cost (800,000 shares) | (5) | (|
| Additional Paid-In Capital | 38,663 | 31,79 |
| Cumulative Other Comprehensive Loss | (24) | (2 |
| Accumulated Deficit | (29,709) | (29,85 |
| | ----- | ----- |
| Total Stockholders' Equity | 8,926 | 1,91 |
| | ----- | ----- |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 13,915 | \$ 7,17 |
| | ===== | ===== |

See condensed notes to consolidated financial statements.

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PACIFICNET INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited. In thousands of United States dollars, except profit/(loss) per share and share amounts)

| | THREE MONTHS ENDED MARCH 31, | |
|--|------------------------------|-------|
| | 2004 | 2003 |
| | ----- | ----- |
| Revenues | \$ 3,502 | \$ 97 |
| | ----- | ----- |
| Cost of Revenues | (2,253) | (36) |
| | ----- | ----- |
| Gross Margin | 1,249 | 61 |
| | | |
| Selling, General and Administrative expenses | (777) | (419) |
| Depreciation and amortization | (67) | (1) |
| Provision for written off of fixed assets | -- | (91) |
| | ----- | ----- |
| PROFIT/(LOSS) FROM OPERATIONS | 405 | (450) |
| | | |
| Interest Income | 3 | 7 |
| Sundry income | 61 | -- |

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| | | |
|---|-----------|-----------|
| PROFIT/(LOSS) BEFORE INCOME TAXES, MINORITY INTEREST AND DISCONTINUED OPERATIONS | 469 | (443) |
| Provision for income taxes | -- | -- |
| Minority Interests | (328) | 14 |
| PROFIT/(LOSS) BEFORE DISCONTINUED OPERATIONS | 141 | (429) |
| LOSS FROM DISCONTINUED OPERATIONS | -- | (185) |
| NET PROFIT/(LOSS) AVAILABLE TO COMMON STOCKHOLDERS | \$ 141 | \$ (614) |
| BASIC AND DILUTED PROFIT/(LOSS) PER COMMON SHARE: | | |
| Profit/(Loss) from continuing operations | \$ 0.02 | \$ (0.09) |
| Profit/(Loss) from discontinued operations | -- | \$ (0.03) |
| Net Profit/(Loss) | \$ 0.02 | \$ (0.12) |
| BASIC AND DILUTED WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING | 6,642,095 | 4,976,092 |

See condensed notes to consolidated financial statements.

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

| | THREE MONTHS ENDED MARCH 31, | |
|--|------------------------------|----------|
| | 2004 | 2003 |
| | ----- | ----- |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net profit/(loss) | \$ 141 | \$ (614) |
| Adjustment to reconcile net profit/(loss) to net cash used in operating activities: | | |
| Expenses settled by issuance of warrants | -- | 15 |
| Expenses settled by issuance of common shares | -- | 12 |
| Provision for written off of fixed assets | -- | 91 |
| Loss from discontinued operations | -- | 185 |
| Allowance for doubtful accounts | -- | 201 |
| Minority Interest | 809 | (13) |
| Depreciation and amortization | 67 | 1 |
| Accounts receivable and other current assets | (2,285) | (144) |
| Inventories | (580) | -- |
| Accounts payable and accrued expenses | 808 | (90) |
| Net cash used in operating activities | (1,040) | (356) |
| CASH FLOWS FROM INVESTMENT ACTIVITIES | | |
| Acquisition of property and equipment | (128) | -- |
| Acquisition of subsidiaries | (232) | -- |

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| | | |
|---|----------|----------|
| Net cash used in investing activities | (360) | -- |
| CASH FLOWS PROVIDED BY FINANCING ACTIVITIES: | | |
| (Repayments)/advances under bank line of credit | (1,056) | 238 |
| Repayment of amount borrowed under bank loans and capital lease obligations | (1,756) | -- |
| Proceeds from sale of common stock | 2,813 | -- |
| Proceeds from exercise of stock options | 55 | 110 |
| Advances under bank loans | 1,645 | -- |
| Net cash provided by financing activities | 1,701 | 348 |
| NET INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS | 301 | (8) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 3,823 | 3,694 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$ 4,124 | \$ 3,686 |
| CASH PAID FOR: | | |
| Interest | 59 | 9 |
| Income taxes | -- | -- |
| NONCASH INVESTING AND FINANCING ACTIVITIES: | | |
| Investment in subsidiaries acquired through issuance of common stock | \$ 4,000 | \$ -- |
| Common stock issued to satisfy certain liabilities and to settle expenses | \$ -- | \$ 27 |
| Common stock issued as a result of exercise of stock options | \$ 5 | \$ -- |

See condensed notes to consolidated financial statements.

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

1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-QSB. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows for all periods presented have been made. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns and impairment losses, accounting for income taxes, bad debts, and property, plant and equipment lives for depreciation purposes. Actual results may differ from these estimates. The results of operations for the three-month period ended March 31, 2004 are not necessarily indicative of the operating results that may be expected for the entire year ending December 31, 2004. These financial statements should be read in conjunction with the Management's

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Discussion and Analysis and financial statements and notes thereto included in the Company's financial statements and accompanying notes thereto as of and for the year ended December 31, 2003, filed with the Company's Annual Report on Form 10-KSB.

2. EARNINGS (LOSS) PER SHARE

Basic earnings (loss) per share are based on the weighted average number of shares of common stock outstanding. Diluted earnings or loss per share is based on the weighted average number of shares of common stock outstanding and dilutive common stock equivalents. All earnings per share amounts in these financial statements are basic earnings (loss) per share as defined by SFAS No. 128, "Earnings Per Share." Diluted weighted average shares outstanding exclude the potential issuances of common stock upon exercise of options and warrants because to do so would be antidilutive.

The computation of basic and diluted profit/(loss) per share is as follows:

(IN THOUSANDS OF UNITED STATES DOLLARS, EXCEPT WEIGHTED SHARES AND PER SHARE AMOUNTS)

| | THREE MONTHS ENDED | |
|--|--------------------|-------------------|
| | MARCH 31, 2004 | MARCH 31, 2003 |
| Numerator-net profit /(loss) | \$ 141 | \$ (614) |
| Denominator-weighted average number of shares of common stock outstanding | 6,642,095 | 4,976,092 |
| Basic and diluted profit/(loss) per share | \$ 0.02 | \$ (0.12) |

3. BUSINESS DISPOSITIONS

In May 2003, the Company decided not to further invest in the Customer Service Support Center in the U.S. As of March 31, 2003, all activities have significantly slowed down due to the economic slowdown in the U.S. During the quarter ended March 31, 2003, the Company wrote off property and equipment of \$150,000. Revenues and net loss information related to Customer Service Support Center operations are as follows (in thousands):

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| | THREE MONTHS ENDED | |
|----------|----------------------------------|--------------------------------|
| | MARCH 31, 2004 (UNAUDITED) | MARCH 31, 2003 (AUDITED) |
| Revenues | \$ -- | \$ 4 |
| Net Loss | \$ -- | \$ (185) |

Total Net assets of the Customer Service Support Center were comprised primarily of property equipment.

4. JOINT VENTURE OPERATIONS

The Company has ceased its participation with International Elite Limited (IEL) in the joint venture company, PacificNet Communications Limited - Macao

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Commercial Offshore (the "Joint Venture"). Pursuant to the terms of the Equity Joint Venture Agreement, signed on December 21, 2002, the Company was required to obtain the requisite regulatory and shareholder approval to issue 34 million shares of the Company's common stock in connection with the Joint Venture transaction. The Company still has not received the necessary regulatory and shareholder approval to issue the shares. Since the Company was unable to obtain shareholder approval, the board of directors of the Company determined that it was in the best interest of the Company to terminate its interest in the Joint Venture. Since the Company has not obtained regulatory and shareholder approval of the joint venture transaction and the Company does not control the operating and financing decisions of the joint venture, the Company does not consolidate the assets, liabilities, revenues and expenses of the joint venture. The Company will no longer seek approval to issue the 34 million shares to the Joint Venture and the original 800,000 deposit shares held in escrow were canceled and returned to the Company's treasury. The termination agreement was signed on March 30, 2004. As such, the results of operations for the three months ended March 31, 2003, do not include the activity for the joint venture as previously reported in its March 31, 2003 quarterly filing.

5. STOCKHOLDERS' EQUITY

For the period ended March 31, 2004, the Company issued (i) 800,000 shares with total consideration of \$4,000,000 to acquire subsidiaries representing (a) 100,000 deposit shares of common stock plus 200,000 shares as a result of achievement of certain earnings criteria to Epro; b) 350,000 deposit shares of common stock plus 150,000 shares as a result of achievement of certain earnings criteria to Linkhead; (ii) 617,285 shares with cash consideration of \$3,000,000 pursuant to a private placement, including warrants to purchase up to an aggregate of 154,320 common shares of the Company issued to a group of institutional investors, and (iii) 32,000 shares as a result of exercise of share options with cash consideration of \$55,000 and noncash consideration of \$5,000.

6. STOCK-BASED COMPENSATION

During the quarter ended March 31, 2003, the Company granted stock options to purchase the Company's common stock at \$1.75 per share with expiry date on January 10, 2006. No options were granted during the first quarter of 2004. During the quarter ended March 31, 2004, no options were canceled or forfeited, and 32,000 options were exercised for proceeds of \$60,000. As of March 31, 2004, there were 893,600 stock options outstanding and 208,600 options exercisable. The weighted average exercise price of the options outstanding and exercisable is \$3.06 and \$1.98, respectively, and the weighted average remaining contractual life is 1.91 and 1.28 and years, respectively.

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The Company accounts for stock-based compensation using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," under which no compensation cost for stock options is recognized for stock option awards granted at or above fair market value. Had compensation expense for the Company's stock-based compensation plans been determined under FAS No. 123, based on the fair market value at the grant dates, the Company's pro forma net loss and pro forma net loss per share would have been reflected as follows at March 31:

| | 2004 | 2003 |
|-------------------|-------|-------|
| Net profit (loss) | ----- | ----- |

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| | | | | |
|---|----|-------|----|--------|
| As reported | \$ | 141 | \$ | (614) |
| Stock-based employee compensation cost, net of tax | | -- | | (314) |
| | | ----- | | ----- |
| Pro forma | \$ | 141 | \$ | (928) |
| | | ===== | | ===== |
| | | | | |
| Profit (loss) per share | | | | |
| As reported | \$ | 0.02 | \$ | (0.12) |
| | | ===== | | ===== |
| Pro forma | \$ | 0.02 | \$ | (0.19) |
| | | ===== | | ===== |

The fair value of each option grant during the quarter ended March 31, 2003, was \$1.62 and was estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions: dividend yield of 0%, expected volatility of 266%, risk-free interest rate of 2.5%, and an expected life of 3 years.

7. SUBSEQUENT EVENTS - BUSINESS ACQUISITIONS

GUANGZHOU YUESHEN TAIYANG TECHNOLOGY LIMITED

On April 12, 2004, the Company, through its subsidiary PacificNet Strategic Investment Holdings Limited, consummated the acquisition of a 51% controlling interest (the "Acquisition") in Guangzhou YueShen TaiYang Technology Limited, a newly formed company incorporated in the People's Republic of China ("Yueshen"). Yueshen is engaged in the business of distributing telecom services, including calling cards, mobile SIM cards, prepaid stored-value cards, VoIP, IDD calling cards, bundled insurance cards and customer loyalty membership cards in China.

The Company acquired the controlling interest in Yueshen through the purchase of 85 shares (representing 100% of the issued and outstanding shares, the "Shanghai Shares") of Shanghai Classic Group Limited, the beneficial owner of the 51% controlling interest in Yueshen. The consideration for the Acquisition was an aggregate value of approximately USD\$1,196,143, which was paid in cash and shares of common stock of the Company (the "Common Stock"), and a warrant to purchase up to 50,000 shares of Common Stock. The consideration was paid as follows:

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

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

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

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The cash portion of the purchase price for the Acquisition was from working capital of the Company.

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CHEER ERA LIMITED

On April 7, 2004, the Company, through its subsidiary PacificNet Strategic Investment Holdings Limited, consummated the acquisition of 300 shares (the "Shares"), representing 30% of the issued and outstanding shares of Cheer Era Limited, a newly formed company incorporated in Hong Kong SAR ("Cheer Era"). Cheer Era is engaged in the business of designing, developing and manufacturing multimedia entertainment and communication kiosk products, including photo and video entertainment kiosks, digital camera photo development stations, MMS, ring-tone and mobile content download, payment and delivery stations for mobile phones, and other coin-operated kiosks and kiosk consumables. The consideration for the Shares was an aggregate value of approximately USD\$1,156,812, which was paid in cash and shares of Common Stock, and a warrant to purchase up to 80,000 shares of Common Stock. The consideration was paid as follows:

(i) approximately USD\$771,208 by delivery of 149,459 shares of Common Stock as consideration for the purchase of 100 of the Shares from Apex Legend Limited, a company incorporated in the British Virgin Islands ("Apex") within thirty (30) days of the signing of the agreement for the purchase of the Shares. All of the Common Stock deliverable to Apex is being held in escrow pursuant to the terms of an escrow agreement, which provides that the Common Stock will be released in installments over the twelve month period following the consummation of the purchase and sale of the Shares, provided, that Cheer Era attains certain net income milestones during such period. In the event there is a shortfall in the net income during the period, Apex shall return to the Company shares of the Common Stock equivalent to the dollar amount of such shortfall divided by \$6.00; and

(ii) approximately USD\$385,604 in cash directly to Cheer Era within thirty (30) days of the closing of the purchase and sale of the Shares for the Company's subscription to purchase 200 of the Shares. The cash used to pay for the Shares was from working capital of the Company.

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

THE FOLLOWING DISCUSSION SHOULD BE READ IN CONJUNCTION WITH THE INFORMATION CONTAINED IN THE FINANCIAL STATEMENTS OF THE COMPANY AND THE NOTES THERETO APPEARING ELSEWHERE HEREIN AND IN CONJUNCTION WITH THE MANAGEMENT'S DISCUSSION AND ANALYSIS SET FORTH IN THE COMPANY'S ANNUAL REPORT ON FORM 10-KSB FOR THE YEAR ENDED DECEMBER 31, 2003.

PRELIMINARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements contained in this Form 10-QSB that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These include statements about the Company's expectations, beliefs, intentions or strategies for the future, which are indicated by words or phrases such as "anticipate," "expect," "intend," "plan," "will," "the Company believes," "management believes" and similar words or phrases. The forward-looking statements are based on the Company's current expectations and are subject to certain risks, uncertainties and assumptions. The Company's

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actual results could differ materially from results anticipated in these forward-looking statements. All forward-looking statements included in this document are based on information available to the Company on the date hereof, and the Company assumes no obligation to update any such forward-looking statements.

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CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our plan of operations are 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.

We believe 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. The allowances are calculated based on detailed review of certain individual customer accounts, historical rates and an estimation of the overall economic conditions affecting our customer base. We review a customer's credit history before extending credit. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

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 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.

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.

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LONG-LIVED ASSETS - We periodically assesses the need to record impairment losses on long-lived assets, such as property, plant and equipment, goodwill 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 an impairment is identified, the carrying amount of the asset is reduced to its estimated fair value. All goodwill will no longer be amortized and potential impairment of goodwill and purchased intangible assets with indefinite useful lives will be evaluated using the specific guidance provided by SFAS No. 142 and SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This impairment analysis will be performed at least annually. For investments in affiliated companies that are not majority-owned or controlled, indicators of 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.

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NATURE OF THE OPERATIONS OF THE COMPANY

NATURE OF BUSINESS.

PacificNet Inc. (referred to herein as "PacificNet" or the "Company") was incorporated in the state of Delaware in 1999. The Company is focused on systems integration, network communications, customer relationship management (CRM) solutions, information technology solutions and telecommunications in Asia. Through its subsidiaries, the Company invests, operates and provides value-added telecom services (VAS) in Greater China. The Company's VAS includes operating call centers, providing telemarketing services, customer relationship management services (CRM), interactive voice response systems (IVR), short messaging services (SMS), multimedia messaging services (MMS), voice over internet protocol (VoIP) services, mobile applications and calling cards. In addition, the Company sells and distributes telecom services. The Company intends to continue to grow by acquiring and managing growing technology and network communications businesses with established products and customers in Asia.

The Company's goal is to take a leading role in providing information technology services and network communications in Asia and greater China. The Company's business can be classified into the following operating units:

PacificNet Solutions Ltd. ("PacSo"), is a subsidiary that specializes in systems integration, software application, and e-business solutions services in Hong Kong and greater China. The scope of PacSo's products and services includes smart card solutions, web based user applications and web based connections to remote or fixed database services, which are also referred to as backend enterprise planning systems.

PacificNet Communications Ltd. ("PacComm"), a subsidiary, is a leading provider of VAS services including call centers, CRM, telemarketing, data-mining services, mobile data services such as SMS, MMS, unified messaging services (UMS), location-based service (LBS), wireless application protocol (WAP), and binary runtime environment for wireless (BREW)based CDMA applications, mobile commerce, roaming, paging, wireless internet, virtual private network (VPN) and VoIP services in greater China. In December 2003, PacComm completed an agreement

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to acquire a 50% controlling interest in Epro Telecom Holdings Limited (Epro), one of the largest providers of value-added telecom services (VAS), interactive voice response (IVR), mobile chatting, and voice-portal services in Greater China with over 500 employees, 1,000 call center seats and processes over 100,000 calls daily. Epro is in the business of providing VAS, such as call center services, CRM, mobile marketing and promotion services, call center training, management and consulting services, call center software, IVR systems, mobile payment and mobile point of sale (POS) solutions, internet e-commerce and mobile commerce, mobile applications based on SMS, MMS, outsourced telemarketing and customer support services, and other mobile VAS for Hong Kong and PRC's telecom operators, banks, insurance, and other financial services companies in China. Epro's clients include major telecom operators, banks, insurance and financial services companies in greater China, such as China Telecom (NYSE: CHA), China Unicom (NYSE: CHU), PCCW (NYSE: PCW), CSL, SmarTone Telecom, Sunday Communications (Nasdaq: SDAY), Hutchison Whampoa Limited (HKSE:0013.HK), Swire Coca-Cola, Samsung, Dun & Bradstreet, DBS, Dao Heng Insurance, Shenzhen Development Bank, Hong Kong Government Housing Authority and Hongkong Post.

PacificNet Limited ("PNL"), a subsidiary, is a distributor and reseller of telecommunication, networking and computer equipment, which complements our telecommunication services. PNL is engaged in the resale of PABX telephone systems, basic switches and router equipments to commercial customers, and mobile phone accessories targeted to retail customers.

PacificNet Tech (SZ) Limited ("SZ"), is a subsidiary located in Shenzhen, SZ was established to expand the Company's research, development, marketing and distribution opportunities in mainland China.

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PacificNet Strategic Investment Holdings Limited ("PSI") is a subsidiary. In December 2003, PSI completed an agreement to acquire 51% of the shares of a private PRC company, Beijing Linkhead Technologies Co., Limited (Linkhead), a leading provider of VAS, IVR systems, mobile chatting, and voice-portal services in greater China. Linkhead is in the business of providing VAS, IVR system development and integration, voice internet portals, computer telephony integration (CTI), VoIP, internet and mobile application development and CRM services for China's telecom operators. Linkhead also provides telecom related management and consulting services, mobile consumer analytics, mobile data-mining, internet e-commerce and mobile commerce, mobile applications based on WAP, K-Java, BREW, EMS, SMS, MMS, outsourced software development, and other mobile VAS in greater China. Linkhead's major clients and profit-sharing partners include some of the leading telecom operators such as China Telecom (NYSE: CHA), China Mobile (NYSE: CHL), China Unicom (NYSE: CHU), UTStarcom (Nasdaq: UTSI). Linkhead is also channel partner, or a master reseller, of NMS Communications (Nasdaq: NMSS), a leading provider of communications technologies and solutions.

- In April 2004, PSI completed an agreement to acquire a 30% interest in Cheer Era Limited ("Cheer Era"), a newly formed company incorporated in Hong Kong SAR. Cheer Era is engaged in the business of designing, developing and manufacturing multimedia entertainment and communication kiosk products, including photo and video entertainment kiosks, digital camera photo development stations, MMS, ring-tone and mobile content download, payment and delivery stations for mobile phones, and other coin-operated kiosks and kiosk consumables.

- In April 2004, PSI consummated the acquisition of a 51% controlling interest in Guangzhou YueShen TaiYang Technology Limited, a newly formed company incorporated in the People's Republic of China ("Yueshen"). Yueshen is engaged

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in the business of distributing telecom services, including calling cards, mobile SIM cards, prepaid stored-value cards, VoIP, IDD calling cards, bundled insurance cards and customer loyalty membership cards in China.

RESULTS OF OPERATIONS

THREE MONTHS ENDED MARCH 31, 2004 COMPARED TO THREE MONTHS ENDED MARCH 31, 2003

REVENUES. Revenues for the three months ended March 31, 2004 were \$3,502,000, an increase of \$3,405,000 from \$97,000 for the three months ended March 31, 2003. For the three months ended March 31, 2004, revenues of \$2,052,000 and \$1,157,000 were derived from the services rendered by the Company's newly acquired subsidiaries, Epro and Linkhead, respectively. The increase in revenues is due to the revenues associated with the operations of Epro and Linkhead which generated total revenue of \$3,209,000 for the three months ended March 31, 2004.

COST OF REVENUES. Cost of revenues for the three months ended March 31, 2004 was \$2,253,000, an increase of \$2,217,000 from \$36,000 for the three months ended March 31, 2003. This significant increase is associated with the increase in revenues.

GROSS MARGIN. Gross margin for the three months ended March 31, 2004 was \$1,249,000, an increase of \$1,188,000 from \$61,000 for the three months ended March 31, 2003. Gross margins for the three months ended March 31, 2004, were comprised of 36% in revenues of value-added telecom services rendered.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Selling, general and administrative expenses totaled \$777,000 for the three months ended March 31, 2004, an increase of \$358,000, from \$419,000 for the three months ended March 31, 2003. This increase resulted from increasing the size of our operations, which included increased premises costs and staff costs.

INTEREST INCOME. Interest income was \$3,000 for the three months ended March 31, 2004, as compared to \$7,000 for the three months ended March 31, 2003. The decrease is due to lower interest rates in 2004 than 2003.

INCOME TAXES. No tax provision has been recorded for the three months ended March 31, 2004, as the result of the cumulative operating loss generated by the Company. Interim income tax provisions are based upon management's estimate of taxable income and the resulting consolidated effective income tax rate for the full year. As a result, such interim estimates are subject to change as the year progresses and more information becomes available.

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MINORITY INTERESTS. Minority interests for the three months ended March 31, 2004 totaled \$328,000, compared with \$(14,000) for the same period in the prior year, which represents the Company's existing interest in its subsidiary PacSo of \$3,000, and its interest in newly acquired subsidiaries, Epro of \$142,000 and Linkhead of \$183,000 respectively.

LIQUIDITY AND CAPITAL RESOURCES

CASH AND CASH EQUIVALENTS. As of March 31, 2004, the Company had cash and cash equivalents of \$4,124,000 and working capital of \$5,694,000 as compared to \$3,823,000 and \$1,442,000, respectively, at December 31, 2003.

WORKING CAPITAL. The Company's working capital increased to \$5,694,000 at March 31, 2004, as compared to \$1,442,000 at December 31, 2003. When compared to balances at December 31, 2003, the increase in working capital at March 31, 2004

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reflects an increase in current assets primarily resulting from the Company's completion of a \$3,000,000 private placement, and a decrease in current liabilities of \$3,171,000 and \$1,081,000, respectively.

NET CASH USED IN OPERATING ACTIVITIES. Net cash used in operating activities was \$1,040,000 for the three months ended March 31, 2004 as compared to net cash used in operating activities of \$356,000 for the three months ended March 31, 2003. Net cash used in operating activities in the three months ended March 31, 2004 was primarily due to a net profit of \$141,000, increased by noncash items totaling \$876,000 and decreased by changes in operating assets of \$2,057,000. Net cash used in operating activities in the three months ended March 31, 2004 was primarily due to a net loss of \$614,000, increased by noncash items totaling \$492,000 and decreased by changes in operating assets of \$234,000.

NET CASH USED IN INVESTING ACTIVITIES. Net cash used in investing activities for the three months ended March 31, 2004 was \$360,000 representing the acquisition of subsidiary companies and property and equipment of \$232,000 and \$128,000, respectively. The additions to property and equipment were for the expansion of the CRM and call centre business in Hong Kong.

NET CASH PROVIDED BY FINANCING ACTIVITIES. Net cash provided by financing activities for the three months ended March 31, 2004 was \$1,701,000 representing net proceeds from issuance of common stock of \$2,813,000, net cash proceeds received from the exercise of stock options of \$55,000, repayments on debt of \$2,812,000, and advances under bank loans of \$1,645,000. Net cash provided by financing activities for the three months ended March 31, 2003 was \$348,000 representing advances under the company's bank line of credit by \$238,000 and proceeds from the exercise of stock options of \$110,000.

ISSUANCE OF COMMON STOCK. For the period ended March 31, 2004, we issued (i) 800,000 shares with total consideration of \$4,000,000 to acquire subsidiaries, (ii) 617,285 shares with cash consideration of \$3,000,000 pursuant to a private placement and (iii) 32,000 shares as a result of exercise of share options with cash consideration of \$55,000 and noncash consideration of \$5,000.

CURRENCY EXCHANGE FLUCTUATIONS. All of PacificNet's revenues are denominated either in United States dollars or Hong Kong dollars, while its expenses are denominated primarily in Hong Kong dollars and Renminbi ("RMB"), the currency of the People's Republic of China. There can be no assurance that RMB-to-United States dollar or Hong Kong dollar-to-United States dollar exchange rates will remain stable. Although a devaluation of the Hong Kong dollar or RMB relative to the United States dollar would likely reduce PacificNet's expenses (as expressed in United States dollars), any material increase in the value of the Hong Kong dollar or RMB relative to the United States dollar would increase PacificNet's expenses, and could have a material adverse effect on PacificNet's business, financial condition and results of operations. PacificNet has never engaged in currency hedging operations and has no present intention to do so.

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ITEM 3. CONTROLS AND PROCEDURES

Under the supervision and with the participation of the Company's management, including our principal executive officer and the principal accounting officer, the Company conducted an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as of the end of the period covered by this report (the "Evaluation Date"). Based on this evaluation, the Company's principal executive officer and principal accounting officer concluded as of the Evaluation Date that the Company's disclosure

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controls and procedures were effective such that the material information required to be included in our Securities and Exchange Commission ("SEC") reports is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms relating to the Company, including our consolidating subsidiaries, and was made known to them by others within those entities, particularly during the period when this report was being prepared.

Additionally, there were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the Evaluation Date. We have not identified any significant deficiencies or material weaknesses in our internal controls, and therefore there were no corrective actions taken.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

None.

ITEM 2. CHANGES IN SECURITIES AND ISSUER PURCHASES OF EQUITY SECURITIES

The following private placement of the Company's securities were made in reliance upon the exemption from registration under Section 4(2) of the Securities Act of 1933 and / or Rule 506 of Regulation D promulgated under the Securities Act of 1933. The Company did not use underwriters in any of the following private placement.

- o On January 15, 2004, the Company closed a \$3 million equity private placement in which an aggregate of 617,285 shares of common stock and warrants to purchase up to an aggregate of 154,320 shares of common stock of the Company were issued to a group of institutional investors. The warrants are exercisable until January 15, 2009 at an exercise price of \$7.15 per share. The shares of common stock issued and underlying the warrants were subsequently registered on April 30, 2004.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

The Company does not currently have in place formal procedures by which security holders may recommend nominees to the registrant's board of directors.

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ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

(a) Exhibits

The following exhibits are filed as part of this report:

| EXHIBIT NUMBER | DESCRIPTION |
|-------------------|--|
| 2.1 | Share Exchange Agreement by and among Davin Enterprises, Inc., |

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- Carl Tong, Leo Kwok and Acma Strategic Holdings Limited dated December 15, 1997. (1)
- 2.2 Share Exchange Agreement dated February 17, 2000, between Registrant and holders of membership interests in PacificNet.com LLC. (3)
- 2.3 Supplement to Share Exchange Agreement dated April 29, 2000, between Registrant and holders of membership interests in PacificNet.com LLC. (3)
- 2.4 Agreement dated September 30, 2000, among the Company and the "Purchasers" named therein. (4)
- 2.5 Supplemental Agreement dated October 3, 2000, among the Company and the "Purchasers" named therein. (4)
- 2.6 Deed of Waiver, dated October 3, 2000, by Creative Master Limited in favor of the Company. (4)
- 3.1 Certificate of Incorporation, as amended. (7) Certificate of amendment of Certificate of Incorporation.(7)
- 3.2 By Laws of the Company. (5)
- 3.3 Amendment to By Laws of the Company. (2)
- 4 Specimen Stock Certificate of the Company.
- 4.1 Securities Purchase Agreement, dated as of January 15, 2004, among PacificNet Inc. and the purchasers identified therein (12).
- 4.2 Form of Common Stock Purchase Warrant issued to each of the purchasers (12).
- 10.1 Form of Indemnification Agreement with officers and directors. (1)
- 10.2 Amendment to 1998 Stock Option Plan.
- 10.3 Form of Notice of Stock Option Grant and Stock Option Agreement under the 1998 Stock Option Plan. (3)
- 10.4 Amendment dated January 31, 2002 to the Subscription Agreement by and between the Company and Sino Mart Management Ltd., dated as of December 9, 2001 (6)
- 10.5 19.9% Private Placement Agreement and Amendments between Ho Shu-Jen and PacificNet.com, Inc.
- 10.6 Sub-Lease Agreement dated August 30, 2002.(8)
- 10.7 Agreement dated on December 1, 2003 for the Sale and Purchase of 50% Shares in Epro Telecom Holdings Limited (12)
- 10.8 Agreement dated on December 15, 2003 for the Sale and Purchase of 51% Shares in Beijing Linkhead Technologies Co., Ltd (12)
- 10.9 Agreement for the Sale and Purchase of Shares in Shanghai Classic Group Limited (13)
- 10.10 Agreement for the Sale and Purchase of Shares in Cheer Era Limited (13).
- 14 Code of Ethics
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99.2 Subscription Agreement by and between the Company and Sino Mart Management Ltd., dated as of December 9, 2001 (6)

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- (1) Incorporated by reference to the Company's Form SB-2 filed on October 21, 1998.
- (2) Incorporated by reference to the Company's Form 10-KSB filed on March 30, 1999.
- (3) Incorporated by reference to the Company's Form 8-K filed on August 11, 2000.
- (4) Incorporated by reference to the Company's Form 8-K filed on October 17, 2000.

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- (5) Incorporated by reference to the exhibits of the Company's registration statement (file no. 33-14521-NY)
- (6) Incorporated by reference to the Company's Form 8-K filed on March 20, 2002.
- (7) Incorporated by reference to the Company's Form 8-K filed on March 28, 2002.
- (8) Incorporated by reference to the Company's Form 10-KSB filed on April 16, 2002.
- (9) Incorporated by reference to the Company's Form 8-K filed on September 30, 2002.
- (10) Incorporated by reference to the Company's Form 8-K filed on December 24, 2002.
- (11) Incorporated by reference to the Company's 10-KSB filed on March 31, 2003.
- (12) Incorporated by reference to the Company's 10-KSB filed on April 2, 2004.
- (13) Incorporated by reference to the Company's Amendment to Form S-3 or Form SB-2 filed on April 21, 2004.

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(b) Reports on Form 8-K:

The Company filed a Form 8-K on April 19, 2004 under Items 2 and 7. There were no financial statements required to be filed.

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: May 4, 2004

By: /s/ TONY TONG

Tony Tong
Chief Executive Officer
(Principal Executive Officer)

Date: May 4, 2004

By: /s/ WANG SHAO JIAN

Wang Shao Jian
Chief Financial Officer
(Principal Financial Officer)

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