

ASIAINFO HOLDINGS INC  
Form 10-Q  
November 09, 2005  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2005

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

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

Commission File Number 001-15713

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**ASIAINFO HOLDINGS, INC.**

(Exact name of registrant as specified in its charter)

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DELAWARE

752506390

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(State or other jurisdiction of  
incorporation or organization)

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

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

(Address of principal executive office, including zip code)

+8610 8216 6688

(Registrant's telephone number, including area code)

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

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

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

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

The number of shares outstanding of the Registrant's common stock as of November 7, 2005 was 46,921,606

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ASIAINFO HOLDINGS, INC.

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2005

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
<b>Revenues:</b>				
Software products and solutions				
Sales to non-related parties	\$ 13,464	\$ 9,114	\$ 39,323	\$ 26,583
Sales to related parties	1,790	500	8,141	2,032
<b>Total software products and solutions</b>	<b>15,254</b>	<b>9,614</b>	<b>47,464</b>	<b>28,615</b>
Service				
Sales to non-related parties	5,782	3,507	18,827	12,273
Sales to related parties	538	797	1,385	2,576
<b>Total Service</b>	<b>6,320</b>	<b>4,304</b>	<b>20,212</b>	<b>14,849</b>
Third party hardware				
Sales to non-related parties	3,378	5,712	12,541	28,186
Sales to related parties	268	376	1,519	2,845
<b>Total third party hardware</b>	<b>3,646</b>	<b>6,088</b>	<b>14,060</b>	<b>31,031</b>
<b>Total revenues</b>	<b>25,220</b>	<b>20,006</b>	<b>81,736</b>	<b>74,495</b>
<b>Cost of revenues:</b>				
Software products and solutions (including purchases from related parties of \$10 and \$8 for the three months ended September 30, 2005 and 2004, respectively, and \$96 and \$22 for the nine months ended September 30, 2005 and 2004, respectively)				
	7,355	4,536	22,825	12,799
Service (including purchases from related parties of \$14 and \$2 for the three months ended September 30, 2005 and 2004, respectively, and \$64 and \$6 for the nine months ended September 30, 2005 and 2004, respectively)				
	3,435	1,328	11,900	5,904
Third party hardware	3,463	5,784	13,356	29,480

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Total cost of revenues	14,253	11,648	48,081	48,183
Gross profit	10,967	8,358	33,655	26,312
Operating expenses:				
Sales and marketing (including sales and marketing expenses to related parties of \$79 and \$3 for the three months ended September 30, 2005 and 2004, respectively, and \$190 and \$8 for the nine months ended September 30, 2005 and 2004, respectively)	5,361	3,092	15,202	8,687
General and administrative (including general and administrative expenses to related parties of \$8 and \$4 for the three months ended September 30, 2005 and 2004, respectively, and \$79 and \$11 for the nine months ended September 30, 2005 and 2004, respectively; including stock-based compensation expense of \$3 and nil for the three months ended September 30, 2005 and 2004, respectively, and \$3 and nil for the nine months ended September 30, 2005 and 2004, respectively)	2,548	2,413	7,638	6,396
Research and development (including research and development expenses to related parties of \$9 and \$6 for the three months ended September 30, 2005 and 2004, respectively, and \$37 and \$17 for the nine months ended September 30, 2005 and 2004, respectively)	3,085	2,279	9,018	6,593
Amortization of acquired intangible assets	401	151	1,255	480
Total operating expenses	11,395	7,935	33,113	22,156
(Loss) Income from operations	(428)	423	542	4,156
Other income				
Interest income	749	674	2,368	1,589
Gain on sales of investments	11	4,018	(3)	4,018
Other income (expenses), net	170		181	(20)
Total other income, net	930	4,692	2,546	5,587
Income before income taxes and equity in loss of an affiliate	502	5,115	3,088	9,743
Income tax expense	75	137	463	718
Income before equity in loss of an affiliate	427	4,978	2,625	9,025
Equity in loss of an affiliate				(42)
Net income	\$ 427	\$ 4,978	\$ 2,625	\$ 8,983
Net income per share:				
Basic	\$ 0.01	\$ 0.11	\$ 0.06	\$ 0.20
Diluted	\$ 0.01	\$ 0.11	\$ 0.06	\$ 0.19
Shares used in computation:				
Basic	46,042,854	45,426,451	44,592,807	45,377,384
Diluted	47,413,803	46,705,356	45,911,250	46,988,388

See notes to condensed consolidated financial statements.



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

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

	<b>September 30, 2005</b>	<b>December 31, 2004<sup>(1)</sup></b>
	<b>(Unaudited)</b>	
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 78,996	\$ 94,156
Restricted cash	15,500	15,625
Short-term investments	53,845	56,949
Notes receivable (including notes receivable of \$1,348 and \$2,045 from related parties as of September 30, 2005 and December 31, 2004, respectively)	2,865	6,482
Accounts receivable		
Accounts receivable due from non-related parties (net of allowances of \$3,540 and \$3,497 as of September 30, 2005 and December 31, 2004, respectively)	44,180	44,538
Accounts receivable due from related parties (net of allowances of \$528 and \$147 as of September 30, 2005 and December 31, 2004, respectively)	6,739	13,814
Total accounts receivable	50,919	58,352
Inventories	6,957	7,932
Other receivables (including other receivables of \$359 and \$198 due from related parties as of September 30, 2005 and December 31, 2004, respectively)	3,911	3,917
Deferred income taxes - current	1,689	1,715
Prepaid expenses and other current assets	6,356	4,851
Assets held for sale	6,623	
Total current assets	227,661	249,979
Property and equipment-net	2,600	1,895
Goodwill	34,177	37,704
Other acquired intangible assets-net	4,823	7,392
Deferred income taxes	267	394
Total Assets	\$ 269,528	\$ 297,364
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Notes payable	\$ 2,423	\$ 5,720
Accounts payable (including accounts payable of nil and \$2,300 due to related parties as of September 30, 2005 and December 31, 2004, respectively)	12,773	16,793
Accrued expenses	12,644	14,701
Deferred revenue (including deferred revenue of \$1,839 and \$1,327 from related parties as of September 30, 2005 and December 31, 2004, respectively)	15,839	15,381
Accrued employee benefits	10,118	7,061
Other payables (including other payables of \$507 and \$135 due to related parties as of September 30, 2005 and December 31, 2004, respectively)	4,117	4,739
Shares payable for acquisition		27,213

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Other taxes payable	2,219	2,142
Income taxes payable	1,882	1,822
Liabilities held for sale	313	
	<u>          </u>	<u>          </u>
Total current liabilities	62,328	95,572
	<u>          </u>	<u>          </u>
Commitments and contingencies (Note 13)		
Stockholders' Equity:		
Common stock (authorized: 100,000,000 shares, \$0.01 par value; shares issued: September 30, 2005: 46,918,089; December 31, 2004: 46,473,532; shares issued and outstanding: September 30, 2005: 46,141,988; December 31, 2004: 46,314,706)		
	469	465
Additional paid-in capital	215,146	211,394
Treasury stock at cost (September 30, 2005: 776,101 shares; December 31, 2004: 158,826 shares)	(4,027)	(868)
Accumulated deficit	(6,593)	(9,218)
Accumulated other comprehensive income	2,205	19
	<u>          </u>	<u>          </u>
Total stockholders' equity	207,200	201,792
	<u>          </u>	<u>          </u>
Total Liabilities and Stockholders' Equity	\$ 269,528	\$ 297,364
	<u>          </u>	<u>          </u>

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

See notes to condensed consolidated financial statements.



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

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

	Nine Months Ended September 30,	
	2005	2004
	(unaudited)	
Cash flows from operating activities:		
Net income	\$ 2,625	\$ 8,983
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	1,408	1,092
Stock-based compensation expense	3	
Amortization of other acquired intangible assets	1,255	480
Deferred income taxes	153	(113)
Equity in loss of an affiliate		42
Loss on disposal of property and equipment	21	18
Loss (gain) on sales of investment	3	(4,018)
Change in bad debt provision	321	(217)
Changes in operating assets and liabilities:		
Notes receivable	3,617	2,008
Accounts receivable	5,401	(7,278)
Inventories	970	(437)
Other receivables	(10)	6,131
Prepaid expenses and other current assets	(1,506)	(984)
Notes payable	(3,296)	1,198
Accounts payable	(4,020)	(1,168)
Accrued expenses	(1,765)	737
Deferred revenue	474	1,227
Accrued employee benefits	3,057	1,061
Other payables	(375)	315
Other taxes payable	77	(112)
Income taxes payable	60	625
	<u>8,473</u>	<u>9,590</u>
Net cash provided by operating activities		
Cash flows from investing activities:		
Change in restricted cash	125	(626)
Decrease in investments	2,214	1,286
Purchases of property and equipment	(2,136)	(755)
Payment for acquisitions	(2,266)	(354)
Proceeds from sales of investment	1,074	
Proceeds from disposal of property and equipment	1	7
Proceeds from affiliate		1,615
	<u>(988)</u>	<u>1,173</u>
Net cash (used in) provided by investing activities		
Cash flows from financing activities:		
Repayment of short-term bank loans		(60)
Proceeds on exercise of stock options	1,818	1,189

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Repurchase of common stock	(26,414)	
Net cash (used in) provided by financing activities	(24,596)	1,129
Net (decrease) increase in cash and cash equivalents	(17,111)	11,892
Cash and cash equivalents at beginning of period	94,156	119,395
Effect of exchange rate changes on cash and cash equivalents	1,951	(3)
Cash and cash equivalents at end of period	\$ 78,996	\$ 131,284

In October 2004, the Company acquired Lenovo Group Limited's (Lenovo) non-telecom IT services business for a total consideration of \$36,784. In connection with the acquisition, the Company has entered into a forward contract to deliver shares of the Company's common stock having an aggregate market value of approximately \$27,213 at any time during the twelve month period following the closing date. On July 1, 2005, the Company settled the forward contract by delivering from treasury stock 4,498,130 shares of its common stock, with a fair value of \$25,189 and cost of \$23,255, and paying cash in the amount of \$2,024 to Lenovo.

See notes to condensed consolidated financial statements.

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**ASIAINFO HOLDINGS, INC.**

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

Nine Months Ended September 30, 2005 and 2004

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

**1. BASIS OF PREPARATION**

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

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

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

Revenue from software products and solutions includes the benefit of the rebate of valued-added taxes on sales of software and services received from the Chinese tax authorities as part of the People's Republic of China (PRC) government's policy of encouragement of software development in the PRC. The rebate was \$1,095 and \$352 for the three months ended September 30, 2005 and 2004, respectively, and \$3,331 and \$1,762 for the nine months ended September 30, 2005 and 2004, respectively.

Revenue in excess of billings is recorded as unbilled receivables and included in accounts receivable, and amounted to \$21,524 as of September 30, 2005 and \$33,084 as of December 31, 2004. Billings in excess of revenues recognized are recorded as deferred revenue. Billings are rendered based on agreed milestones included in the contracts with customers.

As of September 30, 2005 and December 31, 2004, the balance of accounts receivable of \$29,395 and \$25,268, respectively, represented amounts billed but not yet collected. All billed and unbilled amounts are expected to be collected within one year.

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

The RMB is not fully convertible into US dollars or other foreign currencies. The rate of exchange quoted by the People's Bank of China on September 30, 2005 was US\$1.00=RMB8.092. No representation is made that the RMB amounts could have been, or could be, converted into United States dollars at that rate or at any other rate.

### **Recently Issued Accounting Pronouncements**

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

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beginning after June 15, 2005 (as modified by the SEC on April 14, 2005). Under APB Opinion No. 25, *Accounting for Stock Issued to Employees*, no stock-based compensation cost had been reflected in the net income of the Company for grants of stock options to employees. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 ( *SAB 107* ) regarding the SEC's interpretation of SFAS 123R and the valuation of share-based payments for public companies. On October 24, 2005, the Compensation Committee of the Board of Directors (the *Board* ) of the Company approved the acceleration of vesting of approximately 2.1 million unvested stock options previously awarded to employees, officers and members of the Board under the Company's 2000 Stock Option Plan and 2002 Stock Option Plan. Options held by members of the Compensation Committee were excluded from the acceleration. The effective date of the acceleration was October 25, 2005. The primary purpose of the accelerated vesting is to enable the Company to avoid recognizing future compensation expense associated with the accelerated stock options upon the planned adoption of SFAS 123R by the Company in fiscal 2006. The Company expects the acceleration to reduce the stock option expense it otherwise would be required to record beginning in fiscal 2006 by more than \$7.5 million on a pre-tax basis.

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

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

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

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

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

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

**2. CASH AND CASH EQUIVALENTS**

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

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

Short-term investments are classified as available-for-sale and consist principally of corporate stock and bonds, variable rate preferred securities and certificates of deposit issued by major financial institutions. The available-for-sale investments are carried at fair market value and their unrealized holding gains or losses resulting from the change in market value are recorded in accumulated other comprehensive income (loss) in stockholders' equity. As of September 30, 2005 and December 31, 2004, all short-term investments of the Company had maturities of less than one year. The Company incurred a gain of \$11 (proceeds from the sales of corporate stock of

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\$593 with cost of \$582) and a loss of \$3 (proceeds from the sales of corporate stock of \$1,074 with cost of \$1,077) on the sales of short-term investments during the three and nine month periods ended September 30, 2005, and no gains or losses on the sale of short-term investments during the comparable periods in 2004.

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

	September 30, 2005		December 31, 2004	
	Cost	Fair value	Cost	Fair value
Certificate of deposit	\$ 5,029	\$ 5,029	\$ 7,163	\$ 7,163
Corporate bonds	12,378	12,391	2,594	2,594
Variable rate preferred securities	35,000	35,000	45,000	45,000
Corporate stock	1,077	1,425	2,153	2,192
<b>Total</b>	<b>\$ 53,484</b>	<b>\$ 53,845</b>	<b>\$ 56,910</b>	<b>\$ 56,949</b>

**4. NOTES RECEIVABLE**

As of September 30, 2005 and December 31, 2004, the balances of notes receivable of \$2,865 and \$6,482, respectively, represented bank acceptance drafts of \$756 and \$4,344 that are non-interest bearing and due within six months and commercial acceptance notes of \$2,109 and \$2,138.

**5. COMPREHENSIVE INCOME**

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

	Three Months Ended September 30,	
	2005	2004
Net income	\$ 427	\$ 4,978
Unrealized gain on available-for-sale investments net of tax effect	290	
Change in cumulative foreign currency translation adjustment	1,990	
<b>Comprehensive income</b>	<b>\$ 2,707</b>	<b>\$ 4,978</b>

	Nine Months Ended September 30,	
	2005	2004
Net income	\$ 2,625	\$ 8,983
Unrealized gain on available-for-sale investments net of tax effect	186	
Change in cumulative foreign currency translation adjustment	2,000	(3)
Comprehensive income	\$ 4,811	\$ 8,980

## 6. CREDIT FACILITIES

As of September 30, 2005 and December 31, 2004, the Company had total short-term banking facilities for working capital purposes totaling \$27,269 and \$35,707 expiring by December 2005. The facilities were secured by bank deposits of \$14,000 as of September 30, 2005 and December 31, 2004. At September 30, 2005 and December 31, 2004, unused short-term credit facilities were \$23,278 and \$27,340 and used facilities totaled \$3,991 and \$8,367, respectively. The used facilities are pledged as security for standby letters of credit and notes issued to hardware suppliers and customers. Additional bank deposits of \$1,500 and \$1,625 were used for issuing standby letters of credit and bank acceptance drafts as of September 30, 2005 and December 31, 2004, respectively. Bank deposits pledged as security for these credit facilities totaled \$15,500 and \$15,625 as of September 30, 2005 and December 31, 2004, respectively, and are presented as restricted cash in the condensed consolidated balance sheets.

## 7. NOTES PAYABLE

As of September 30, 2005 and December 31, 2004, the balances of notes payable of \$2,423 and \$5,720, respectively, represented commercial notes of \$626 and \$1,733, and bank acceptance drafts of \$1,797 and \$3,987, respectively, which are non-interest bearing and due within six months.



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

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

	<b>Nine Months Ended September 30 ,</b>	
	<b>2005</b>	<b>2004</b>
US federal rate	35%	35%
Difference between statutory rate and foreign effective tax rate	(25)	(35)
Permanent differences and others	25	
Change in statutory tax rates of foreign subsidiaries	(34)	7
Increase in valuation allowance	14	
	<u>15%</u>	<u>7%</u>

**9. STOCK-BASED COMPENSATION**

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

	<b>Number of shares</b>	<b>Weighted average exercise price per share</b>
Outstanding, January 1, 2005	10,740,594	\$ 6.77
Granted	50,000	4.67
Cancelled	(230,329)	6.85
Exercised	(15,230)	3.62
Outstanding, March 31, 2005	<u>10,545,035</u>	6.76
Cancelled	(458,263)	6.88
Exercised	(153,288)	4.01
Outstanding, June 30, 2005	<u>9,933,484</u>	6.80
Cancelled	(1,072,477)	7.80
Exercised	(276,039)	4.16

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Outstanding, September 30, 2005	8,584,968	6.76
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The exercise price of all options granted during nine months ended September 30, 2005 was equal to the fair market value of the Company's common stock on the dates of grant.

The Company awarded 80,000 restricted stock units in September 2005 pursuant to the Company's 2005 Stock Incentive Plan. A restricted stock unit is an agreement to issue stock at the time the award vests. These units vest on an annual basis equally over four years, 25% on each anniversary of the grant date. The Company accounts for employee stock-based compensation in accordance with Accounting Principles Board Opinion No. 25, Accounting or Stock Issued to Employees. The compensation cost is measured at the grant date based on the fair value of the award, which is the market price of the stock at the grant date. The compensation expense is recorded over the applicable service period, which is usually the vesting period. The amount of stock-based compensation attributable to cost of revenues, sales and marketing, general and administrative expenses, research and development etc. are included in those line items on the face of the statement of operations. The Company recorded \$3 compensation expenses which are included in general and administrative expenses for the three and nine months ended September 30, 2005.

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

	<b>Three Months Ended September 30,</b>	
	<b>2005</b>	<b>2004</b>
Net income as reported	\$ 427	\$ 4,978
Deduct: Total stock-based compensation expense under SFAS No. 123, net of tax effect	(766)	(1,847)
<b>Pro forma net (loss) income</b>	<b>\$ (339)</b>	<b>\$ 3,131</b>
<b>Net income per share as reported</b>		
Basic	\$ 0.01	\$ 0.11
Diluted	\$ 0.01	\$ 0.11
<b>Pro forma net (loss) income per share</b>		
Basic	\$ (0.01)	\$ 0.07
Diluted	\$ (0.01)	\$ 0.07

	<b>Nine Months Ended September 30,</b>	
	<b>2005</b>	<b>2004</b>
Net income as reported	\$ 2,625	\$ 8,983
Deduct: Total stock-based compensation expense under SFAS No. 123, net of tax effect	(3,171)	(5,319)
<b>Pro forma net (loss) income</b>	<b>\$ (546)</b>	<b>\$ 3,664</b>
<b>Net income per share as reported</b>		
Basic	\$ 0.06	\$ 0.20
Diluted	\$ 0.06	\$ 0.19
<b>Pro forma net (loss) income per share</b>		
Basic	\$ (0.01)	\$ 0.08
Diluted	\$ (0.01)	\$ 0.08

**10. NET INCOME PER SHARE**

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

	<b>Three Months Ended September 30,</b>	
	<b>2005</b>	<b>2004</b>
<b>Net income (numerator)</b>		
Net income		
Basic and diluted	\$ 427	\$ 4,978
<hr style="border: 1px solid black;"/>		
<b>Shares (denominator):</b>		
Weighted average common stock outstanding		
Basic	46,042,854	45,426,451
Dilutive effect of employee stock options and restricted stock units	1,370,949	1,278,905
<hr style="border: 1px solid black;"/>		
Diluted	47,413,803	46,705,356
<hr style="border: 1px solid black;"/>		
<b>Net income per share:</b>		
Basic	\$ 0.01	\$ 0.11
<hr style="border: 1px solid black;"/>		
Diluted	\$ 0.01	\$ 0.11
<hr style="border: 1px solid black;"/>		

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	Nine Months Ended September 30,	
	2005	2004
Net income (numerator)		
Net income		
Basic and diluted	\$ 2,625	\$ 8,983
Shares (denominator):		
Weighted average common stock outstanding		
Basic	44,592,807	45,377,384
Dilutive effect of employee stock options and restricted stock units	1,318,443	1,611,004
Diluted	45,911,250	46,988,388
Net income per share:		
Basic	\$ 0.06	\$ 0.20
Diluted	\$ 0.06	\$ 0.19

As of September 30, 2005 and 2004, the Company had 4,041,038 and 10,407,195 common stock options outstanding respectively, that were excluded in the computation of diluted earnings per share (EPS) in these periods, as their exercise prices were above the average market values in such periods. These options could potentially have a dilutive effect on EPS in the future.

**11. SEGMENT INFORMATION**

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

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

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

	Three Months Ended September 30,			
	2005		2004	
	AsiaInfo Technologies	Lenovo- AsiaInfo	Total	Total
<b>Revenues:</b>				
Software products and solutions	\$ 11,996	\$ 3,258	\$ 15,254	\$ 9,614
Service	4,053	2,267	6,320	4,304
Third party hardware	2,788	858	3,646	6,088
<b>Total revenues</b>	<b>18,837</b>	<b>6,383</b>	<b>25,220</b>	<b>20,006</b>
<b>Cost of revenues:</b>				
Software products and solutions	5,372	1,983	7,355	4,536
Service	1,601	1,834	3,435	1,328
Third party hardware	2,647	816	3,463	5,784
<b>Total cost of revenues</b>	<b>9,620</b>	<b>4,633</b>	<b>14,253</b>	<b>11,648</b>
<b>Gross profit</b>	<b>9,217</b>	<b>1,750</b>	<b>10,967</b>	<b>8,358</b>
<b>Business unit expenses:</b>				
Sales and marketing	2,993	2,368	5,361	3,092
General and administrative <sup>(1)</sup>	(123)	744	621	2,413
Research and development	2,736	349	3,085	2,279
Amortization of acquired intangible assets		401	401	151
<b>Total business unit expenses</b>	<b>5,606</b>	<b>3,862</b>	<b>9,468</b>	<b>7,935</b>
<b>Contribution profit (loss)</b>	<b>\$ 3,611</b>	<b>\$ (2,112)</b>	<b>\$ 1,499</b>	<b>\$ 423</b>

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	Nine Months Ended September 30,			
	2005		2004	
	AsiaInfo Technologies	Lenovo- AsiaInfo	Total	Total
<b>Revenues:</b>				
Software products and solutions	\$ 35,809	\$ 11,655	\$ 47,464	\$ 28,615
Service	12,854	7,358	20,212	14,849
Third party hardware	12,517	1,543	14,060	31,031
<b>Total revenues</b>	<b>61,180</b>	<b>20,556</b>	<b>81,736</b>	<b>74,495</b>
<b>Cost of revenues:</b>				
Software products and solutions	15,866	6,959	22,825	12,799
Service	6,402	5,498	11,900	5,904
Third party hardware	11,889	1,467	13,356	29,480
<b>Total cost of revenues</b>	<b>34,157</b>	<b>13,924</b>	<b>48,081</b>	<b>48,183</b>
<b>Gross profit</b>	<b>27,023</b>	<b>6,632</b>	<b>33,655</b>	<b>26,312</b>
<b>Business unit expenses:</b>				
Sales and marketing	7,831	7,371	15,202	8,687
General and administrative <sup>(1)</sup>	805	1,084	1,889	6,396
Research and development	7,597	1,421	9,018	6,593
Amortization of acquired intangible assets		1,255	1,255	480
<b>Total business unit expenses</b>	<b>16,233</b>	<b>11,131</b>	<b>27,364</b>	<b>22,156</b>
<b>Contribution profit (loss)</b>	<b>\$ 10,790</b>	<b>\$ (4,499)</b>	<b>\$ 6,291</b>	<b>\$ 4,156</b>

	As of September 30, 2005			As of December 31, 2004		
	AsiaInfo Technologies	Lenovo- AsiaInfo	Total	AsiaInfo Technologies	Lenovo- AsiaInfo	Total
Total assets <sup>(2)</sup>	\$ 201,974	\$ 67,554	\$ 269,528	\$ 234,580	\$ 62,784	\$ 297,364

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

(2) Included in total assets are net accounts receivable of \$40,119 and \$10,800 for AsiaInfo Technologies and Lenovo-AsiaInfo at September 30, 2005, respectively, and \$42,762 and \$15,590 for AsiaInfo Technologies and Lenovo-AsiaInfo at December 31, 2004, respectively.

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

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Total contribution profit for reportable segments	\$ 1,499	\$ 2,427	\$ 6,291	\$ 4,156
Corporate general and administrative expenses	1,927	2,004	5,749	
Net interest income	749	674	2,368	1,589
Gain from sales of investments	11	4,018	(3)	4,018
Other income (expense), net	170		181	(20)
Income before income taxes and equity in loss of affiliate	\$ 502	\$ 5,115	\$ 3,088	\$ 9,743



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

**12. RELATED PARTIES TRANSACTIONS**

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

In the three months ended September 30, 2005 and 2004, the Company entered into network solutions and software revenue contracts with China Netcom (Group) Company Limited ("China Netcom", formerly known as China Netcom Corporation Ltd.) with a total contract value of approximately \$2,973 and \$3,560, respectively. In the nine months ended September 30, 2005 and 2004, the Company entered into network solutions and software revenue contracts with China Netcom with a total contract value of approximately \$8,937 and \$8,648, respectively. Edward Tian, a Director and major shareholder of the Company, is the Chief Executive Officer of China Netcom, as well as the Vice President of China Netcom's parent company, China Network Communication Group Corporation.

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

	Three Months Ended September 30,			Nine Months Ended September 30,				
	2005		2004	2005			2004	
	China Lenovo	Netcom Total	China Netcom	Lenovo	China Netcom	Total	China Netcom	
<b>Revenues:</b>								
Software products and solutions	\$	\$ 1,790	\$ 1,790	\$ 500	\$ 2,941	\$ 5,200	\$ 8,141	\$ 2,032
Service		538	538	797	31	1,354	1,385	2,576
Third party hardware		268	268	376		1,519	1,519	2,845
<b>Total revenues</b>		<b>2,596</b>	<b>2,596</b>	<b>1,673</b>	<b>2,972</b>	<b>8,073</b>	<b>11,045</b>	<b>7,453</b>
<b>Purchases:</b>								
Software products and solutions		5	10	8	72	24	96	22
Service		1	13	2	40	24	64	6
<b>Total purchases</b>		<b>6</b>	<b>24</b>	<b>10</b>	<b>112</b>	<b>48</b>	<b>160</b>	<b>28</b>
<b>Operating expenses:</b>								

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Sales and marketing	69	10	79	3	165	25	190	8
General and administrative	4	4	8	4	67	12	79	11
Research and development	2	7	9	6	16	21	37	17
	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>
Total operating expenses	\$ 75	\$ 21	\$ 96	\$ 13	\$ 248	\$ 58	\$ 306	\$ 36
	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>

	As of September 30, 2005			As of December 31, 2004		
	China			China		
	Lenovo	Netcom	Total	Lenovo	Netcom	Total
	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>	<u>        </u>
Balances with related parties:						
Notes receivable	\$	\$ 1,348	\$ 1,348	\$	\$ 2,045	\$ 2,045
Net accounts receivable	169	6,570	6,739	8,457	5,357	13,814
Other receivables	276	83	359	198		198
Accounts payable				2,300		2,300
Deferred revenue	414	1,425	1,839	64	1,263	1,327
Other payables	507		507	135		135

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

### **13. COMMITMENTS AND CONTINGENCIES**

**Litigation-** On December 4, 2001, a securities class action case was filed against the Company, certain of its current officers and directors and the underwriters of the Company's initial public offering, or IPO. The lawsuit alleged violations of the federal securities laws and was docketed in the United States District Court for the Southern District of New York, or the Court, as *Hassan v. AsiaInfo Holdings, Inc., et al.* The lawsuit alleged, among other things, that the underwriters of the Company's IPO improperly required their customers to pay the underwriters excessive commissions and to agree to buy additional shares of the Company's common stock in the aftermarket as conditions to their purchasing shares in the Company's IPO. The lawsuit further claimed that these supposed practices of the underwriters should have been disclosed in the Company's IPO prospectus and registration statement. For purposes of case management, the Court has consolidated this case with lawsuits brought against approximately 300 other companies, all alleging similar practices by the underwriters of the companies' IPOs.

In June 2003, the Company elected to participate in a proposed settlement agreement with the plaintiffs in this litigation. If ultimately approved by the Court, this proposed settlement would result in a dismissal, with prejudice, of all claims in the litigation against the Company and against any of the other issuer defendants who elect to participate in the proposed settlement, together with the current or former officers and directors of participating issuers who were named as individual defendants. The proposed settlement does not provide for the resolution of any claims against the underwriter defendants, and the litigation against those defendants is continuing. The proposed settlement provides that the class members in the class action cases brought against the participating issuer defendants will be guaranteed a recovery of \$1 billion by insurers of the participating issuer defendants. If recoveries totaling \$1 billion or more are obtained by the class members from the underwriter defendants, however, the monetary obligations to the class members under the proposed settlement will be satisfied. In addition, all participating issuer defendants will be required to assign to the class members certain claims that the Company may have against the underwriters. The plaintiffs have filed a motion asking the Court to give its preliminary approval to the form of the documents, including the notice of the settlement to be sent to class members. On September 1, 2005, after considering the underwriter defendants' objections, the Court issued an order preliminarily approving the proposed settlement with the issuers in all respects.

The proposed settlement contemplates that any amounts necessary to fund the settlement or settlement-related expenses would come from participating issuers' directors and officers' liability insurance policy proceeds as opposed to funds of the participating issuer defendants themselves. A participating issuer defendant could be required to contribute to the costs of the settlement if that issuer's insurance coverage were insufficient to pay that issuer's allocable share of the settlement costs. The Company expects that its insurance proceeds will be sufficient for these purposes and that it will not otherwise be required to contribute to the proposed settlement. The Company believes that the final result of these actions will have no material effect on the Company's consolidated financial condition, results of operations or cash flows.

### **14. STOCK REPURCHASE PROGRAM**

In November 2004, the Board of Directors approved a stock repurchase program under which the Company was authorized to purchase up to 5,000,000 shares of its outstanding common stock, par value US\$0.01, during a period of up to six months. In the second quarter of 2005, the Board of Directors approved the repurchase of an additional 500,000 shares under the program, and an extension of the repurchase period to August 17, 2005.

During the nine month period ended September 30, 2005, the Company purchased 5,115,405 shares of its common stock at a cost of \$26,414. From the commencement of the program through September 30, 2005, the Company has purchased a total of 5,274,231 shares at a total cost of

\$27,282.

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In line with the Company's strategy of focusing on its core business lines, the Company entered into an agreement in October 2005 to sell certain assets constituting its human resources and business intelligence software business to Hinge Software Co. Ltd. ( Hinge ). Under the terms of the sale, Hinge has agreed to purchase the assets in exchange for cash in the amount of RMB15 million (approximately \$1.85 million), and to assume certain liabilities associated with such assets. Hinge is obligated to pay the purchase price no later than the close of business on December 30, 2005. The payment of the purchase price is secured by 8% of the outstanding equity interests of Hinge. In connection with the sale, the Company has agreed to reinvest the cash proceeds for 5% of the outstanding equity interests of Hinge. The Company presented these assets and liabilities separately as held for sale on the condensed consolidated balance sheet. The Company is in the processing of determining the possible gain or loss on the disposal of the assets and liabilities.

The assets and liabilities held for sale are as follows:

	<b>September 30,</b>
	<b>2005</b>
	<b>_____</b>
<b>Assets held for sale</b>	
Accounts receivable due from non-related parties (net of allowances of \$2 as of September 30, 2005)	\$ 1,711
Inventories	6
Other receivables	16
Goodwill	3,543
Other acquired intangible assets - net	1,347
	<b>_____</b>
<b>Total assets held for sale</b>	<b>\$ 6,623</b>
	<b>_____</b>
<b>Liabilities held for sale</b>	
Accrued expenses	\$ 292
Deferred revenue	16
Other payables	5
	<b>_____</b>
<b>Total liabilities held for sale</b>	<b>\$ 313</b>
	<b>_____</b>

**16. SUBSEQUENT EVENTS**

In November 2005, the Company entered into two separate agreements to sell 100% of the outstanding equity interest of Han Management Consulting (China) Limited ( Han ) and to transfer certain assets constituting the Company's e-government business unit acquired from Lenovo in 2004. Both arrangements are in line with the Company's strategy in focusing on its core business telecommunication software solutions and security products and services. Under the terms of the equity transfer agreement for Han, the selling price is RMB 25 million (approximately US\$3.1 million), payable by Han management team out of the future earnings of Han within 5 years from the transaction's effective date of October 1, 2005. 43% of the outstanding equity interests in Han have been pledged to the Company to secure the outstanding payment. The Company is also responsible for certain transition costs related to the disposal. Under the agreement signed with Pansky Technology Group ( Pansky ), the Company will transfer all assets, liabilities and sales backlog of its e-government business unit to Pansky for no consideration, with an effective date of November 1, 2005.



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

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

**Overview**

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

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

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

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

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addition, any future restructurings affecting our major telecommunications customers may result in delays or cancellation of telecommunications-related spending, which would likely have an adverse impact on our business.

In line with our strategy of focusing on our core business lines, we entered into an agreement in October 2005 to sell certain assets constituting our human resources and business intelligence software business to Hinge Software Co. Ltd. ( Hinge ). Under the terms of the sale, Hinge has agreed to purchase the assets in exchange for cash in the amount of RMB15 million (approximately \$1.85 million), and to assume certain liabilities associated



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with such assets. Hinge is obligated to pay the purchase price no later than the close of business on December 30, 2005. The payment of the purchase price is secured by 8% of the outstanding equity interests of Hinge. In connection with the sale, we have agreed to reinvest the cash proceeds for 5% of the outstanding equity interests of Hinge. We presented these assets and liabilities separately as held for sale on the condensed consolidated balance sheet. We are in the processing of determining the possible gain or loss on the disposal of the assets and liabilities.

In November 2005, we entered into an agreement to sell our subsidiary, Han Management Consulting (China) Limited ( Han ), to Han's management team and also will transfer certain assets constituting our e-government business unit to Pansky Technology Group ( Pansky ). Both arrangements are in line with the Company's strategy to focus on our core telecom software solutions and security products and services business. Under the terms of the sale, Han has been valued at RMB 25 million (approximately US\$3.1 million). Han's management is obligated to pay the purchase price with 5 years of the effective date of the agreement. In a separate agreement, we will transfer our e-government business to Pansky. Under the terms of the agreement, all assets and sales backlog as of November 1, 2005 will be transferred to Pansky.

**Revenues**

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

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

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

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

**Net revenue.** Although we report our revenue on a gross basis, inclusive of hardware acquisition costs, we manage our business internally based on revenues net of hardware costs, or net revenues, which is consistent with our strategy of providing our customers with high value IT professional services and, where efficient, outsourcing lower-end services such as hardware acquisition and installation. This strategy may result

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in lower growth rates for total revenue as against prior periods, but will not adversely impact revenue net of hardware costs. The following table shows our revenue breakdown on this basis and reconciles our net revenues to our total revenues:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
	(amounts in thousands of US dollars)			
Software products and solutions revenue	\$ 15,254	\$ 9,614	\$ 47,464	\$ 28,615
Service revenue	6,320	4,304	20,212	14,849
Hardware revenue net of hardware costs	183	304	704	1,551
	21,757	14,222	68,380	45,015
Total revenues net of hardware costs				
Total hardware costs	3,463	5,784	13,356	29,480
	\$ 25,220	\$ 20,006	\$ 81,736	\$ 74,495
Total revenues				

The information on total revenues net of hardware costs, or net revenues, in the above table is a non-GAAP financial measure within the meaning of Item 10 of Regulation S-K under the Exchange Act. We have provided a reconciliation of this non-GAAP financial measure to the most directly comparable GAAP financial measure, total revenues. We believe that the presentation of this non-GAAP measure provides useful information for investors regarding our regular financial performance because total revenues net of hardware costs more accurately reflect the core of our business, which is the provision of software solutions and services. We believe such measure

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

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

## **Cost of Revenues**

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

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

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

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

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

*Service costs.* Service costs consist primarily of compensation and travel expenses for the professionals involved in designing and implementing IT services, management consulting and network solutions projects. Service costs also include hardware warranty costs. We accrue hardware warranty costs upon final acceptance. We typically obtain manufacturers' warranties for hardware we sell, which cover a portion of the warranties that we give to our customers. We currently accrue 0.5% of hardware sales to cover potential warranty expenses. This estimate of warranty cost is based on our current experience with contracts for which the warranty period has expired.

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

## **Operating Expenses**

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

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

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

### **Taxes**

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

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

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

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

## **Foreign Exchange**

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

## **Critical Accounting Policies**

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

**Revenue recognition.** We generally charge a fixed price for all of our projects and recognize revenue based on the percentage of completion of the project as required under Statement of Position No. 81-1, Accounting for Performance of Construction-Type and certain Production-Type Contracts ( SOP 81-1 ). With respect to software products and solutions, revenue from customer orders requiring significant production, modifications, or customizations of the software are recognized over the installation and customization period. Labor costs and direct project

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expenses are used to determine the stage of completion. Costs related to insignificant obligations for a period of up to one year, which include telephone support, are accrued at the time the revenue is recorded. In cases where the customer requires additional software licenses, we typically enter into an extension agreement with the customer to expand and upgrade the customer's system. Revenue arising from such extension agreements is also recognized under SOP 81-1. We recognize service revenue (which is charged on a fixed price basis) based on the percentage of completion of the project as required under SOP 81-1. We use labor costs and direct project expenses to determine the state of completion. We recognize third party hardware revenue upon delivery of the hardware to the customer. Since a large part of the cost of certain projects often relates to hardware, the timing of hardware delivery can cause our quarterly gross revenue and inventory level to fluctuate significantly. However, those fluctuations do not significantly affect our gross profits because third party hardware revenue generally approximates the costs of the hardware.

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

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

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

## **Consolidated Results of Operations**

**Revenues.** Total revenues, including hardware costs, were \$25.2 million and \$81.7 million, respectively, in the three- and nine-month periods ended September 30, 2005, representing increases of 26.1% and 9.7%, respectively, against the comparable periods in 2004 and a 6.9% decrease compared to the previous quarter. The increases in our total revenue in the three- and nine-month periods ended September 30, 2005 were primarily attributable to the inclusion of Lenovo-AsiaInfo's operating results in those periods. Lenovo - AsiaInfo is the business unit we formed from the IT services business we acquired from Lenovo Group Limited in October 2004.

Net revenues (i.e., total revenues net of third party hardware costs) were \$21.7 million and \$68.3 million, respectively, for the three- and nine-month periods ended September 30, 2005, representing increases of 53.0% and 51.9% against the comparable periods in 2004, and representing decrease of 7.2% sequentially. The increase in our net revenues was attributable to the Company's continued focus on increasing high-margin software and service revenues, and to the inclusion of Lenovo-AsiaInfo's operating results.

Software revenue was \$15.3 and \$47.5 million in the three- and nine-month periods ended September 30, 2005, representing an increase of 58.7% and 65.9% over the comparable periods in 2004, and a decrease of 5.4% sequentially. Service revenue was \$6.3 and \$20.2 million,

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respectively, in the three- and nine-month periods ended September 30, 2005, representing increases of 46.9% and 36.1% over the comparable periods in 2004 and an 11.4% decrease sequentially. Third party hardware revenue was \$3.6 million and \$14.0 million, respectively, in the three- and nine-month periods ended September 30, 2005, representing decreases of 40.1% and 54.7% over the comparable periods in 2004 and a 4.8% decrease over the previous quarter. During the three- and nine-month periods ended September 30, 2005, Lenovo - AsiaInfo contributed 21.4% and 24.6% to software revenue, 35.9% and 36.4% to service revenue, and 23.5% and 11.0% to third party hardware revenue, respectively.

**Cost of revenues.** Our cost of revenues increased 22.4% to \$14.3 million and decreased 0.2% to \$48.1 million, respectively, in the three- and nine-month periods ended September 30, 2005. Our cost of revenues decreased 10.6% against the previous quarter. The Increase in the quarter on quarter comparison resulted from the consolidation of Lenovo-AsiaInfo's operating results.



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**Gross profit.** Our gross profit was \$11.0 million and \$33.7 million, respectively, in the three- and nine-month periods ended September 30, 2005, representing increases of 31.2% and 27.9%, respectively, against the comparable periods in 2004, and a slight sequential decrease. Our gross margin increased to 43% and 41%, respectively, in the three- and nine-month periods ended September 30, 2005, as compared to 42% and 35%, respectively, in the comparable periods of 2004 and 41% in the previous quarter. These increases are primarily due to reduced hardware pass-through and the increase in our higher-margin software revenue.

**Operating expenses.** Our operating expenses in the three- and nine-month periods ended September 30, 2005 were \$11.4 million and \$33.1 million, respectively, representing increases of 43.6% and 49.5% against the comparable periods in 2004 and a slight sequential increase. The period on period increases in operating expenses are attributable to the inclusion of Lenovo-AsiaInfo's operating results. Lenovo-AsiaInfo contributed 34% to operating expenses for both the three and the nine- month periods ended September 30, 2005.

Sales and marketing expenses were \$5.4 million and \$15.2 million, respectively, in the three- and nine-month periods ended September 30, 2005, representing increases of 73.4% and 75.0% against the comparable periods in 2004 and a sequential increase of 14.7%. The increases were primarily attributable to sales and marketing expenses of \$2.4 million and \$7.4 million from Lenovo-AsiaInfo, respectively, in the three- and nine-month periods ended on September 30, 2005, reflecting increased sales and marketing efforts in the security products and services business.

General and administrative expenses were \$2.5 million and \$7.6 million in the three- and nine-month periods ended on September 30, 2005, representing increases of 5.6% and 19.4%, respectively, compared with the same period last year and a sequential decrease of 18.1%. The decrease was mainly due to lower provision for bad debts as a result of improved collection.

Research and development expenses were \$3.1 million and \$9.0 million in the three- and nine-month periods ended on September 30, 2005, representing increases of 35.4% and 36.8%, respectively, compared with the same period in 2004 and a sequential increase of 12.0%. These increases are primarily attributable to the inclusion of Lenovo-AsiaInfo's operating results, as well as to our research and development efforts in developing software products to support our future growth.

**(Loss) Income from operations.** Loss from operations were approximately \$428,000 in the three-month period and income from operations were approximately \$542,000 in the nine-month period ended September 30, 2005, representing decreases of 201.2% and 87.0%, respectively compared with the same period last year, and a sequential decrease of 344.6%. The period on period decreases were primarily due to the inclusion of Lenovo-AsiaInfo's operating results, which included a \$2.1 million operating loss, during the third quarter of 2005. The sequential decrease was primarily due to the lower operating margin from Lenovo-AsiaInfo and an increase in research and development expenses attributable to our efforts in developing software products to support our future growth.

**Other Income.** Other income was approximately \$930,000 and \$2.5 million in the three-month and nine-month period ended September 30, 2005, representing decreases of 80.2% and 54.4% respectively, compared with the same periods last year and a sequential increase of 16.3%. The decreases are mainly due to the disposal gain on long-term investment in the third quarter of year 2004 and the increase is primarily due to the change in the exchange rate between the U.S. Dollar and the Renminbi during the third quarter.

**Net income.** Net income for the quarter ended on September 30, 2005 was \$0.4 million, or \$0.01 per basic share, compared to \$5.0 million or \$0.11 per basic share after an investment disposal gain of \$4 million in the year-ago period, and \$0.8 million or \$0.02 per basic share, for the previous quarter.

## Liquidity and Capital Resources

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

Our net operating cash flow was \$6.6 million for the third quarter of 2005. Our total cash position, including cash and cash equivalents, restricted cash and short term investments, increased from \$142.4 million at June 30, 2005 to \$148.3 million at September 30, 2005.

Our accounts receivable balance at September 30, 2005 was \$50.9 million, consisting of \$29.4 million in billed receivables and \$21.5 million in unbilled receivables. Our billed receivables are based on revenue we have booked and billed. Our unbilled receivables are based on revenue we have booked through the percentage completion method, but for which we have not yet billed the customer. For example, we recognize revenues for hardware pass-through at the time the hardware is accepted by the customer, based on the cost of the underlying hardware. However, our contracts with customers often allow the customers to withhold 10-20% of the total contract payments until final project acceptance, which on average is eight to nine months after hardware delivery. As a result, revenues from hardware pass-through generally represent a significant portion of our unbilled receivables and can cause the aging of these receivables to be relatively long.

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At the end of the third quarter, our days sales outstanding were 183 days, as compared to 185 days at June 30, 2005, as a result of enhanced collection efforts.

Our total shareholders' equity as of September 30, 2005 had increased by 15.6% sequentially, compared to the previous quarter - end, as a result of our reissue of 4.5 million of our treasury shares to Lenovo in July 2005 as part of the acquisition consideration for Lenovo's IT services division. Shareholders' equity also increased as a result of a currency translation adjustment due to the change on the foreign currency exchange rate in the third quarter. Upon delivery of these shares, Lenovo held approximately 11% of our outstanding common stock.

As of September 30, 2005, we had total short-term credit facilities for working capital purposes totaling \$27.3 million, expiring by December 2005, which were secured by bank deposits of \$14.0 million. \$4.0 million of the short-term credit facilities were used to issue letters of credit and notes payable at that date. Additional bank deposits of \$1.5 million were used for issuing standby letters of credit and bank acceptance drafts. Bank deposits pledged as security for these standby letters of credit, bank acceptance drafts and short-term credit facilities totaled \$15.5 million as of September 30, 2005, and are presented as restricted cash in our condensed consolidated balance sheets.

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

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

**Off-Balance Sheet Arrangements**

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

**Tabular Disclosure of Contractual Obligations**

The following table presents a breakdown of our outstanding contractual obligations by maturity as of September 30, 2005.

	Payment due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years

**Contractual Obligations**

Operating Lease Obligations	\$ 5,475	736	4,739
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**Recent Accounting Pronouncements**

The following are recently issued accounting pronouncements.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R). SFAS 123R is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation* and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. SFAS 123R requires all share-based payments to employees including grants of employee stock options, to be recognized in the financial statement based on their fair values. SFAS 123R is effective at the beginning of the first fiscal year beginning after June 15, 2005 (as modified by the SEC on April 14, 2005). Under APB Opinion No. 25, *Accounting for Stock Issued to Employees*, no stock-based compensation cost had been reflected in the net income of the Company for grants of stock options to employees. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 ( *SAB 107* ) regarding the SEC's interpretation of SFAS 123R and the valuation of share-based payments for public companies. On October 24, 2005, the Compensation Committee of our Board of Directors (the *Board* ) approved the acceleration of vesting of approximately 2.1 million unvested stock options previously awarded to employees and officers under

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our 2000 Stock Option Plan and 2002 Stock Option Plan. Options held by members of the Compensation Committee were excluded from the acceleration. The effective date of the acceleration was October 25, 2005. The primary purpose of the accelerated vesting is to enable us to avoid recognizing future compensation expense associated with the accelerated stock options upon the planned adoption of SFAS 123R by the Company in fiscal 2006. The Company expects the acceleration to reduce the stock option expense it otherwise would be required to record beginning in fiscal 2006 by more than \$7.5 million on a pre-tax basis.

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

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

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

We do not expect that the adoption of the following recent accounting pronouncements in January 2006 will have material impact on our financial statements:

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

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

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

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

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

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

Historically, China's telecommunications sector has been subject to a number of state-mandated restructurings. For example, in 2002 China Telecom was split geographically into a northern division (comprising ten provinces) and a southern division (comprising 21 provinces). Under the restructuring, the northern division of China Telecom merged with China Netcom and was renamed China Network Communications Group Corporation, or China

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

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

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

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

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

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

*Our working capital requirements may increase significantly.*

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

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

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



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

We maintain a relatively stable work force of software and network engineers engaged in all phases of planning and executing projects on behalf of our customers. As a result, our operating costs are relatively fixed from quarter to quarter, regardless of fluctuations in our revenues. In certain periods, this has resulted in our gross profit decreasing as a percentage of our net revenues. For example, during the second quarter of 2003 our revenues were impacted by the outbreak of SARS and our gross profit as a percentage of net revenue decreased to 56% as compared to 66% in the comparable period of 2002. Future fluctuations in our net revenues could result in similar decreases in our operating margins. In addition, enhanced competition in the software market and other markets in which we operate could result in reduced prices, which, together with our relatively fixed operating costs, could also result in reduced operating margins.

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

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

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

the diversion of management attention from other business concerns;

the additional expense associated with acquired contingent liabilities;

the loss of key employees in acquired businesses; and

the risk of being sued by terminated employees and contractors.

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

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

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In 2001, the State Secrecy Bureau of China promulgated the Administrative Measures for Qualification of Computer Information Systems Integration Involving State Secrets, which expressly prohibits foreign persons or foreign-invested enterprises from engaging in systems integration businesses involving state secrets (the restricted businesses ). We and our PRC operating subsidiaries are considered foreign persons or foreign-invested enterprises under PRC laws. In addition to a number of other types of IT services, one of the businesses operated by the IT services division we acquired from Lenovo in 2004 was a restricted business. We currently operate the restricted business through Lenovo Computer System and Technology Services Ltd., or Lenovo Computer. We intend to operate the restricted business through Lenovo Security Technologies (Beijing), Inc., or Lenovo Security, upon the receipt by Lenovo Security of all requisite business licenses and qualifications. Lenovo Security has obtained the Computer Information System Integration Concerning State Secrets Qualification Certificate issued by the National Administration for Protection of State Secrets, and is in the process of applying for other licenses and qualifications.

Lenovo Computer is owned by certain subsidiaries of Lenovo. Lenovo Security is owned by Legend Holdings Limited, the parent company and controlling shareholder of Lenovo, and certain of our employees who are PRC citizens. Lenovo Computer currently conducts substantially all of our operations relating to the restricted business, generates substantially all of our revenue relating to such business, and makes use of the licenses and approvals that are essential to such business. We do not currently have any equity interest in Lenovo Computer or Lenovo Security, but instead derive economic benefits similar to equity ownership in such companies through contractual arrangements between Lenovo-AsiaInfo Technologies, Inc., our wholly-owned subsidiary,

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and these affiliated entities and their respective shareholders. Further information on these arrangements is set forth under the heading "Certain Relationships and Related Transactions" in the definitive proxy statement for our 2005 annual meeting of shareholders, filed with the Securities and Exchange Commission on March 16, 2005.

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

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

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

The PRC State Administration of Foreign Exchange, or SAFE, issued a public notice on January 24, 2005 concerning the application of foreign exchange regulations to mergers and acquisitions involving foreign investments in China. Among other things, the public notice provides that if an offshore company controlled by PRC residents intends to acquire a PRC company, such acquisition will be subject to strict examination by the relevant foreign exchange authorities.

On April 21, 2005, SAFE issued another public notice clarifying the January notice, and on October 21, 2005 SAFE issued a notice, known as Circular 75, which replaced the first two notices and set forth a new regulatory framework for transactions involving offshore companies. Under Circular 75, if an acquisition of a PRC company by an offshore company controlled by PRC residents occurred prior to the various SAFE notices, certain PRC residents may be required to submit a registration form to the local SAFE branch to register their ownership interests in the offshore company before March 31, 2006. The PRC resident must also amend such registration form if there is a material event affecting the offshore company, such as, among other things, a change to share capital, a transfer of shares, or if such company is involved in a merger and an acquisition or a spin-off transaction or uses its assets in China to guarantee offshore obligations. In the past, we have acquired a number of PRC company's assets or equity interests through issuances of our shares of common stock to individuals who may be deemed to be PRC residents for

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purpose of the SAFE notices. However, there is substantial uncertainty as to whether our company would be considered an offshore company for purposes of Circular 75, thus giving rise to a retroactive filing obligation. Moreover, it is uncertain whether SAFE would impose any obligations on us in the event it determined that these PRC residents have an obligation to register under the notices.

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

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

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

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

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

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

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

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

*We are highly dependent on our executive officers.*

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

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

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

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

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

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

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

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

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

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

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

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

A portion of our business involves the development and customization of software applications for customers. We generally retain significant ownership or rights to use and market such software for other customer projects, where possible. However, our customers sometimes retain co-ownership and rights to use the applications, processes, and intellectual property so developed. In some cases, we may have no right or only limited rights to reuse or provide



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these developments in projects involving other customers. To the extent that we are unable to negotiate contracts which permit us to reuse source-codes and methodologies, or to the extent that we have conflicts with our customers regarding our ability to do so, we may be unable to provide similar solutions to our other customers.

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

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

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

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

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

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

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

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

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

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

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

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

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

Our main competitors in China include local systems integration and IT services firms, including Digital China, Huawei, Linkage and Neusoft. Our international competitors include multinational companies such as IBM Global Services and HP Services, which are establishing more active presences in the IT services market in China.

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

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

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

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

*High technology and emerging company stock has historically experienced extreme volatility and may cause losses to our stockholders.*

The trading price of our common stock may be subject to significant market volatility due to investor perceptions of investments relating to China and Asia, as well as developments in the telecommunications industry. In addition, the high technology sector of the stock market frequently experiences extreme price and volume fluctuations, which have particularly affected the market prices of many software companies, without regard to the operating performance of those companies.

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

In the past, following periods of volatility in the market price of a particular company's securities, securities class action litigation has often been brought against that company. Many companies in our industry have been subject to this type of litigation in the past, and we are currently involved in this type of litigation as a result of alleged improper allocation procedures relating to the sale of our common stock in connection with our initial public offering in March 2000. For more information on that litigation, please see the discussion under the heading "Item 1. Legal Proceedings" in Part II of this report. Litigation is often expensive and diverts management's attention and resources, which could materially and adversely affect our business.

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

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

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

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

We currently have authorized the size of our board of directors to be not less than three or more than ten directors. The terms of the office of the ten-member board of directors have been divided into three classes: Class I, whose term will expire at the annual meeting of the stockholders to be held in 2006; Class II, whose term will expire at the annual meeting of stockholders to be held in 2007; and Class III, whose term will expire at the annual meeting of stockholders to be held in 2008. This classification of the board of directors may have the effect of delaying or preventing changes in our control or management.

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

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

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

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

The Sarbanes-Oxley Act (the Act), which became effective in July 2002, imposed additional corporate governance, reporting and disclosure requirement on public companies introduced stricter independence and financial expertise standards for audit committees, and set stiff penalties for securities fraud.

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

Section 404 of the Act requires our management and our independent auditors to assess our internal controls over financial reporting on an annual basis. During the course of our assessment of our internal controls in 2004, we identified certain deficiencies that, if not remedied and re-tested by December 31, 2004, would result in material weaknesses in our internal controls. We subsequently hired an in-house U.S. tax expert and updated our control process for U.S. tax accounting. As a result, we believe we have successfully eliminated all previously identified deficiencies in our internal controls as of December 31, 2004. However, there can be no assurances that no deficiencies or material weaknesses in our internal financial reporting will arise in the future. Any of our inability to eliminate such deficiencies or material weaknesses could negatively impact investor confidence and our stock price.

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

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

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We are exposed to exchange rate risk in connection with the relative value of the U.S. dollar and the Renminbi. Substantially all of our revenues and expenses relating to the service and software components of our business are denominated in Renminbi. As of September 30, 2005, the rate of exchange quoted by the People's Bank of China was US\$1.00 = RMB8.092. If the exchange rate were to increase by 2% to US\$1.00 = RMB8.2538, our net assets would potentially decrease by \$1,927. If the exchange rate were to decrease by 2% to US\$1.00 = RMB7.9302, our net assets would potentially increase by \$1,852. To reduce currency risk related to the Renminbi, we maintain a significant portion of our cash deposits in U.S. dollars, and we have used such deposits to collateralize Renminbi denominated loans from Chinese banks.

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

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

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

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

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

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

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

**Table of Contents****PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

See discussions under Item I, Part II of our quarterly report on Form 10-Q filed with the Securities and Exchange Commission on August 9, 2005. On September 1, 2005, after considering the underwriter defendants' objections, the court issued an order preliminarily approving the proposed settlement with the issuer defendants in all respects.

The proposed settlement is subject to final approval by the court.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS****Issuer Purchases of Equity Securities (1)**

<u>Period</u>	<u>(a) Total Number of Shares Purchased</u>	<u>(b) Average Price Paid per Share</u>	<u>(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs</u>
July 1, 2005 - July 31, 2005	182,298	5.67	182,298	225,769
August 1, 2005 - August 31, 2005				
September 1, 2005 - September 30, 2005				
<u>Total</u>	182,298	5.67	182,298	

- (1) In November 2004, the Board of Directors approved a stock repurchase program under which the Company was authorized to purchase up to 5,000,000 shares of its outstanding common stock, par value US\$0.01, during a period of up to six months. In the second quarter of 2005, the Board of Directors approved the repurchase of an additional 500,000 shares under the program, and an extension of the repurchase period to August 17, 2005.

During the nine month period ended September 30, 2005, we purchased 5,115,405 shares of our common stock at a cost of \$26.4 million. From the commencement of the program through September 30, 2005, we have purchased a total of 5,274,231 shares at a total cost of \$27.3 million.

**ITEM 6. EXHIBITS**

(a) *Exhibits*



Please see Exhibit Index.

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SIGNATURE

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

AsiaInfo Holdings, Inc.

Date: November 9, 2005

By: /s/ Ying Han

\_\_\_\_\_  
Name: Ying Han  
Title: Chief Financial Officer

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## EXHIBIT INDEX

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

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

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10.15 (7) Power of Attorney executed by Lenovo (Beijing) Limited dated October 19, 2004

10.16 (7) Power of Attorney executed by Lenovo Manufacturing Limited dated October 19, 2004

10.17 (7) Loan Agreement between Lenovo-AsiaInfo Technologies, Inc. and Legend Holdings Limited dated October 19, 2004

10.18 (7) Employment Agreement between AsiaInfo Holdings, Inc. and Bing Yu dated September 9, 2004\*

10.19 (8) AsiaInfo Holdings, Inc. 2005 Stock Incentive Plan, as amended through April 8, 2005\*

10.20 (9) Power of Attorney executed by Legend Holdings Limited dated December 2, 2004

10.21 (9) Exclusive Business Cooperation Agreement between Lenovo-AsiaInfo Technologies, Inc. and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004

10.22 (9) Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Legend Holdings Limited and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004

10.23 (9) Equity Transfer Arrangement Agreement between Lenovo-AsiaInfo Technologies, Inc., Legend Holdings Limited and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004

10.24 (9) Loan Agreement executed by Lenovo-AsiaInfo Technologies, Inc. and Bing Yu dated October 19, 2004

10.25 (9) Loan Agreement executed by Lenovo-AsiaInfo Technologies, Inc. and Zheng Wang dated October 19, 2004

10.26 (9) Power of Attorney executed by Bing Yu dated December 2, 2004

10.27 (9) Power of Attorney executed by Zheng Wang dated December 2, 2004

10.28 (9) Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Zheng Wang and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004

10.29 (9) Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Bing Yu and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004

10.30 (9) Exclusive Option Agreement between Lenovo-AsiaInfo Technologies, Inc., Zheng Wang and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004\*

10.31 (9) Exclusive Option Agreement between Lenovo-AsiaInfo Technologies, Inc., Bing Yu and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004\*

11.1 Statement regarding computation of per share earnings (included in note 11 to the consolidated financial statements in this report)

31.1 Certification of Principal Executive Officer required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Principal Financial Officer required by Rules 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
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\* Management contract, or compensatory plan or arrangement.

- (1) Incorporated by reference to our Registration Statement on Form S-1 (No.333-93199).
- (2) Incorporated by reference to our Annual Report on Form 10-K for the fiscal year ended December 31, 2000.
- (3) Incorporated by reference to our Current Report on Form 8-K filed on October 25, 2004.
- (4) Incorporated by reference to our Quarterly Report on Form 10-Q filed on August 14, 2003.
- (5) Incorporated by reference to our Annual Report on Form 10-K for the fiscal year ended December 31, 2004.
- (6) Incorporated by reference to our Quarterly Report on Form 10-Q filed on August 9, 2004.
- (7) Incorporated by reference to our Quarterly Report on Form 10-Q filed on November 9, 2004.
- (8) Incorporated by reference to our Revised Proxy Statement for the 2004 Annual Meeting of Stockholders filed on April 14, 2004.
- (9) Incorporated by reference to our Quarterly Report on Form 10-Q filed on May 10, 2005.