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ASIAINFO HOLDINGS INC  
Form 10-Q  
August 14, 2003

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED June 30, 2003

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

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

DELAWARE 752506390  
(State or other jurisdiction of (I.R.S. Employer Identification No.)  
incorporation or organization)

4TH FLOOR, ZHONGDIAN INFORMATION TOWER  
6 ZHONGGUANCUN SOUTH STREET, HAIDIAN DISTRICT  
BEIJING 100086, CHINA  
(Address of principal executive office, including zip code)

+8610 6250 1658  
(Registrant's telephone number, including area code)

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

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

The number of shares outstanding of the Registrant's common stock as of  
August 11, 2003 was 44,479,447

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ASIAINFO HOLDINGS, INC.

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FORM 10-Q  
FOR THE QUARTER ENDED JUNE 30, 2003  
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## PART I. FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

ASIAINFO HOLDINGS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)  
(In US Dollars thousands, except per share amounts)

Three Month

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|  | 2002       |
|--|------------|
| Revenues:  |            |
| Communications solutions .....   | \$ 15,256  |
| Operation support system solutions .....   | 21,303     |
| Total revenues .....   | 36,559     |
| Cost of revenues:  |            |
| Communications solutions .....   | 9,188      |
| Operation support system solutions .....   | 14,334     |
| Total cost of revenues .....   | 23,522     |
| Gross profit .....   | 13,037     |
| Operating expenses:  |            |
| Sales and marketing (excluding stock-based compensation: 2002: \$7; 2003:<br>\$15 and amortization of acquired intangible assets: 2002: \$338; 2003:<br>nil) .....         | 4,809      |
| General and administrative (excluding stock-based compensation: 2002:<br>\$73; 2003: \$20 and amortization of acquired intangible assets: 2002:<br>\$48; 2003: \$40) ..... | 1,472      |
| Research and development (excluding stock-based compensation: 2002: \$17;<br>2003: \$2 and amortization of acquired intangible assets: 2002: \$91;<br>2003:nil) .....      | 2,345      |
| Amortization of deferred stock compensation .....  | 97         |
| Amortization of acquired intangible assets .....   | 477        |
| Total operating expenses .....   | 9,200      |
| Income (loss) from operations .....  | 3,837      |
| Other income (expense):  |            |
| Interest income .....  | 500        |
| Interest expense .....   | (30)       |
| Other income (expense), net .....  | 37         |
| Total other income, net .....  | 507        |
| Income (loss) before income taxes, minority interests and equity in loss<br>of affiliate .....   | 4,344      |
| Income tax expense (benefit) .....   | 529        |
| Income (loss) before minority interests .....  | 3,815      |
| Minority interests in loss of consolidated subsidiaries .....  | (45)       |
| Equity in loss of affiliate .....  | (154)      |
| Net income (loss) .....  | \$ 3,616   |
| Net income (loss) per share:   |            |
| Basic .....  | \$ 0.08    |
| Diluted .....  | \$ 0.08    |
| Shares used in computation:  |            |
| Basic .....  | 43,629,646 |
| Diluted .....  | 46,554,057 |

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See notes to condensed consolidated financial statements.

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ASIAINFO HOLDINGS, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)  
 (In US Dollars thousands, except per share amounts)

|   | Six M  |
|---|--------|
|   | -----  |
|   | 2002   |
|   | -----  |
| Revenues:   |        |
| Communications solutions .....  | \$ 32, |
| Operation support system solutions .....  | 32,    |
|   | -----  |
| Total revenues .....  | 65,    |
|   | -----  |
| Cost of revenues:   |        |
| Communications solutions .....  | 21,    |
| Operation support system solutions .....  | 19,    |
|   | -----  |
| Total cost of revenues .....  | 40,    |
|   | -----  |
| Gross profit .....  | 24,    |
|   | -----  |
| Operating expenses:   |        |
| Sales and marketing (excluding stock-based compensation: 2002: \$35;<br>2003: \$ 43 and amortization of acquired intangible assets: 2002: \$563;<br>2003: \$6) .....        | 8,     |
| General and administrative (excluding stock-based compensation: 2002:<br>\$165; 2003: \$51 and amortization of acquired intangible assets: 2002:<br>\$80; 2003: \$81) ..... | 5,     |
| Research and development (excluding stock-based compensation: 2002: \$50;<br>2003: \$11 and amortization of acquired intangible assets: 2002: \$152;<br>2003: nil) .....    | 4,     |
| Amortization of deferred stock compensation .....   |        |
| In-process research and development .....   |        |
| Impairment of goodwill and acquired intangible assets .....   |        |
| Amortization of acquired intangible assets .....  |        |
|   | -----  |
| Total operating expenses .....  | 19,    |
|   | -----  |
| Income (loss) from operations .....   | 4,     |
|   | -----  |
| Other income (expense):   |        |
| Interest income .....   | 1,     |
| Interest expense .....  |        |
| Other income (expense), net .....   |        |
|   | -----  |
| Total other income, net .....   | 1,     |
|   | -----  |
| Income (loss) before income taxes, minority interests and equity in loss  |        |

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|   |         |
|---|---------|
| of affiliate .....  | 6,      |
| Income tax expense (benefit) .....                            | -----   |
| Income (loss) before minority interests .....                 | 5,      |
| Minority interests in loss of consolidated subsidiaries ..... | (       |
| Equity in loss of affiliate .....                             | -----   |
| Net income (loss) .....                                       | \$ 5,   |
|   | =====   |
| Net income (loss) per share:                                  |         |
| Basic .....   | \$ 0    |
|   | =====   |
| Diluted .....   | \$ 0    |
|   | =====   |
| Shares used in computation:                                   |         |
| Basic .....   | 43,040, |
|   | =====   |
| Diluted .....   | 46,230, |
|   | =====   |

See notes to condensed consolidated financial statements.

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ASIAINFO HOLDINGS, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)  
(In US Dollars thousands, except per share amounts)

|   |              |
|---|--------------|
|   | December 31, |
|   | -----        |
|   | 2002 (1)     |
|   | -----        |
| ASSETS  |              |
| Current Assets:   |              |
| Cash and cash equivalents .....   | \$ 115,153   |
| Restricted cash .....   | 14,458       |
| Short-term investments .....  | 11,260       |
| Notes receivable .....  | 64           |
| Accounts receivable, trade (net of allowance for doubtful accounts of<br>\$1,133 and \$2,272 at December 31, 2002 and June 30, 2003, respectively) .... | 49,373       |
| Inventories .....   | 10,934       |
| Other receivables .....   | 8,758        |
| Deferred income taxes - current .....   | 1,653        |
| Prepaid expenses and other current assets .....   | 3,441        |
|   | -----        |
| Total current assets .....  | 215,094      |
| Property and equipment - net .....  | 4,046        |
| Goodwill .....  | 37,255       |
| Other acquired intangibles - net .....  | 4,031        |
| Investment in affiliate .....   | 2,808        |
| Deferred income taxes .....   | 196          |
|   | -----        |
| Total Assets .....  | \$ 263,430   |
|   | =====        |

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### LIABILITIES AND STOCKHOLDERS' EQUITY

|   |    |         |
|---|----|---------|
| Current Liabilities:  |    |         |
| Short-term bank loans .....   | \$ | 60      |
| Notes payable .....   |    | 2,447   |
| Accounts payable .....  |    | 19,261  |
| Other payables .....  |    | 2,483   |
| Deferred revenue .....  |    | 5,056   |
| Accrued employee benefits .....   |    | 5,083   |
| Other accrued expenses .....  |    | 13,226  |
| Income taxes payable .....  |    | 2,760   |
| Other taxes payable .....   |    | 2,579   |
|   |    | -----   |
| Total current liabilities .....   |    | 52,955  |
| Minority interest .....   |    | 317     |
|   |    | -----   |
| Stockholders' Equity:   |    |         |
| Common stock, 100,000,000 shares authorized, \$0.01 par value, shares<br>issued and outstanding: 2002: 44,193,474; 2003: 44,265,446 ..... |    | 442     |
| Additional paid-in capital .....  |    | 200,649 |
| Deferred stock compensation .....   |    | (105)   |
| Retained earnings (accumulated deficit) .....   |    | 9,110   |
| Accumulated other comprehensive income .....  |    | 62      |
|   |    | -----   |
| Total stockholders' equity .....  |    | 210,158 |
|   |    | -----   |
| Total Liabilities and Stockholders' Equity .....  | \$ | 263,430 |
|   |    | =====   |

(1) December 31, 2002 balances were obtained from audited financial statements.

See notes to condensed consolidated financial statements.

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### ASIAINFO HOLDINGS, INC. CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited) (In US Dollars thousands, except per share amounts)

|   | Six Months Ended June |         |
|---|-----------------------|---------|
|   | 2002                  | 2003    |
|   | (unaudited)           |         |
| Cash flows from operating activities:   |                       |         |
| Net income (loss) .....   | \$ 5,037              | \$ (30, |
| Adjustments to reconcile net income (loss) to net cash provided by<br>(used in) operating activities: |                       |         |
| Depreciation .....  | 1,433                 | 1,      |
| Amortization of other acquired intangible assets .....  | 795                   |         |
| Impairment of goodwill and acquired intangible assets .....   | -                     | 30,     |
| In-process research and development .....   | 350                   |         |
| Amortization of deferred stock compensation .....   | 250                   |         |
| Deferred income taxes .....   | (240)                 |         |
| Minority interest in loss of consolidated subsidiaries .....  | 10                    |         |

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|  |          |       |
|--|----------|-------|
| Equity in loss of an affiliate .....   | 281      |       |
| Loss on disposal of property and equipment .....                                     | 15       |       |
| Bad debt expense .....   | (14)     | 1,    |
| Stocks issued for services and other .....   | -        |       |
| Changes in operating assets and liabilities, net of effects of<br>business acquired: |          |       |
| Restricted cash .....  | 4,606    | (1,   |
| Notes receivable .....   | -        | (2,   |
| Accounts receivable .....  | 3,822    | (21,  |
| Inventories .....  | (865)    | 6,    |
| Other receivables .....  | 120      | 1,    |
| Prepaid expenses and other current assets .....                                      | (537)    | (     |
| Notes payable .....  | -        |       |
| Accounts payable .....   | (386)    | 7,    |
| Other payables .....   | (5)      | (     |
| Deferred revenue .....   | (1,187)  | 1,    |
| Accrued employee benefits .....  | (495)    |       |
| Other accrued expenses .....   | 2,345    | (2,   |
| Income taxes payable .....   | 356      | (1,   |
| Other taxes payable .....  | (279)    | (1,   |
|  | -----    | ----- |
| Net cash provided by (used in) operating activities .....                            | 15,412   | (10,  |
|  | -----    | ----- |
| Cash flows from investing activities:  |          |       |
| Decrease (increase) in short-term investments .....                                  | 25,794   |       |
| Purchases of property and equipment .....  | (618)    | (     |
| Increase in loan receivable .....  | (3,572)  |       |
| Purchase of a subsidiary, net of cash acquired .....                                 | (26,041) | (     |
|  | -----    | ----- |
| Net cash used in investing activities .....  | (4,437)  | (     |
|  | -----    | ----- |

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ASIAINFO HOLDINGS, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)--(CONTINUED)  
(In US Dollars thousands, except per share amounts)

|  | Six Months Ended<br>June 30, |       |
|--|------------------------------|-------|
|  | 2002                         | 2001  |
|  | (unaudited)                  |       |
|  | -----                        | ----- |
| Cash flows from financing activities:                                  |                              |       |
| Increase in short-term bank loans .....                                | \$ 1,957                     | \$    |
| Repayment of short-term bank loans .....                               | (5,220)                      |       |
| Proceeds on exercise of stock options .....                            | 2,441                        |       |
| Distribution to minority shareholder of consolidated subsidiaries .... | (217)                        |       |
|  | -----                        | ----- |
| Net cash used in financing activities .....                            | (1,039)                      |       |
|  | -----                        | ----- |
| Net increase (decrease) in cash and cash equivalents: .....            | 9,936                        | (11   |
| Cash and cash equivalents at beginning of period .....                 | 110,635                      | 115   |
| Effect of exchange rate changes on cash and cash equivalents .....     | 33                           |       |
|  | -----                        | ----- |

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|  |            |        |
|--|------------|--------|
| Cash and cash equivalents at end of period ..... | \$ 120,604 | \$ 103 |
|  | =====      | =====  |
| Supplemental cash flow information:              |            |        |
| Cash paid during the period:                     |            |        |
| Interest .....                                   | \$ 47      |        |
|  | =====      | =====  |
| Income taxes .....                               | \$ 246     | \$     |
|  | =====      | =====  |

### Non-cash investing activity:

In February 2002, the Company acquired 100% of the outstanding equity shares of Bonson for cash of \$33,387, of which \$624 represented acquisition costs, and the issuance of 1,031,686 shares of common stock with a fair market value at the time the acquisition was announced of approximately \$18,003. Of the cash amount, \$20,433 was paid on April 4, 2002. In connection with the acquisition, the Company acquired assets with a fair value of \$28,364 and assumed liabilities of \$17,737.

See notes to condensed consolidated financial statements.

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ASIAINFO HOLDINGS, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)  
Six Months Ended June 30, 2002 and 2003  
(In US dollars thousands, except per share amounts)

### 1. GENERAL AND BASIS OF PREPARATION

AsiaInfo Holdings, Inc. (the "Company") is incorporated in the State of Delaware, in the United States of America (the "US"). The Company principally operates through the following directly owned subsidiaries, or their respective subsidiaries: AsiaInfo Technologies (China), Inc. ("AsiaInfo Technologies") (100% owned), incorporated in the People's Republic of China ("China" or the "PRC"), Marsec Holdings, Inc. ("Marsec") (100% owned), and Bonson Information Technology Holdings Limited, ("Bonson") (100% owned), both incorporated in the Cayman Islands.

On March 2, 2000, the Company completed an initial public offering of 5,750,000 shares of its common stock, raising net proceeds of \$126,610. The Company's common stock is traded on The Nasdaq National Market in the United States.

The Company acts as a holding company and, through certain subsidiaries, sources network-related equipment in the United States for sale to customers in the PRC.

AsiaInfo Technologies was established as a wholly foreign owned enterprise with an initial operating term of 15 years commencing May 2, 1995 (date of establishment). Its principal activities are conducted in the PRC and comprise the provision of telecommunications-related information technology professional services and software products. In November 2001, the Company merged its wholly owned subsidiary, Zhejiang AsiaInfo Telecommunication Technology Co., Ltd. ("AI Zhejiang"), into AsiaInfo Technologies. AI Zhejiang's activities were performed in the PRC and comprised the development and sale of communication hardware and software as well as providing related technology services. AI Zhejiang was acquired in April 1999.

On December 31, 2001, AsiaInfo Technologies formed a wholly owned subsidiary, AsiaInfo Technologies (Chengdu), Inc. ("AI Chengdu"), with an initial operating



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term of 15 years to provide operational support for systems integration projects.

Guangdong Wangying Communications Technology Co., Ltd. ("Wangying") (40% owned, but controlled by AsiaInfo Technologies) was established on September 6, 2000 with an initial operating term of 4 years for a particular customer project in the PRC. As of July 25, 2003, Wangying has been dissolved.

Marsec, through its wholly owned subsidiary, provides network security consulting and services in the PRC. In September 2001, the Company exercised warrants to purchase 200,000 additional voting preferred shares of Marsec at \$3.50 a share, increasing its investment in Marsec from 75% to 79%. On January 22, 2003, the Company entered into an agreement to acquire the remaining 250,000 common shares of Marsec, thereby increasing its ownership interest in Marsec from 79% to 100%. The aggregate acquisition price consisted of 14,375 shares of the Company's common stock and approximately \$150 in cash. The total consideration was recorded as goodwill on the date of the transaction but management believed such goodwill was impaired. As a result, the full amount was charged to the impairment of goodwill and acquired intangible assets in the condensed consolidated statements of operations.

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ASIAINFO HOLDINGS, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)  
Six Months Ended June 30, 2002 and 2003  
(In US dollars thousands, except per share amounts)

### 1. GENERAL AND BASIS OF PREPARATION - CONTINUED

On April 27, 2001, the Company invested approximately \$6,157 to acquire a 14.25% interest (in the form of voting preferred shares) in Intrinsic Technology (Holdings), Ltd. ("Intrinsic"), a Cayman Islands company engaged in wireless infrastructure solutions development through two wholly owned subsidiaries in the PRC. As of June 30, 2003, the Company's interest in Intrinsic had been diluted from 14.25% to 14.22% due to another shareholder's exercise of warrants to purchase 37,770 shares of Intrinsic's stock.

In February 2002, the Company acquired 100% of the outstanding equity shares of Bonson, a leading developer of wireless telecommunications software and solutions, operating through its subsidiary AsiaInfo Management Software, Inc. (formerly Guangzhou Bonson Technology Limited) ("AsiaInfo Management"), based in Guangzhou, China, for \$32,763 in cash, including a holdback of \$105 which was paid in June 2003, and the issuance of 1,031,686 shares of the Company's common stock.

The consolidated financial statements include the financial statements of the Company and its subsidiaries. All significant inter-company transactions and balances are eliminated in consolidation. Investments in 50% or less owned affiliates over which the Company exercises significant influence, but not control, are accounted for using the equity method. The Company's share of earnings (losses) of these companies is included in the accompanying consolidated statement of operations.

In the Company's opinion, all adjustments necessary for a fair presentation of the unaudited results of operations for the three months and six months ended June 30, 2002 and 2003 are included in the accompanying condensed financial statements. All such adjustments are of a normal and recurring nature. The results of operations for the periods are not necessarily indicative of the results of operations for the full year. The financial statements are unaudited.

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The Company's revenue is derived from the procurement of hardware on behalf of customers, software license fees, and professional services for systems design, planning, consulting, and systems integration, and is recognized based on the percentage of completion method. Revenues in both communications solutions and operation support system solutions from customer orders requiring significant production, modifications, or customization of the software are recognized over the installation and customization period. Labor costs and direct project expenses are used to determine the stage of completion, except for revenues associated with the procurement of hardware. Such hardware-related revenues are recognized upon delivery. Estimates of hardware warranty costs are included in determining project costs. Revenue from packaged software license fees through reseller arrangements is recorded when the related products are shipped and installed. 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.

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ASIAINFO HOLDINGS, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)  
Six Months Ended June 30, 2002 and 2003  
(In US dollars thousands, except per share amounts)

1. GENERAL AND BASIS OF PREPARATION - CONTINUED

Revenue in both communications solutions and operation support system solutions include the benefit of the rebate of value added taxes on sales of software received from the Chinese tax authorities as part of the PRC government's policy of encouragement of software development in the PRC. The rebate was \$613 and \$355 for the three months ended June 30, 2002 and 2003, respectively, and \$1,263 and \$848 for the six months ended June 30, 2002 and 2003, respectively.

Revisions in estimated contract profits are made in the period in which the circumstances requiring the revision become known. Provisions, if any, are made currently for anticipated losses on uncompleted contracts. Revenue in excess of billings is recorded as unbilled receivables and included in trade accounts receivable, and amounted to \$28,767 at December 31, 2002 and \$49,729 at June 30, 2003. Billings in excess of revenues recognized are recorded as deferred income. Billings are rendered based on agreed milestones included in the contracts with customers.

At December 31, 2002 and June 30, 2003, the balance of trade accounts receivable of \$20,606 and \$20,308, respectively, represented amounts billed but not yet collected. All billed and unbilled amounts are expected to be collected within 1 year.

These financial statements of the Company and its subsidiaries are prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"). This basis of accounting differs from that used in the statutory financial statements of the PRC subsidiaries which are prepared in accordance with the accounting principles and the relevant financial regulations applicable to enterprises with foreign investment as established by China's Ministry of Finance. The principal adjustments made to conform the statutory financial statements of these subsidiaries to U.S. GAAP included an adjustment to record goodwill from business acquisitions and the related impairment provisions, and an adjustment to recognize compensation expense on the issuance of stock options.

The preparation of financial statements in conformity with U.S. GAAP requires

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management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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 as cumulative translation adjustments in stockholders' equity. The Renminbi is not fully convertible into United States dollars or other foreign currencies. The rate of exchange quoted by the People's Bank of China on June 30, 2003 was US\$1.00=RMB8.2774. No representation is made that the Renminbi amounts could have been, or could be, converted into United States dollars at that rate or at any other rate.

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ASIAINFO HOLDINGS, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)  
Three Months Ended June 30, 2002 and 2003  
(In US dollars thousands, except per share amounts)

### 1. GENERAL AND BASIS OF PREPARATION - CONTINUED

In August 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations," which addresses the accounting for the recognition of obligations associated with the retirement of tangible long-lived assets. The Company adopted SFAS No. 143 on January 1, 2003. This adoption did not have a significant impact on the Company's financial position or results of operations.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure - an Amendment of FASB Statement No. 123," which provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The amended disclosure requirements of SFAS No. 148 are effective for years ending after December 15, 2002 and are reflected in the Company's condensed consolidated financial statements.

In November 2002, the Emerging Issues Task Force (the "EITF") reached a consensus on Issue No. 00-21 ("EITF 00-21"), "Revenue Arrangements with Multiple Deliverables". EITF 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which the vendor will perform multiple revenue generating activities. EITF 00-21 is effective for fiscal periods beginning after June 15, 2003. The adoption of EITF 00-21 did not have a material impact on the Company's financial statements.

Reclassifications - Certain comparative figures have been reclassified to conform to current period's presentation.

### 2. CASH AND CASH EQUIVALENTS

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

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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 certificates of deposit issued by major financial institutions that have maturities of between 6 and 12 months. As there are no significant market price movements for such investments, they are held at cost and accrued interest. There were no realized or unrealized gains or losses as of June 30, 2003.

### 4. NOTES RECEIVABLE

At December 31, 2002 and June 30, 2003, the balances of notes receivable of \$64 and \$2,196, respectively, represented bank acceptance drafts that are non-interest bearing and due within six months.

### 5. COMPREHENSIVE INCOME

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

|   | Three Months Ended June 30, |            |
|---|-----------------------------|------------|
|   | 2002                        | 2003       |
| Net income (loss) .....                           | \$3,616                     | \$ (1,053) |
| Change in cumulative translation adjustment ..... | 21                          | (8)        |
|   | -----                       | -----      |
| Comprehensive income (loss) .....                 | \$3,637                     | \$ (1,061) |
|   | =====                       | =====      |

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ASIAINFO HOLDINGS, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)  
Six Months Ended June 30, 2002 and 2003  
(In US dollars thousands, except per share amounts)

### 5. COMPREHENSIVE INCOME - CONTINUED

|   | Six Months Ended June 30, |             |
|---|---------------------------|-------------|
|   | 2002                      | 2003        |
| Net income (loss) .....                           | \$5,037                   | \$ (30,100) |
| Change in cumulative translation adjustment ..... | 37                        | (4)         |
|   | -----                     | -----       |
| Comprehensive income (loss) .....                 | \$5,074                   | \$ (30,104) |
|   | =====                     | =====       |

### 6. SHORT-TERM BANK LOANS

As of December 31, 2002 and June 30, 2003, the Company had total short-term credit facilities for working capital purposes totaling \$20,000 and \$32,081 expiring by October 2003 and June 2004, respectively. The facilities were secured by bank deposits of \$10,000 as of December 31, 2002 and June 30, 2003, respectively. At December 31, 2002, unused short-term credit facilities were \$18,574 and used facilities totaled \$1,426. The used facilities were pledged as

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security for standby letters of credit issued to hardware suppliers and customers. Additional bank deposits of \$4,458 were used for issuing standby letters of credit and guarantees as of December 31, 2002. At June 30, 2003, unused short-term credit facilities were \$31,638 and used facilities totaled \$443. The used facilities are pledged as security for standby letters of credit issued to hardware suppliers and customers. Additional bank deposits of \$6,055 were used for issuing standby letters of credit and guarantees as of June 30, 2003. Bank deposits pledged as security for these credit facilities totaled \$14,458 and \$16,055 as of December 31, 2002 and June 30, 2003, respectively, and are presented as restricted cash in the consolidated balance sheets.

In addition, as of December 31, 2002 and June 30, 2003, the Company had short-term borrowings of \$60 in RMB, the currency of the PRC, bearing an interest rate of 4.8% and secured by AsiaInfo Management's assets.

7. NOTES PAYABLE

At December 31, 2002 and June 30, 2003, the balances of notes payable of \$2,447 and \$2,907, respectively, represented commercial notes of \$1,245 and \$2,868, and bank acceptance drafts of \$1,202 and \$39, that are non-interest bearing and due within six months.

8. INCOME TAXES

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.

A reconciliation between the provision for income taxes computed by applying the US federal tax rate to income (loss) before income taxes, minority interests and equity in loss of affiliate and the actual provision for income taxes is as follows:

|  | Three Months Ended June |       |
|--|-------------------------|-------|
|  | 2002                    | 2003  |
|  | -----                   | ----- |
| US federal rate .....  | 35%                     |       |
| Difference between statutory rate and foreign effective tax rate .....                       | (22)                    |       |
| Change in valuation allowance .....  | (4)                     |       |
| Expenses not deductible for tax purposes-deferred stock compensation expense and other ..... | 3                       |       |
|  | -----                   | ----- |
|  | 12%                     |       |
|  | =====                   | ===== |

ASIAINFO HOLDINGS, INC.  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)  
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8. INCOME TAXES - CONTINUED

Six Months Ended  
 -----

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|  |       |
|--|-------|
|  | 2002  |
|  | ----- |
| US federal rate .....  | 35%   |
| Difference between statutory rate and foreign effective tax rate .....                       | (22)  |
| Change in valuation allowance .....  | (3)   |
| Benefit of stock option deduction .....  | -     |
| Non-deductible goodwill and intangible expenses .....  | -     |
| Expenses not deductible for tax purposes-deferred stock compensation expense and other ..... | 3     |
|  | ----- |
|  | 13%   |
|  | ===== |

9. CAPITAL STOCK

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

|                                   | Number of shares | Outstanding options weighted average exercise price per share |
|-----------------------------------|------------------|---|
|                                   | -----            | -----   |
| Outstanding, January 1, 2003:     | 9,885,565        | \$ 8.14   |
| Granted .....                     | 80,750           | 5.25  |
| Cancelled .....                   | (404,524)        | 10.61   |
| Exercised .....                   | (3,100)          | 3.83  |
|                                   | -----            | -----   |
| Outstanding, March 31, 2003 ..... | 9,558,691        | \$ 8.01   |
|                                   | =====            | =====   |
| Granted .....                     | 807,000          | 4.20  |
| Cancelled .....                   | (454,957)        | 9.92  |
| Exercised .....                   | (6,650)          | 3.11  |
|                                   | -----            | -----   |
| Outstanding, June 30, 2003 .....  | 9,904,084        | \$ 7.62   |
|                                   | =====            | =====   |

The exercise price of all options granted during the three months and the six months ended June 30, 2003 was equal to the fair market value of the Company's common stock on the dates of grant.

10. ACCOUNTING FOR STOCK-BASED COMPENSATION

The following table summarizes relevant information as to reported results under the Company's intrinsic value method of accounting for stock awards, with supplemental information as if the fair value recognition provisions of FASB Statement 123 had been applied:

|   |                    |
|---|--------------------|
|   | Three Months Ended |
|   | -----              |
|   | 2002               |
|   | -----              |
| Net income (loss) as reported .....                                       | \$ 3,616           |
| Add: Stock-based compensation included in reported net income (loss) .... | 97                 |

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|   |           |
|---|-----------|
| Deduct: Total stock-based compensation expense      |           |
| Under SFAS 123, net of tax effect .....             | (4,235)   |
|   | -----     |
| Pro forma net loss .....                            | \$ (522)  |
|   | =====     |
| Basic and diluted net income (loss) per share:      | \$ 0.08   |
|   | =====     |
| Reported basic net income (loss) per common share   |           |
| Reported diluted net income (loss) per common share | \$ 0.08   |
|   | =====     |
| Pro forma net income (loss) per common share        | \$ (0.01) |
|   | =====     |

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ASIAINFO HOLDINGS, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)  
Six Months Ended June 30, 2002 and 2003  
(In US dollars thousands, except per share amounts)

10. ACCOUNTING FOR STOCK-BASED COMPENSATION - CONTINUED

|   | Six Months Ended |
|---|------------------|
|   | -----            |
|   | 2002             |
|   | -----            |
| Net income (loss) as reported .....                                       | \$ 5,037         |
| Add: Stock-based compensation included in reported net income loss) ..... | 250              |
| Deduct: Total stock-based compensation expense                            |                  |
| Under SFAS 123, net of tax effect .....                                   | (8,110)          |
|   | -----            |
| Pro forma net loss  | \$ (2,823)       |
|   | =====            |
| Basic and diluted net income (loss) per share:                            |                  |
| Reported basic net income (loss) per share .....                          | \$ 0.12          |
|   | =====            |
| Reported diluted net income (loss) per share .....                        | \$ 0.11          |
|   | =====            |
| Pro forma net income (loss) per common share .....                        | \$ (0.07)        |
|   | =====            |

11. NET INCOME (LOSS) PER SHARE

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

|                         | Three Months Ended June 30, |            |
|-------------------------|-----------------------------|------------|
|                         | -----                       |            |
|                         | 2002                        | 2003       |
|                         | -----                       | -----      |
| Net income (numerator): |                             |            |
| Net income (loss)       |                             |            |
| Basic and diluted ..... | \$ 3,616                    | \$ (1,053) |
|                         | =====                       | =====      |

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|                                 |            |             |
|---------------------------------|------------|-------------|
| Shares (denominator):           |            |             |
| Weighted average                |            |             |
| Common Stock Outstanding ....   | 43,629,646 | 44,261,401  |
|                                 | -----      | -----       |
| Basic .....                     | 43,629,646 | 44,261,401  |
| Options (Treasury Method) ..... | 2,924,411  | -           |
|                                 | -----      | -----       |
| Diluted .....                   | 46,554,057 | 44,261,401  |
|                                 | =====      | =====       |
| Net income (loss) per share:    |            |             |
| Basic .....                     | \$ 0.08    | \$ (0.02)   |
|                                 | =====      | =====       |
| Diluted .....                   | \$ 0.08    | \$ (0.02)   |
|                                 | =====      | =====       |
| Six Months Ended June 30,       |            |             |
|                                 | -----      | -----       |
|                                 | 2002       | 2003        |
|                                 | -----      | -----       |
| Net income (numerator):         |            |             |
| Net income (loss)               |            |             |
| Basic and diluted .....         | \$ 5,037   | \$ (30,100) |
|                                 | =====      | =====       |
| Shares (denominator):           |            |             |
| Weighted average                |            |             |
| Common Stock Outstanding ....   | 43,040,879 | 44,234,013  |
|                                 | -----      | -----       |
| Basic .....                     | 43,040,879 | 44,234,013  |
| Options (Treasury Method) ..... | 3,189,177  | -           |
|                                 | -----      | -----       |
| Diluted .....                   | 46,230,056 | 44,234,013  |
|                                 | =====      | =====       |
| Net income (loss) per share:    |            |             |
| Basic .....                     | \$ 0.12    | \$ (0.68)   |
|                                 | =====      | =====       |
| Diluted .....                   | \$ 0.11    | \$ (0.68)   |
|                                 | =====      | =====       |

As of June 30, 2002, the Company had 1,269,800 options outstanding that could have potentially diluted earnings per share ("EPS") in the future, but which were excluded in the

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ASIAINFO HOLDINGS, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)  
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11. NET INCOME (LOSS) PER SHARE - CONTINUED

computation of diluted EPS in these periods, as their exercise prices were above the average market values in such periods.

As of June 30, 2003, the Company had 9,904,084 options outstanding that could have potentially diluted EPS in the future, but which were excluded in the computation of diluted EPS in these periods, as their effect would have been antidilutive due to the net loss reported in these periods.

12. ACQUISITION



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On February 6, 2002 (the "date of acquisition"), the Company acquired all of the outstanding common shares of Bonson. The results of Bonson's operations have been included in the consolidated financial statements since that date. Bonson is a provider of operation support system solutions and other services in China. As a result of the acquisition, the Company is expected to be the leading provider of operation support system solutions in the China market.

The aggregate purchase price was \$51,390, including \$32,763 in cash, \$624 of acquisition costs and common stock valued at \$18,003. The value of the 1,031,686 common shares issued was determined based on the average market price of the Company's common shares over the 5-day period before and after the terms of the acquisition were agreed to and announced.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition:

|                                | At February 6, 2002 |
|--------------------------------|---------------------|
| Current assets                 | \$ 27,517           |
| Property, plant, and equipment | 843                 |
| Intangible assets              | 6,130               |
| Goodwill                       | 35,067              |
| Deferred tax assets            | 4                   |
|                                | -----               |
| Total assets acquired          | 69,561              |
| Current liabilities            | (17,737)            |
| Deferred tax liabilities       | (434)               |
|                                | -----               |
| Total liabilities assumed      | (18,171)            |
|                                | -----               |
| Net assets acquired            | \$ 51,390           |

The total purchase price had been allocated to the assets acquired and liabilities assumed based on their respective fair values as follows:

#### Purchase Price Allocation:

|   |          |               |
|---|----------|---------------|
| Fair market value of net tangible assets acquired at February 6, 2002 | \$10,627 |               |
| Intangible assets acquired:   |          | Economic Life |
| Core technology   | 1,280    | 3.5 years     |
| Trade name  | 700      | Indefinite    |
| Indefinite contract backlog   | 2,700    | 2 years       |
| Favorable lease   | 400      | 2.1 years     |
| License   | 700      | Indefinite    |
| In-process technology   | 350      |               |
| Goodwill  | 35,067   | Indefinite    |
| Deferred tax liabilities  | (434)    |               |
|   | -----    |               |
|   | \$51,390 |               |

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ASIAINFO HOLDINGS, INC.  
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12. ACQUISITION - CONTINUED

The Company recorded a one-time charge of \$350 at the date of acquisition in accordance with FASB Interpretation No. 4, "Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method," for purchased in-process technology related to a development project that had not reached technological feasibility, had no alternative future use, and for which successful development was uncertain. The conclusion that the in-process development effort, or any material sub-component, had no alternative future use was reached in consultation with the Company's management and Benson's management.

The goodwill of \$35,067 arising from the acquisition was assigned to the operation support system segment and is not expected to be deductible for tax purposes.

During the quarter ended March 31, 2003, the Company completed the annual impairment test for the goodwill and other acquired intangible assets of Bonson and concluded that an impairment of \$29,836 of the recorded goodwill and other acquired intangible assets of Bonson was necessary due to industry-wide equity devaluations of the past year. Both an income (discounted cash flow) approach and a market (guideline company) approach were employed to determine the fair value of the net assets of Bonson. The fair value was then allocated among all the assets of Bonson at their fair values, including previously unrecognized intangible assets. The residual value after the allocation was then compared to the carrying value of goodwill to determine the amount of impairment loss. The impaired goodwill of \$26,000 and other acquired intangible assets of \$3,836 are related to the operation support system solutions segment. After the impairment is recorded, the remaining goodwill and other acquired intangible assets of Bonson are \$9,067 and \$148, respectively.

The following selected unaudited pro forma combined results of operations for the three months and six months ended June 30, 2002 of the Company and Bonson have been prepared assuming that the acquisitions occurred at the beginning of that period. The following pro forma financial information is not necessarily indicative of the results that would have occurred had the acquisition been completed at the beginning of the period indicated, nor is it indicative of future operating results:

|                      | Three Months Ended June 30, | Six Months Ended June 30, |
|----------------------|-----------------------------|---------------------------|
|                      | 2002                        |                           |
| Total revenue        | \$ 36,559                   |                           |
| Net income           |                             | 3,616                     |
| Net income per share |                             |                           |
| - Basic              | \$ 0.08                     |                           |

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|  |            |
|--|------------|
| - Diluted  | \$ 0.08    |
| Shares used in calculation of net income per share |            |
| - Basic  | 43,802,176 |
| - Diluted  | 46,726,587 |

The pro forma results of operations give effect to certain adjustments, including amortization of purchased intangibles with definite lives, associated with the acquisition. The charge for purchased in-process research and development of \$350 has been excluded from the pro forma results, as it is a material non-recurring charge. Amortization of these assets ceased upon the adoption of SFAS No. 142 on January 1, 2002.

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ASIAINFO HOLDINGS, INC.  
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13. SEGMENT AND GEOGRAPHIC OPERATING INFORMATION

During the fourth quarter of 2002, the Company conducted a business reorganization in order to more accurately reflect its strategic focus. As such, the company restructured its operations into two strategic business units ("SBUs"): Operation Support System Solutions ("OSS") and Communications Solutions ("CS"). Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the Company's chief operating decision maker. By this definition, the Company has two operating segments (separate lines of business): OSS and CS (each net of hardware costs). Each business line has separate operating data and separate management individuals responsible for the sales, marketing and development efforts. The OSS SBU is designed to offer customers a "one window" shopping solution for all of their OSS needs. The second SBU, CS, includes all the remaining business lines from the Company such as network solutions, service applications solutions and network security solutions, as well as network monitoring. Both units contain revenues previously listed under Network Solutions and Software Solutions. The new units benefit from cost efficiencies gained from combined sales staff and offer more integrated quality services to their customers.

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ASIAINFO HOLDINGS, INC.  
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13. SEGMENT AND GEOGRAPHIC OPERATING INFORMATION - CONTINUED

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|   | Three Months Ended June 30, |          |
|---|-----------------------------|----------|
|   | 2002                        | 2003     |
|   | (unaudited)                 |          |
| Revenues net of hardware cost:                        |                             |          |
| Communications solutions net of hardware cost .....   | \$ 9,603                    | \$ 7,101 |
| Operation support system solutions .....              | 10,009                      | \$ 5,655 |
|   | -----                       | -----    |
| Consolidated revenues net of hardware cost .....      | \$19,612                    | \$12,756 |
| Consolidated cost of sales net of hardware cost ..... | 6,575                       | 5,554    |
|   | -----                       | -----    |
| Consolidated gross profit .....                       | \$13,037                    | \$ 7,202 |
|   | =====                       | =====    |
| Gross profit:   |                             |          |
| Communications solutions .....                        | \$ 6,069                    | \$ 4,820 |
| Operation support system solutions .....              | 6,968                       | 2,382    |
|   | -----                       | -----    |
| Consolidated gross profit .....                       | \$13,037                    | \$ 7,202 |
|   | =====                       | =====    |

|   | Six Months Ended June 30, |          |
|---|---------------------------|----------|
|   | 2002                      | 2003     |
|   | (unaudited)               |          |
| Revenues net of hardware cost:                        |                           |          |
| Communications solutions net of hardware cost .....   | \$18,776                  | \$13,782 |
| Operation support system solutions .....              | 17,910                    | 11,692   |
|   | -----                     | -----    |
| Consolidated revenues net of hardware cost .....      | 36,686                    | 25,474   |
| Consolidated cost of sales net of hardware cost ..... | 12,361                    | 10,768   |
|   | -----                     | -----    |
| Consolidated gross profit .....                       | \$24,325                  | \$14,706 |
|   | =====                     | =====    |
| Gross profit:   |                           |          |
| Communications solutions .....                        | \$11,246                  | \$ 9,208 |
| Operation support system solutions .....              | \$13,079                  | \$ 5,498 |
|   | -----                     | -----    |
| Consolidated gross profit .....                       | \$24,325                  | \$14,706 |
|   | =====                     | =====    |

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ASIAINFO HOLDINGS, INC.  
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### 13. SEGMENT AND GEOGRAPHIC OPERATING INFORMATION - CONTINUED

The 2002 information has been reclassified to conform to the current operating segments.

For the six months ended June 30, 2002 and 2003, almost all of the Company's revenues have been derived from sales to customers in the People's Republic of China. 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 December 31, 2002 and June 30, 2003, 99% of the Company's long-lived assets are located in the People's Republic of China.

Effective July 1, 2003, the Company has reorganized its operating structure so that its operations focus on specific customers, rather than product areas. Instead of marketing and selling its products and services through its two former SBUs, CS and OSS, the Company now has one point of sales contact per major customer - thus streamlining its relationship with the customers, and its interaction with them.

### 14. COMMITMENTS AND CONTINGENCIES

#### IPO Litigation

On December 4, 2001, a securities class action case was filed in New York City 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. The suit seeks rescission of the plaintiffs' alleged purchases of the Company's common stock as well as unspecified damages. In addition to the case against the Company, various other plaintiffs have filed approximately 1,000 other, substantially similar class action cases against approximately 300 other publicly traded companies and their IPO underwriters in New York City, which along with the case against the Company have all been transferred to a single federal district judge for purposes of case management.

On July 15, 2002, together with the other issuer defendants, the Company filed a collective motion to dismiss the consolidated, amended complaints against the issuers on various legal grounds common to all or most of the issuer defendants. The underwriters also filed separate motions to dismiss the claims against them. On October 9, 2002, the Court dismissed without prejudice all claims against the individual defendants in the litigation. The dismissals were based on stipulations signed by those defendants and the plaintiffs' representatives. On February 19, 2003, the Court issued its ruling on the motions to dismiss filed by the underwriter and issuer defendants. In that ruling the Court granted in part and denied in part those motions. As to the claims brought against the Company under the anti-fraud provisions of the securities laws, the Court dismissed all such claims without prejudice. As to the claims brought under the registration provisions of the securities laws, which do not require that intent to defraud be pleaded, the Court denied the motion to dismiss such claims as to the Company and as to substantially all of the other issuer defendants. The Court also denied the underwriter defendants' motion to dismiss in all respects.

In June 2003, based on a decision made by a special independent committee of its board of directors, the Company elected to participate in a proposed settlement

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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

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### 14. COMMITMENTS AND CONTINGENCIES - CONTINUED

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 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. Consummation of the proposed settlement is conditioned upon, among other things, negotiating, executing, and filing with the Court final settlement documents, and final approval by the Court. If the proposed settlement described above is not consummated, the Company intends to continue to defend the litigation vigorously. Moreover, if the proposed settlement is not consummated, the Company believes that the underwriters may have an obligation to indemnify the Company for the legal fees and other costs of defending this suit and that the Company's directors' and officers' liability insurance policies would also cover the defense and potential exposure in the suit. While the Company cannot guarantee the outcome of these proceedings, 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.

#### Warranty Costs

The Company's product warranty accrual reflects management's best estimate of probable liability under its product warranties. Management determines the warranty based on historical experience and other currently available evidence.

Changes in the product warranty accrual for the 6 months ended June 30, 2003 were as follows:

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|   |         |
|---|---------|
| Balance, beginning of period .....                              | \$2,229 |
| Payments made .....   | (27)    |
| Change in liability for warranties issued during the period ... | 242     |
|   | -----   |
| Balance, end of period .....                                    | \$2,444 |
|   | =====   |

### 15. RELATED PARTY TRANSACTION

On May 16, 2002, China Merchants Bank, Beijing Branch ("Merchants Bank") entered into an agreement to provide a revolving credit facility to China Netcom of up to approximately \$9,061 in connection with China Netcom's past and future purchases of communications solutions and operation support system solutions from AsiaInfo Technologies. China Netcom may draw on the facility to fund amounts that will become payable to AsiaInfo Technologies under bankers' acceptances and the amount drawn down by China Netcom was approximately \$2,055 as of June 30, 2003. AsiaInfo Technologies has guaranteed China Netcom's obligations to Merchants Bank under the facility and agreed to pay principal and interest on the drawn loan if China Netcom defaulted.

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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. 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 document 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. Among the factors that could cause actual results to differ materially are the factors discussed below under the heading "Factors Affecting our Operating Results and our Common Stock."

#### OVERVIEW

We are a leading provider of telecommunications network solutions and software solutions in China. Our software products and network services enable our customers to build, maintain, operate, manage and continuously improve their telecommunications infrastructure. Our customers are primarily the major telecommunications carriers in China and their provincial subsidiaries, such as China Mobile Communications Corporation, or China Mobile, China United Telecommunication Corporation, or China Unicom, China Network Communications Group Corporation, or China Netcom Group and China Telecommunications Corporation, or China Telecom.

We commenced our operations in the United States in 1993 and moved our operations from the United States to China in 1995. We began generating

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significant network solutions revenues in 1996 and significant software solutions revenues in 1998. We conduct the bulk of our business through our wholly-owned operating subsidiaries, AsiaInfo Technologies (China) Inc., or AsiaInfo Technologies, and AsiaInfo Management Software, Inc. (formerly Guangzhou Bonson Technology Limited), or AsiaInfo Management, which are both Chinese companies.

In recent periods, we have marketed and sold our products and services through two strategic business units, or SBUs: Communications Solutions, or CS, and Operation Support System Solutions, or OSS. Communications Solutions offered network infrastructure solutions, service application solutions, network security solutions and network monitoring solutions. Operation Support System Solutions offered customer care and billing, customer relationship management (including business intelligence and decision support systems) and order fulfillment management solutions for telecommunications providers. Effective July 1, 2003, we have reorganized our operating structure so that our business operations focus on specific customers, rather than product areas. For more information on our new operating structure, please see the discussion below in Item 5 of Part II of this report, under the heading "New Operating Structure." Because this change took effect at the beginning of the third quarter of 2003, our second quarter operating results are discussed in this report on the basis of our old operating structure.

We believe that there are opportunities for us to expand into new business areas and to grow our business both organically and through acquisitions. On February 6, 2002, we completed our acquisition of Bonson Information Technology Holdings Limited, or Bonson, a leading provider of operation support systems solutions to wireless telecommunications carriers in China. Bonson's operating results have been consolidated with our operating results from the date of acquisition. In view of the Bonson acquisition and potential future acquisitions we may engage in, our historical operating results may not be an adequate basis on which to evaluate our prospects.

**IMPACT OF SARS OUTBREAK.** The outbreak of Severe Acute Respiratory Syndrome, or

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SARS, is believed to have started in Guangdong Province, China in late 2002 and to have later spread to Beijing. The SARS outbreak impacted our second quarter 2003 revenues by disrupting travel throughout China and causing delays in service delivery to our customers. In addition, the outbreak of SARS interrupted our collection efforts, causing our accounts receivable and days sales outstanding to increase. Although the spread of SARS in China appears to have been contained, and the World Health Organization has lifted its travel advisories, the medical community worldwide has not fully understood the origin of SARS and has not found a well-recognized effective treatment for SARS. As a consequence, the potential long-term effects of SARS on economic growth in China are still unknown. Any future re-emergence or worsening of the SARS epidemic could have an adverse impact on our business.

**IMPACT OF GOODWILL IMPAIRMENT.** In connection with our acquisition of Bonson, we paid the former shareholders of that company \$32.76 million (net of acquisition costs) in cash and 1,031,686 shares of our common stock (which were valued at approximately \$18 million at the time the acquisition was announced). During the first quarter of 2003, we completed an annual impairment test as required by Statement of Financial Accounting Standard ("SFAS") No.142 and recorded a one-time, non-cash impairment charge of \$29.8 million relating to the goodwill and acquired intangible assets attributable to our acquisition of Bonson. In addition, during the first quarter of 2003 we recorded a goodwill impairment of \$0.38 million in connection with our acquisition of the minority interest in our



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subsidiary, Marsec Holdings, Inc. The impairments resulted primarily from the industry-wide equity devaluations of the past year. Continued deterioration of market conditions may require us to record additional impairment charges in the future.

IMPACT OF TELECOMMUNICATIONS INDUSTRY RESTRUCTURING. As a result of a restructuring in China's telecommunications industry that occurred in 2002, new orders for telecommunications infrastructure expansion and improvement projects have decreased over the past several quarters, adversely affecting our net revenue and profitability. According to China's Ministry of Information Industry, or MII, overall capital expenditure by telecommunications service providers decreased by 20% to \$24.6 billion in 2002. Although we expect that the restructuring will have a positive impact on growth in the telecommunications industry in China in the long-term, most of China's telecommunications carriers have indicated that their capital expenditures in 2003 will not increase significantly as compared to 2002. Continued delays in capital expenditure projects could continue to negatively affect our growth in the near-term. At the same time, however, we expect the investment focus of our customers to continue to shift towards value-added products and services, including establishing and enhancing their management and operation support systems, which we believe will bring growth opportunities to our business.

### REVENUES

In recent periods we have marketed and sold our products and services through two strategic business units: Communications Solutions and Operation Support System Solutions. Communications Solutions, or CS, includes network solutions, service application solutions, network security solutions and network monitoring solutions. Operation Support System Solutions, or OSS, includes our highly scalable customer care and billing software capable of automating a telecommunications carrier's key business processes, such as billing and order management.

Although we report our revenues on a gross basis, inclusive of hardware acquisition costs that are passed through to our customers, we manage our business internally based on revenues net of hardware costs, 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 in lower growth rates for total revenues as against prior periods, but will not adversely impact revenues net of hardware costs. The following table shows our revenue breakdown on this basis:

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| BUSINESS LINE   | SIX MONTHS ENDED<br>JUNE 30, |       | YEAR ENDED<br>DECEMBER 31, |         |
|---|------------------------------|-------|----------------------------|---------|
|   | 2003                         | 2002  | 2002                       | 2001    |
| Communications Solutions net<br>of hardware costs           | 54%                          | 51%   | 48%                        | 73% (1) |
| Operation Support System<br>Solutions net of hardware costs | 46%                          | 49%   | 52%                        | 27% (1) |
|   | =====                        | ===== | =====                      | =====   |

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(1) Reclassified to conform with 2002 presentation

As indicated in the foregoing table, OSS solutions revenues increased as a percentage of total net revenues from 27% in 2001 to 52% in 2002, and decreased to 46% for the first half of 2003. The increase in 2002 was largely attributable to our acquisition of Bonson, a leading player in China's OSS market in February of that year. One of the reasons for the decrease in the first half of 2003 was an increase in revenues from services applications solutions in our CS business unit.

Because we offer our products and services to our customers on a total-solutions basis, most of the projects we undertake for our customers include revenue for hardware, software and professional services.

**HARDWARE REVENUE.** We generate significant revenue through hardware sales for equipment we procure from hardware vendors on behalf of our customers. We procure hardware for our customers as part of our strategy of offering total solutions. We minimize our exposure to hardware risks by sourcing some equipment from hardware vendors against letters of credit from our customers. We believe that as the telecommunications-related market in China develops our customers will increasingly purchase hardware directly from hardware vendors and hire us for our professional services and software.

**SOFTWARE LICENSE REVENUE.** We generate revenue in the form of fees received from customers for licenses to use our software products in perpetuity. We also include in revenue the benefit of value added tax rebates on software license sales, which are part of the Chinese government's policy of encouraging China's software industry.

**SERVICES REVENUE.** Services revenue consists of revenue for the professional services we provide to our customers for network planning, design and systems integration, software customization and installation, and related training services.

We generally charge a fixed price for all of our projects and recognize revenue based on the percentage of completion of the project. Revenues in both Communications Solutions and Operation Support System Solutions from customer orders requiring significant production, modifications, or customization of the software are recognized over the installation and customization period. We use labor costs and direct project expenses to determine the stage of completion, except for revenue associated with the procurement of hardware, which we recognize upon delivery of the hardware to the customer. Since a large part of the cost of certain projects, particularly network infrastructure solutions 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 hardware-related revenues generally approximate the costs of the hardware.

Our projects generally have a life of nine to twelve months, during which there are three key milestones. The first milestone occurs when the hardware is delivered, which is usually between three and four months after signing the contract. The second milestone in a project is at primary acceptance, which usually occurs around three to four months after hardware delivery. At primary acceptance, most of the services and products are delivered. The third milestone is final acceptance, which occurs when the customer agrees that we have satisfactorily completed all of our work on the project.

**UNBILLED REVENUE.** Our revenue recognition policies result in our recognizing certain revenues even though we are not due to receive the corresponding cash payment under the relevant contract. In the case of hardware sales, the customer

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typically holds back around 10 to 20% of the hardware contract payments at the time of delivery until final project acceptance. Although we record all hardware revenue at the time of delivery, the 10 to 20% held back by the customer is recorded as unbilled receivables and does not become billable until final project acceptance. In the case of services and software license revenues, most of the revenue becomes

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billable at the time of primary acceptance, but the customer typically holds back around 10 to 20% of the services and software contract payments until final acceptance. Unpaid amounts for services and software, as well as for hardware, become payable at the time of final project acceptance. When we recognize revenue for which payments are not yet due, we book unbilled accounts receivable until the corresponding amounts become billable.

REVENUE BACKLOG. Most of our revenues are derived from customers' orders under contracts for hardware, software and services. Our backlog at any given time includes the contracts we have signed but have not yet commenced and the portion of uncompleted contracts for which revenue has not yet been recognized. Revenues are recognized during the course of the relevant project, as described above. At June 30, 2003, our revenue backlog net of hardware costs was \$44.7 million, an 8% increase as compared to the end of the previous quarter and relatively unchanged as compared to our backlog at the end of the corresponding period one year ago. This sequential increase is the second consecutive increase after three consecutive decreases in 2002. We believe the sequential increase in our backlog is primarily due to a shift in focus among China's telecommunications carriers towards greater investment in value-added products and services and towards establishing and enhancing their management and operation support systems.

### COST OF REVENUES

Our costs of revenues include hardware costs, software-related costs and compensation and travel expenses for the professionals involved in the relevant projects.

Hardware costs consist primarily of third party hardware costs and related warranty 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. We accrue hardware warranty costs when hardware revenue is fully recognized upon final acceptance. We 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.

Software-related costs consist primarily of packaging and written manual expenses for our proprietary software products 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. We do not accrue any software warranty costs for our proprietary software and accrue 0.5% of sales of third party software as warranty costs when such revenue is recognized upon final acceptance. The costs associated with creating and enhancing our proprietary software are classified as research and development expenses as incurred.

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### 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 and deferred stock compensation. 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 enhancement and upgrading of existing software. We expense such costs as they are incurred.

We provide most of our officers, employees and directors with stock options. In the past, we granted a number of options with exercise prices below the fair market value of the related shares at the time of grant, resulting in deferred

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compensation expenses. Most of the options granted with exercise prices below fair market value on the date of grant were issued prior to 1997 and we do not intend to issue options below fair market value in the future. Therefore, our deferred compensation expenses have been significantly higher historically than we expect them to be in future years. The difference between the exercise price and the fair market value of the related shares is amortized over the vesting period of the options and reflected on our consolidated statement of operations as amortization of deferred stock compensation. For more information on our deferred compensation expenses, please see note 10 to our consolidated financial statements included in this report.

We make bad debt provisions for accounts receivable balances based on management's assessment of their recoverability. In any event, we make bad debt provisions for all accounts receivable balances that are aged over one year. We include those bad debt provisions in general and administrative expenses.

### TAXES

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

Pursuant to the income tax laws of China, foreign invested enterprises meeting certain criteria set out by the relevant tax authorities can enjoy various preferential tax treatments. AsiaInfo Technologies is registered and operates in the Beijing Zhongguancun Science Park, and is classified as a "new technology enterprise." The effective income tax rate for "new technology enterprises" registered and operating in the Beijing Zhongguancun Science Park is 15%, while the local income tax will be exempted as long as the enterprise holds the "new technology enterprise" status. "New technology enterprises" are exempted from Chinese state corporate income tax for three years, beginning with their first year of operations, and are entitled to a 50% tax reduction at the rate of 7.5% for the subsequent three years. The tax exemption for AsiaInfo Technologies expired on December 31, 1997 and the 50% tax reduction expired on December 31, 2000. However, AsiaInfo Technologies received a continuation of its preferential tax treatment as an "advanced technology enterprise" for a three-year period

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from January 1, 2001 to December 31, 2003 with the effective income tax rate of 10%. Beginning from January 1, 2004, as a "new technology enterprise" set up in Beijing Zhongguancun Science Park, the effective income tax rate for AsiaInfo Technologies will be 15%. As long as AsiaInfo Technologies maintains the "new technology enterprise" status, it will be exempted from Chinese local corporate income tax.

AsiaInfo Management is registered and operates in the High and New Technology Industry Development Zone in Guangzhou, China, and is classified as a "high and new technology enterprise." The effective income tax rate, subject to the approval of the relevant tax authorities, for "high and new technology enterprises" registered in High and New Technology Industry Development Zones is 15%. "High and new technology enterprises" are also exempt from Chinese state and local corporate income tax for two years, beginning with their first profitable year of operations, and are entitled to a 50% tax reduction at the rate of 7.5% for the subsequent three years. The tax exemption for AsiaInfo Management expired on December 31, 2001 and the 50% tax reduction will expire on December 31, 2004.

AsiaInfo Technologies (Chengdu), Inc., or AsiaInfo Chengdu, is registered in the High and New Technology Industry Development Zone in Chengdu and is classified as a "high and new technology enterprise." Subject to the approval of the relevant tax authorities, "high and new technology enterprises" registered in the Chengdu High and New Technology Industry Development Zone are exempt from Chinese state and local corporate income tax for two years, beginning with their first year of operations, which was year 2002 for AsiaInfo Chengdu, and are entitled to a tax reduction at the rate of 15% in subsequent years.

Sales of hardware procured in China are subject to a 17% value added tax. Most of our sales of hardware procured outside 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. Although sales of software in China are subject to a 17% value added tax, companies that

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develop their own software and have the software registered are generally entitled to a value added tax refund. If the net amount of the value added tax payable exceeds 3% of software sales, the excess portion of the value added tax is refundable immediately. This policy is effective until 2010. Changes in Chinese tax laws may adversely affect our future operations.

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. Although, in general, our exposure to foreign exchange risks should be limited, 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, a decline in the value of Renminbi could reduce the U.S. dollar equivalent of the value of the earnings from, and our investment in, our

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subsidiaries in China.

### CONSOLIDATED RESULTS OF OPERATIONS

REVENUES. Our gross revenues were \$26.9 million and \$57.6 million, respectively, in the three- and six-month periods ended June 30, 2003, representing decreases of 26% and 12% against the comparable periods in 2002. These decreases were primarily attributable to the impact of the SARS outbreak in China, which caused delays in our service delivery to our customers and corresponding delays in revenue recognition. Revenues net of hardware costs were \$12.8 million and \$25.5 million, respectively, in the three- and six-month periods ended June 30, 2003, representing decreases of 35% and 31% against the comparable periods in 2002. OSS Solutions net revenues were \$5.7 million and \$11.7 million, respectively, in the three- and six-month periods ended June 30, 2003, representing decreases of 44% and 35% against the comparable periods in 2002. Communications Solutions net revenues were \$7.1 million and \$13.8 million, respectively, in the three- and six-month periods ended June 30, 2003, representing decreases of 26% and 27% against the comparable periods in 2002. In addition to the impact of SARS, the year-over-year decreases in net revenues were attributable to the prolonged telecommunications industry restructuring in China and its year-over-year decreased capital expenditure spending in 2002 which impacted our first half of 2003 revenue.

COST OF REVENUES. Our cost of revenues decreased 16% to \$19.7 million, as compared to the same period in 2002. This decrease in costs of revenues were attributable to the overall decrease in revenues.

GROSS PROFIT. Our gross profit was \$7.2 million and \$14.7 million, respectively, in the three- and six-month periods ended June 30, 2003, representing decreases of 45% and 40% against the comparable periods in 2002. Gross profit as a percentage of gross revenues, or gross margin, decreased to 27% and 26%, respectively, in the three- and six-month periods ended June 30, 2003, as compared to 36% and 37% in the comparable periods of 2002. Gross profit as a percentage of net revenue decreased to 56% and 58%, respectively, in the three- and six-month periods ended June 30, 2003, as compared to 66% and 66% in the comparable periods of 2002. These decreases were primarily attributable to higher labor costs related to the expansion of our OSS business.

OPERATING EXPENSES. Total operating expenses decreased 6% to \$8.6 million in the three-month period ended June 30, 2003, from \$9.2 million in the comparable period in 2002. This decrease resulted largely from a decrease in sales and marketing expenses.

Sales and marketing expenses decreased 39% and 35%, respectively, to \$2.9 million and \$5.4 million in the three- and six-month periods ended June 30, 2003, reflecting our continued efforts to consolidate our sales force and increase operating efficiency.

Research and development expenses increased 14% and 13%, respectively, to \$2.7

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million and \$5.2 million, in the three- and six-month periods ended June 30, 2003, against the comparable periods in 2002 due to our increased focus on developing new products and solutions to increase our competitive advantages.

General and administrative expenses increased 102% and 5%, respectively, to \$2.9 million and \$5.3 million, in the three- and six-month periods ended June 30, 2003, against the comparable periods in 2002. The year-over-year increase for the second quarter of 2003 was due largely to the collection of bad debt in the

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amount of \$1 million which took place in the second quarter of 2002 and drove the general and administrative expenses below typical levels in that period. In addition, general and administrative expenses in the second quarter of 2003 included a \$200,000 compensation expense related to a restricted stock award to our new Chief Executive Officer.

OTHER INCOME (EXPENSE). Other income and expenses, consisting primarily of net interest income and expense, decreased from income of approximately \$0.5 million and \$1.2 million, respectively, in the three- and six-month periods ended June 30, 2002 to income of \$0.3 million and \$0.8 million in the three- and six-month periods ended June 30, 2003, primarily due to a decrease in interest rates and our having less cash invested in interest bearing investments.

EQUITY IN LOSS OF AFFILIATE. In the three- and six-month periods ended June 30, 2003, equity in loss of affiliate of approximately \$0.07 million and \$0.19 million, respectively, represented our proportionate share of losses incurred by Intrinsic, in which we hold a minority stake.

NET INCOME (LOSS). We recorded a net loss of \$1.1 million, or \$0.02 basic loss per share, for the quarter ended June 30, 2003. We expect net revenue for the third quarter of 2003 to be between \$14 to \$15 million, or \$0.01 to \$0.02 per basic share.

### 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 accounts receivable balance at June 30, 2003 was \$70 million, consisting of \$20.3 million in billed receivables and \$49.7 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 our customers will 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 those receivables to be relatively long.

At the end of the second quarter, our days sales outstanding were 219 days, as compared to 190 days at the end of the first quarter of 2003. Our billed receivables were 64 days sales outstanding and our unbilled receivables were 155 days sales outstanding. The higher day sales outstanding were caused by the increased account receivables level and the smaller revenue base resulting from the SARS outbreak in China. We had negative operating cash flow of \$9.8 million in second quarter of 2003, primarily attributable to delayed cash collections resulting from the SARS outbreak in China.

As of June 30, 2003, we had total short-term credit facilities totaling \$32.1

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million, expiring by June 2004, for working capital purposes, of which unused short-term credit facilities were \$31.6 million at that date. At June 30, 2003, \$0.5 million had been used to issue letters of credit and bank guarantees. Additional borrowings of approximately \$0.06 million were secured by AsiaInfo Management's net assets. All the borrowings were in Renminbi. The loans carry interest at a rate of 4.8% per annum and are repayable within one year. Bank deposits pledged as security for those bank loans and short-term credit facilities totaled \$16.1 million as of June 30, 2003, and are presented as restricted cash in our consolidated balance sheets.

We ended the quarter with a cash position of \$131.2 million, of which \$11.3 million was in short term investments, \$16.1 million was in restricted cash, and \$103.8 million was in cash and cash equivalents. Restricted cash consisted of \$10 million used to secure our \$32.1 million credit facility, \$5.6 million pledged as security for issuing standby letters of credit and \$0.5 million held by AsiaInfo Management and pledged as security for guarantees. Our short-term investments feature fixed income, liquidity and low risk. The cash equivalents include investments in cash management accounts to enhance our interest income.

As of June 30, 2003, our inventory position was \$4.7 million, down from \$7 million at the end of the first quarter of 2003. This decrease was attributable to equipment deliveries for several large projects during the second quarter of 2003.

Our contractual obligations consist of noncancellable operating lease agreements. As of June 30, 2003, future minimum lease expenses under noncancellable operating leases are expected to be approximately \$3.0 million, and become due as presented in the table below:

|                                    | Operating Leases |
|------------------------------------|------------------|
| Less than 1 year .....             | \$1.8 million    |
| 1 to 3 years .....                 | 1.2 million      |
| 4 years and thereafter .....       | -                |
|                                    | -----            |
| Total minimum lease expenses ..... | \$3.0 million    |
|                                    | =====            |

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 2003. 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 plan to 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.



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### CRITICAL ACCOUNTING POLICIES

We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. The preparation of those 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 and the reported amount of revenues and expenses during the reporting period. On an on-going basis, we evaluate our estimates and judgments, including those related to revenues and cost of revenues under customer contracts, warranty obligations, bad debts, income taxes, investment in affiliate, goodwill and other intangible assets, and litigation. We base our estimates and judgments on historical experience and on

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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 judgments and estimates used in the preparation of our consolidated financial statements.

**REVENUES AND COST OF REVENUES.** We derive a significant portion of our revenue from fixed-price contracts using the percentage of completion method, which relies on estimates of total expected contract revenue and costs. We follow this method since reasonably dependable estimates of the revenue and costs applicable to various stages of a contract can be made. Recognized revenues and profit are subject to revisions as the contract progresses to completion. Accordingly, changes in our estimates would impact our future operating results.

**WARRANTY OBLIGATIONS.** We record our estimate of warranty costs at the time of final project acceptance, when all hardware pass-through revenue has been recognized. Revisions for estimated warranties may be required in the period in which actual warranty costs become known, thereby impacting our future operating results.

**BAD DEBTS.** We maintain allowances for doubtful accounts for estimated losses resulting from the aging of accounts receivables or the inability of our customers to make required payments. If the financial condition of our customers were to change, changes to these allowances may be required, which 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.

**INVESTMENT IN AFFILIATE.** We account for our minority interest in Intrinsic Technology (Holdings), Ltd., or Intrinsic, using the equity method. Intrinsic has incurred operating losses since our investment in April 2001. We conducted an asset impairment test during the fourth quarter of 2002 in connection with our private equity investments, including our 14.25% interest in Intrinsic, which is recorded on our balance sheet as an "investment in affiliate". As a result of this test, we have recorded an impairment charge of approximately \$2.0

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million in investments in affiliates. Sustained operating losses of this affiliate or other adverse events could result in our inability to recover the carrying value of the investment, which may require us to record an additional impairment charge in the future. As of March 31, 2003, the Company's interest in Intrinsic had been diluted from 14.25% to 14.22% due to another shareholder's exercise of warrants to purchase 37,770 shares of Intrinsic's stock.

**GOODWILL AND OTHER INTANGIBLE ASSETS.** We make assumptions regarding estimated future cash flows and other factors to determine the fair value of goodwill and other intangible assets. If these estimates or their related assumptions change in the future, we may be required to record an impairment charge if the estimated fair value of goodwill and other intangible assets is less than its recorded amount. As required under SFAS No.142, we have completed an annual goodwill impairment test and have recorded a one-time, non-cash impairment charge of \$29.8 million relating to the goodwill and acquired intangible assets attributable to our acquisition of Bonson in February of 2002, as well as a \$0.38 million impairment charge relating to the goodwill arising from our acquisition of the minority interest of Marsec. The impairment resulted primarily from the industry-wide equity devaluations of the past year. Continued deterioration of market conditions may require us to record additional impairment charges in the future.

**LITIGATION.** We record contingent liabilities relating to litigation or other loss contingencies when we believe that the likelihood of loss is probable and the amount of the loss can reasonably be estimated. Changes in judgments of outcome and estimated losses are recorded, as necessary, in the period such changes are determined or become known. Any changes in estimates would impact our future operating results. Significant contingent liabilities, which we believe are at least possible, are disclosed in the notes to our consolidated financial statements.

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### ACCOUNTING PRONOUNCEMENTS RECENTLY ADOPTED

In August 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations," which addresses the accounting for the recognition of obligations associated with the retirement of tangible long-lived assets. We adopted SFAS No. 143 on January 1, 2003. This adoption did not have a significant impact on our financial position or results of operations.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure - an Amendment of FASB Statement No. 123," which provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The amended disclosure requirements of SFAS No. 148 are effective for years ending after December 15, 2002 and are reflected in our condensed consolidated financial statements.

In November 2002, the Emerging Issues Task Force (the "EITF") reached a consensus on Issue No. 00-21 ("EITF 00-21"), "Revenue Arrangements with Multiple Deliverables." EITF No. 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which the vendor will perform multiple revenue generating activities. EITF No. 00-21 is effective for fiscal periods beginning after June 15, 2003. The adoption of EITF 00-21 did not have a material impact on our financial statements.

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### FACTORS AFFECTING 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 POLICY, PARTICULARLY THE ALLOCATION OF FUNDS TO SUSTAIN THE GROWTH OF THE TELECOMMUNICATIONS INDUSTRY IN CHINA.

Virtually all of our large customers are directly or indirectly owned or controlled by the government of China. Accordingly, their business strategies, capital expenditure budgets and spending plans are largely decided in accordance with government policies, which, in turn, are determined on a centralized basis at the highest level 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 and Internet infrastructure. Insufficient government allocation of funds 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.

On December 11, 2001, in an effort to increase the efficiency of telecommunications service providers through competition, the State Council of China announced that it would split China Telecom geographically into a northern division (comprising ten provinces) and a southern division (comprising 21 provinces). Under the State Council's plan, the northern division of China Telecom has merged with China Netcom and Jitong Communication, and has been renamed China Network Communications Group Corporation, or China Netcom Group, while the southern division operates under the China Telecom name. As a result of the restructuring, new orders for telecommunications infrastructure expansion and improvement projects have decreased over the past several quarters, adversely affecting our backlog and our net revenue. Although we expect that the restructuring will have a positive impact on growth in the telecommunications industry in China in the long-term, most of China's telecommunications carriers have indicated that their capital expenditures in 2003 will not increase significantly as compared to 2002. Continued delays in capital expenditure projects could continue to negatively affect our growth in the near-term. In addition, 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.

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We have derived, and believe that we will continue to derive, a significant portion of our revenues from a limited number of large customers, such as China Telecom, China Unicom, China Mobile and China Netcom Group. China Mobile accounted for 46% of our revenues net of hardware cost in 2002 and for 45% of our revenue backlog net of hardware cost as of June 30, 2003. 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.

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

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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 operate large and complex networks, they usually expand their networks and/or apply new features to 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 a network solutions project usually relates to hardware procurement. Since we recognize most of the revenues relating to hardware plus a portion of contract services revenues at the time of hardware delivery, the timing of hardware delivery can cause our quarterly gross revenues and inventory level 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 relied upon. It is likely that our operating results in some periods may be below the expectations of public market analysts and investors. In this event, the price of our common stock will probably decline, perhaps significantly more in percentage terms than any corresponding 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 will require us to increase our working capital needs 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 1998, 2001 and 2002, we sustained net losses in 1999 and 2000. Recently, we have experienced a decline in earnings growth and had net losses in the first quarter of 2003 (after impairment charges) and in the second quarter of the year due to impact of SARS. 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 will be fixed. As a result, any delays in expanding sales volume, generating revenue and delivering services could result in substantial losses.

BUSINESS ACQUISITIONS WE UNDERTAKE MAY BE CHALLENGING, AND WE MAY REALIZE LOSSES ON OUR INVESTMENTS

In February of 2002, as a key component of our business and growth strategy, we acquired Bonson, a leading provider of operation support system solutions in China.

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In the future, we may acquire other companies or assets that we feel will

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enhance our revenue growth, operations and profitability. Such acquisitions could result in the use of significant amounts of cash, 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.

### 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 accounting standards, we may be required to record impairment charges. We have conducted an asset impairment test during the fourth quarter of 2002 and recorded an impairment charge of approximately \$2.0 million from our investment in Intrinsic. We also recorded a one-time, 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 in February 2002. There is no assurance that future reviews will not result in further write-downs to goodwill and other intangible assets.

### SEVERE ACUTE RESPIRATORY SYNDROME MAY HAVE AN IMPACT ON OUR BUSINESS

The outbreak of Severe Acute Respiratory Syndrome, or SARS, is believed to have started in Guangdong Province, China in late 2002 and to have later spread to Beijing. The SARS outbreak impacted our second quarter revenues by disrupting travel throughout China and causing serious delays in service delivery to our customers. The outbreak also interrupted our collection efforts, causing accounts receivable and days sales outstanding to increase. Although the spread of SARS in China appears to have been contained, and the World Health Organization has lifted its travel advisories, the medical community worldwide has not fully understood the origin of SARS and has not found a well-recognized effective treatment for SARS. As a consequence, the potential long-term effects of SARS on economic growth in China are still unknown. Any future re-emergence or worsening of the SARS epidemic could have an adverse impact on our business.

### WE ARE HIGHLY DEPENDENT ON OUR EXECUTIVE OFFICERS.

Each of our executive officers is responsible for an important segment 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

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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.

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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.

WE EXTEND WARRANTIES TO OUR CUSTOMERS 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 do not have disclaimers or limitations on liability for special, consequential and incidental damages, nor do we 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, that in turn could materially and adversely affect us.

WE SELL OUR LARGE SYSTEMS INTEGRATION PROJECTS ON A FIXED-PRICE, FIXED-TIME BASIS WHICH EXPOSES US TO RISKS ASSOCIATED WITH COST OVERRUNS AND DELAYS.

We sell our large systems integration projects 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 cause delays or cost overruns. In this event, we would be exposed to cost overruns and liable for late completion fines.

WE MAY BECOME LESS COMPETITIVE IF WE ARE UNABLE TO DEVELOP OR ACQUIRE NEW PRODUCTS OR ENHANCEMENTS TO OUR SOFTWARE PRODUCTS THAT ARE MARKETABLE ON A TIMELY AND COST-EFFECTIVE BASIS.

We continually develop new services and proprietary software products. Unexpected technical, operational, distribution or other problems could delay or prevent the introduction of one or more of these products or services or any products or services that we may plan to introduce in the future. Moreover, 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 agreements and copyright and trademark registration. We have registered some

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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 telecommunications-related software products, although we have not applied for copyright protection elsewhere (including the United States). Despite these precautions, the legal regime protecting intellectual property rights in China is weak. Moreover, Bonson, which we acquired in February, 2002, had never registered copyrights for its software products prior to the acquisition, although we subsequently registered copyrights for all of its software products. 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.

We do not own any patents and have not filed any patent applications, as we do not believe that the benefits of patent protection outweigh the costs of filing and updating patents for our software products. We enter into confidentiality

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agreements with 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 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 or may allegedly breach the technology rights of others and incur legal expenses and damages, which could be substantial.

INVESTORS MAY NOT BE ABLE TO ENFORCE JUDGMENTS BY UNITED STATES COURTS AGAINST US.

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

- .. effect service of process upon us or those persons within the United States; or
- .. enforce against us or 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 these payments from Renminbi, the currency of China, into foreign currencies.

THE FACT THAT OUR BUSINESS IS CONDUCTED IN BOTH U.S. DOLLARS AND RENMINBI MAY SUBJECT US TO CURRENCY EXCHANGE RATE RISK DUE TO FLUCTUATIONS IN THE EXCHANGE RATE BETWEEN THESE 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 these 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. Although, in general, our exposure to foreign exchange risks should be limited, the value in 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, a decline in the value of the Renminbi could reduce the U.S. dollar value of earnings from, and our investments in, our subsidiaries in China.

THE MARKETS IN WHICH WE SELL OUR SERVICES AND PRODUCTS ARE COMPETITIVE AND WE MAY NOT BE ABLE TO COMPETE EFFECTIVELY.

The market for network solutions in China is new and rapidly changing. Our competitors in the network solutions market mainly include domestic systems integrators such as Zoom Networks and Digital China Holdings Limited. Although we are a leading player in this market, there are many large multinational companies with substantial, existing information technology operations in other markets in China that have significantly greater financial, technological, marketing and human resources. Should they decide to enter the network solutions market, this could hurt our profitability and erode our market share.



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The service application solutions sector is highly competitive. Our principal competitors in that sector are Openwave Systems Inc. (formerly Software.com and Phone.com) and Huawei Technologies. In the network security solutions market, we mainly compete with Information Security One Limited, Nsfocus Information Technology Co., Ltd., and 21ViaNet China Inc. An increasing number of companies are devoting their resources to this sector in developing network security products. In the network monitoring solutions market, our principal competitor is Emerson Electric Co. (through its acquisition of Avansys Power Co., Ltd. from Huawei Technologies).

In the online billing segment, we compete primarily with Portal Software and Zoom Networks. In the operation support system solutions market, we compete mainly with Linkage System Integration Co. Ltd. (Nanjing), SI-TECH Computer System Engineering Ltd. (Beijing) and Powerise Group (Changsha). Currently, due in part to each telecommunication provider's stringent approval system for providers of wireless billing software in China and competitive pricing offered by domestic companies, some multinational information technology companies have been deterred from entering this market. However, multinational companies have recently formed alliances with Chinese companies to expand into China's telecommunications solutions market. For example, CSG Systems, or CSG, has formed a strategic alliance with a subsidiary of Legend Group Limited to develop a suite of customer care and billing solutions for China's telecommunications carriers. In view of the gradual deregulation of the Chinese telecommunications industry and China's entry into the WTO, we anticipate the entrance of new competitors into the operation support system market.

Our competitors, some of whom have greater financial, technical and human resources than us, 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

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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 and investment in the Internet and the telecommunications industry in China. Such developments could reduce, perhaps significantly, the demand for our products and services.

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There is no guarantee that the Chinese government will not impose other economic or regulatory controls that would have a material adverse effect on our business. 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.

HIGH TECHNOLOGY AND EMERGING MARKET SHARES HAVE HISTORICALLY EXPERIENCED EXTREME VOLATILITY AND MAY SUBJECT YOU TO LOSSES.

The trading price of our shares may be subject to significant market volatility due to investor perceptions of investments relating to China and Asia, as well as developments in the Internet and telecommunications industries. 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 and which have often been unrelated to the operating performance of these 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 allegedly improper allocation procedures relating to the sale of our common stock in connection with our initial public offering in March of 2000. For more information on this litigation, 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 OUR COMPANY OR EXISTING SHAREHOLDERS 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 also might 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.

A SMALL NUMBER OF SHAREHOLDERS CONTROLS US.

A small number of shareholders, including Warburg-Pincus Ventures, and their affiliates, as well as Edward Tian, one of our directors, James Ding, our Chairman, and several of our other directors and officers control approximately 50% of our voting stock. As a result, these shareholders collectively are able to control all matters requiring shareholder approval, including election of directors and approval of significant corporate transactions, such as a sale of our assets and the terms of future equity financings. The combined voting power of our large shareholders could have the effect of delaying or preventing a change in control.

WE ARE SUBJECT TO ANTI-TAKEOVER PROVISIONS THAT COULD PREVENT A CHANGE OF CONTROL AND PREVENT OUR SHAREHOLDERS 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. This preferred stock, if it is ever issued, may have preference over and harm the

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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, this 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 nor more than nine directors. The terms of the office of the nine-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 2004; and Class III, whose term will expire at the annual meeting of stockholders to be held in 2005. 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 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.

#### OUR CHANGE OF CONTROL SEVERANCE AGREEMENTS WITH EXECUTIVE OFFICERS MAY DISCOURAGE A CHANGE OF CONTROL

Recently we have entered into change of control severance agreements with several 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.

#### 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, nor do we speculate in foreign currency. However, we do maintain a significant portion of our cash deposits in U.S. dollars to avoid currency risk related to Renminbi. A portion of these U.S. dollar deposits are used to collateralize Renminbi-denominated loans from Chinese banks.

Because substantially all 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 service component of our network solutions business and software business are denominated in Renminbi, we do not have significant exposure to either the U.S. dollar or Renminbi. Thus, we do not believe that it is necessary to enter into derivatives contracts to hedge our exposures to either currency.

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There have been no significant changes in our exposure to changes in either interest rates or foreign currency exchange rates for the quarter ended June 30, 2003. Our exposure to interest rates is limited as we do not have variable rate and long-term borrowings. We are subject to variable interest rates on our bank deposits that are cash and short-term investments. As there are no significant market price movements, such investments are held at cost. As of June 30, 2003, a hypothetical 10% immediate increase or decrease in interest rates would increase our annual interest expense by approximately \$145 and decrease our annual interest income by approximately \$82,000, respectively. The effect of changes in exchange rates on our results of operations has been insignificant.

### ITEM 4. CONTROLS AND PROCEDURES

Within 90 days prior to the filing date of this quarterly report, we carried out an

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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 Securities Exchange Act of 1934, as amended. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective. There were no significant changes in our internal controls or in other factors that could significantly affect those controls subsequent to the date of our evaluation.

## PART II. OTHER INFORMATION

### ITEM 1. Legal Proceedings

On December 4, 2001, a securities class action case was filed in New York City against us, certain of our current officers and directors and the underwriters of our 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 our IPO improperly required their customers to pay the underwriters excessive commissions and to agree to buy additional shares of our common stock in the aftermarket as conditions to their purchasing shares in our IPO. The lawsuit further claimed that these supposed practices of the underwriters should have been disclosed in our IPO prospectus and registration statement. The suit seeks rescission of the plaintiffs' alleged purchases of our common stock as well as unspecified damages. In addition to the case against us, various other plaintiffs have filed approximately 1,000 other, substantially similar class action cases against approximately 300 other publicly traded companies and their IPO underwriters in New York City, which along with the case against us have all been transferred to a single federal district judge for purposes of case management. On July 15, 2002, together with the other issuer defendants, we filed a collective motion to dismiss the consolidated, amended complaints against the issuers on various legal grounds common to all or most of the issuer defendants. The underwriters also filed separate motions to dismiss the claims against them. On October 9, 2002, the Court dismissed without prejudice all claims against the individual defendants in the litigation. The dismissals were based on stipulations signed by those defendants and the plaintiffs' representatives. On February 19, 2003, the Court issued its ruling on the motions to dismiss filed by the underwriter and issuer defendants. In that ruling the Court granted in part and denied in part those motions. As to the claims brought against us under the anti-fraud provisions of the securities

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laws, the Court dismissed all such claims without prejudice. As to the claims brought under the registration provisions of the securities laws, which do not require that intent to defraud be pleaded, the Court denied the motion to dismiss such claims as to us and as to substantially all of the other issuer defendants. The Court also denied the underwriter defendants' motion to dismiss in all respects.

In June 2003, based on a decision made by a special independent committee of our board of directors, we 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 us 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 we may have against the underwriters.

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

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settlement costs. We expect that our insurance proceeds will be sufficient for these purposes and that we will not otherwise be required to contribute to the proposed settlement. Consummation of the proposed settlement is conditioned upon, among other things, negotiating, executing, and filing with the Court final settlement documents, and final approval by the Court. If the proposed settlement described above is not consummated, we intend to continue to defend the litigation vigorously. Moreover, if the proposed settlement is not consummated, we believe that the underwriters may have an obligation to indemnify us for the legal fees and other costs of defending this suit and that our directors' and officers' liability insurance policies would also cover the defense and potential exposure in the suit. While we cannot guarantee the outcome of these proceedings, we believe that the final result of these actions will have no material effect on our consolidated financial condition, results of operations or cash flows.

### ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

On March 2, 2000, our Registration Statement on Form S-1 covering the offering of 5,000,000 shares of our common stock (No.333-93199) was declared effective. The underwriters in the offering exercised an over-allotment option to purchase an additional 750,000 shares of our common stock. The total price to the public for the shares offered and sold was \$138,000,000. The net proceeds of the offering (after deducting expenses) was approximately \$126,610,000. From the effective date of the Registration Statement through June 30, 2003, the net

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proceeds have been used for the following purposes:

|  |               |
|--|---------------|
| Purchase and installation of machinery and equipment .....       | \$ 7,410,000  |
| Temporary investments, including cash and cash equivalents ..... | 28,490,000    |
| Investments in subsidiaries .....                                | 51,110,000    |
| Research and development and sales and marketing expenses .....  | 39,600,000    |
|  | -----         |
|  | \$126,610,000 |
|  | =====         |

The net proceeds will continue to be used for general corporate purposes, including working capital, and expenses such as research and development and sales and marketing. A portion of the net proceeds may also continue to be used to acquire or invest in complementary businesses or products. None of the net proceeds of the offering have been paid directly or indirectly to our directors, officers or their associates, to persons owning ten percent or more of our common stock, or to our affiliates.

### ITEM 5. OTHER INFORMATION

#### NEW OPERATING STRUCTURE

In order to best position ourselves with our customers, all of which are large telecommunications carriers in China, effective July 1, 2003, we have reorganized our operating structure so that our operations focus on specific customers, rather than product areas. Instead of marketing and selling our products and services through our two former strategic business units, Communications Solutions and Operations Support Systems Solutions, we now have one point of sales contact per major customer - thus streamlining their relationship with us, and our interaction with them. Because this change took effect at the beginning of the third quarter of 2003, our second quarter operating results are discussed in this report on the basis of our old SEUs.

#### EMPLOYMENT AGREEMENTS AND CHANGE OF CONTROL SEVERANCE AGREEMENTS

As part of our ongoing strategy to attract and retain highly-skilled employees critical to our growth and long-term success, we entered into certain employment agreements and change of control severance agreements with several of our executive officers in the second quarter of 2003.

Each of Xingsheng Zhang, our President and Chief Executive Officer, Ying Han, our Executive Vice President and Chief Financial Officer, and James Li, our Vice President for Human Resources, entered into new or restated employment agreements with us. The employment agreements set forth the principal terms and conditions of the executive officers' employment with us, including confidentiality, invention

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assignment and non-competition. Copies of the employment agreements are included as exhibits to this report.

Each of Xingsheng Zhang, Ying Han, and James Li also entered into a change of control severance agreement with us. The change of control severance 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 officers and provisions of medical benefits and housing allowance. Copies of the change of control severance

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agreements are included as exhibits to this report.

### NEW BOARD MEMBER

Effective July 21, 2003, we appointed Ying Wu to our board of directors as an independent director. A long-time participant in China's telecommunications industry, Mr. Wu is the co-founder and Vice Chairman of UTStarcom, Inc., a leading global provider of wireless and wireline access and IP switching solutions, and President of UTStarcom China. Before founding Starcom in 1991, which later merged with Unitech in 1995 to become today's UTStarcom, Mr. Wu was a member of the technical staff and senior project manager of AT&T Bell Labs, which he joined in 1987. He holds a MS in Electrical Engineering from New Jersey Institute of Technology and a BS in wireless communication from Beijing Industrial University. Mr. Wu replaced Louis Lau, who had been a member of AsiaInfo's board of directors since the company's inception. Mr. Lau's resignation from the board and Mr. Wu's appointment became effective on the same date, July 21, 2003.

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

#### (a) Exhibits

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

| Exhibit Number | Description Exhibits  |
|----------------|---|
| -----          | -----   |
| 2.1            | Share Purchase Agreement for the acquisition of Bonson Information Technology Holdings Limited/***/   |
| 3.1            | Certificate of Incorporation of AsiaInfo Holdings, Inc., dated June 8, 1998/**/   |
| 3.2            | Certificate of Amendment to Certificate of Incorporation of AsiaInfo Holdings, Inc., dated August 27, 1999/**/  |
| 3.3            | Certificate of Amendment to Certificate of Incorporation of AsiaInfo Holdings, Inc., dated November 15, 2000/**/  |
| 3.4            | Certificate of Correction to Certificate of Amendment to Certificate of Incorporation of AsiaInfo Holdings, Inc., dated January 18, 2001/**/                |
| 3.5            | By-Laws of AsiaInfo Holdings, Inc., dated December 19, 2000/**/   |
| 4.1            | Specimen Share Certificate representing AsiaInfo Holdings, Inc. shares of common stock/**/  |
| 10.1           | 2002 Stock Option Plan, approved and adopted as of April 18, 2003 /****/  |
| 10.2           | Lease of AsiaInfo's headquarters at 6 Zhongguancun South Street, Beijing, China, dated August 31, 1999/**/  |
| 10.3           | Agreement for the Establishment of a Limited Liability Company (Guangdong Wangying Communications Technology Company Limited) and Capital Contribution /**/ |
| 10.4           | Employment Agreement between AsiaInfo Holdings, Inc. and Xingsheng Zhang dated January 27, 2003   |
| 10.5           | Change of Control Severance Agreement between AsiaInfo Holdings, Inc. and Xingsheng Zhang dated May 30, 2003  |
| 10.6           | Master Executive Employment Agreement between AsiaInfo Holdings, Inc. and Ying Han dated May 30, 2003   |
| 10.7           | Change of Control Severance Agreement between AsiaInfo Holdings, Inc. and Ying Han dated May 30, 2003   |
| 10.8           | Master Executive Employment Agreement between AsiaInfo Holdings, Inc. and James Li dated May 30, 2003   |
| 10.9           | Change of Control Severance Agreement between AsiaInfo Holdings, Inc. and James Li dated May 30, 2003   |
| 11.1           | Statement regarding computation of per share earnings (included in note 9 to  |

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- condensed consolidated financial statements)
- 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
- 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

/\*/ Incorporated by reference to our Registration Statement on Form S-1 (No.333-93199).

\*\*/ Incorporated by reference to our Annual Report on Form 10-K for the fiscal year ended December 31, 2000.

\*/\*/ Incorporated by reference to our Current Report on Form 8-K filed on February 21, 2002.

\*/\*/\*/ Incorporated by reference to our Proxy Statement for the 2003 Annual Meeting of Stockholders filed on March 21, 2003.

(b) Reports on form 8-K

We furnished a Current Report on Form 8-K on July 23, 2003 relating to our quarterly earnings announcement for the quarter ended June 30, 2003, pursuant to the requirements of Regulation G.

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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: August 14, 2003

By: /s/ Ying Han

-----  
Name: Ying Han  
Title: Chief Financial Officer  
(duly authorized officer  
and principal financial officer)

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Certification

I, Xingsheng Zhang, certify that:

1. I have reviewed this quarterly report on Form 10-Q of AsiaInfo Holdings, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;



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3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - (c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: August 14, 2003

/s/ Xingsheng Zhang

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Xingsheng Zhang  
Chief Executive Officer

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Certification

I, Ying Han, certify that:

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1. I have reviewed this quarterly report on Form 10-Q of AsiaInfo Holdings, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - (c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: August 14, 2003

/s/ Ying Han

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Ying Han  
Chief Financial Officer

