

SINA CORP  
Form 10-Q  
November 09, 2005

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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 September 30, 2005**

**OR**

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

**For the transition period from**

**to**

**Commission File Number 000-30698**

**SINA CORPORATION**  
**(Exact Name of Registrant as Specified in Its Charter)**

**Cayman Islands**  
**(State or other jurisdiction of  
incorporation or organization)**

**52-2236363**  
**(I.R.S. Employer  
Identification Number)**

**Room 1802, United Plaza**  
**1468 Nan Jing Road West**  
**Shanghai 200040, China**  
**(86-21) 6289 5678**

**(Address, including zip code, and telephone number, including area code, of Registrant's principal executive offices)**

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

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

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

The number of shares outstanding of the registrant's ordinary shares as of November 4, 2005 was 53,133,687.

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## PART I FINANCIAL INFORMATION

**Item 1. Condensed Consolidated Financial Statements**

**SINA CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In thousands, except par value)

	<b>September 30, 2005 (Unaudited)</b>	<b>December 31, 2004 (Audited)</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 113,305	\$ 153,768
Short-term investments	175,331	121,867
Accounts receivable, net of allowances for doubtful accounts of \$2,239 and \$1,754, respectively	32,908	39,942
Short-term deferred tax assets	689	689
Prepaid expenses and other current assets	10,904	10,699
Total current assets	333,137	326,965
Investment in Tidetime Sun	1,151	5,468
Property and equipment, net of accumulated depreciation of \$24,558 and \$19,446, respectively	22,202	16,152
Equity investments	5,145	4,541
Intangible assets, net of accumulated amortization of \$7,307 and \$5,151, respectively	10,167	13,218
Goodwill	69,847	61,172
Other assets	3,631	2,909
Total assets	\$ 445,280	\$ 430,425

**LIABILITIES AND SHAREHOLDERS EQUITY**

Current liabilities:		
Accounts payable	\$ 1,947	\$ 2,052
Accrued liabilities *	34,874	68,384
Income taxes payable	3,460	4,502
Total current liabilities	40,281	74,938
Convertible Debt	100,000	100,000
Other long-term liabilities	1,286	2,142
Total liabilities	141,567	177,080

Commitments and contingencies (Note 14)

## Shareholders' equity:

Ordinary Shares: \$0.133 par value; 150,000 shares authorized; 53,131 and 51,359 shares issued and outstanding	7,067	6,834
Additional paid-in capital	280,812	263,912
Ordinary share subject to subsequent issuance	1,098	
Retained earnings (accumulated deficit)	12,298	(17,058)
Accumulated other comprehensive income (loss):		
Unrealized loss on investment in marketable securities	(1,807)	(395)
Cumulative translation adjustments	4,245	52
 Total shareholders' equity	 303,713	 253,345
 Total liabilities and shareholders' equity	 \$ 445,280	 \$ 430,425

\* Accrued liabilities as of December 31, 2004 included an additional consideration of \$28,087 to Crillion Corporation for its achievement of the 2004 performance target. Such additional consideration was paid in the first six months of 2005.

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

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**SINA CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited, in thousands, except per share amount)

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Net revenues:				
Advertising	\$ 22,968	\$ 18,516	\$ 59,989	\$ 47,146
Non-advertising	26,656	33,989	81,613	95,942
	49,624	52,505	141,602	143,088
Cost of revenues:				
Advertising	7,410	7,144	19,845	16,437
Non-advertising	8,670	9,711	25,504	27,241
	16,080	16,855	45,349	43,678
Gross profit	33,544	35,650	96,253	99,410
Operating expenses:				
Sales and marketing	15,735	10,646	37,937	26,816
Product development	3,816	3,034	11,038	7,151
General and administrative	4,210	4,065	13,985	11,220
Amortization of intangible assets	602	1,041	2,684	2,451
Total operating expenses	24,363	18,786	65,644	47,638
Income from operations	9,181	16,864	30,609	51,772
Interest and other income, net	1,698	1,296	4,794	3,596
Amortization of convertible debt issuance cost	(172)	(172)	(514)	(514)
Gain on the sale of a business	1,487		1,487	
Loss on investments and investment in Tidetime Sun	(1,458)	(1,675)	(2,740)	(1,616)
Loss on equity investments	(996)	(1,082)	(2,420)	(2,171)
Income before income taxes	9,740	15,231	31,216	51,067
Provision for income taxes	(647)	(728)	(1,860)	(2,504)
Net income	\$ 9,093	\$ 14,503	\$ 29,356	\$ 48,563
Basic net income per share	\$ 0.17	\$ 0.29	\$ 0.56	\$ 0.98
Diluted net income per share	\$ 0.16	\$ 0.25	\$ 0.51	\$ 0.85

Weighted average shares:

Basic	53,099	50,387	52,214	50,043
Diluted	58,774	57,763	58,680	57,995

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

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**SINA CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND**  
**COMPREHENSIVE INCOME**  
(Unaudited, in thousands)

	Ordinary Shares		Ordinary Shares (Accumulated Subject to Issuance)		Accumulated Deficit) / Retained Earnings		Other Comprehensive Income		Total Shareholder's Equity		Comprehensive Income	
	Shares	Amount	Additional Paid-in Capital	to Subsequent Issuance	Deficit) / Retained Earnings	Other Comprehensive Income	Loss	Equity	Income	Income		
Balances at December 31, 2004	51,359	\$ 6,834	\$ 263,912	\$	\$ (17,058)	\$	(343)	\$ 253,345				
Issuance of ordinary shares pursuant to stock plans	1,497	196	5,702					5,898				
Business acquisition	275	37	11,198	1,098				12,333				
Comprehensive income:												
Net income					29,356			29,356	\$	29,356		
Unrealized loss on investments in marketable securities							(1,412)	(1,412)	\$	(1,412)		(1,412)
Currency translation adjustments							4,193	4,193		4,193		4,193
Comprehensive income											\$	32,137
Balances at September 30, 2005	53,131	\$ 7,067	\$ 280,812	\$ 1,098	\$ 12,298	\$	2,438	\$ 303,713				

	Ordinary Shares		Ordinary Shares (Accumulated Subject to Issuance)		Accumulated Deficit) / Retained Earnings		Other Comprehensive Income		Total Shareholder's Equity		Comprehensive Income	
	Shares	Amount	Additional Paid-in Capital	to Subsequent Issuance	Deficit) / Retained Earnings	Other Comprehensive Income	Loss	Equity	Income	Income		
Balances at December 31,	48,627	\$ 6,471	\$ 236,222	\$ 1,349	\$ (83,054)	\$	(1,481)	\$ 159,507				



2003								
Issuance of ordinary shares pursuant to stock plans	1,413	188	9,269				9,457	
Business acquisition	372	49	9,835	1,051			10,935	
Comprehensive income:								
Net income					48,563		48,563	\$ 48,563
Unrealized loss on investments in marketable securities						(421)	(421)	(421)
Currency translation adjustments						(18)	(18)	(18)
Comprehensive income								\$ 48,124
Balances at September 30, 2004	50,412	\$ 6,708	\$ 255,326	\$ 2,400	\$ (34,491)	\$ (1,920)	\$ 228,023	

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

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**SINA CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited, in thousands)**

	<b>Nine months ended</b>	
	<b>September 30,</b>	
	<b>2005</b>	<b>2004</b>
Cash flows from operating activities:		
Net income	\$ 29,356	\$ 48,563
Adjustments to reconcile net income to net cash provided by operating activities:		
Allowances for doubtful accounts	441	93
Loss on equity investments	2,420	2,171
Loss on disposal of fixed assets	150	24
Depreciation	6,767	4,128
Amortization of convertible debt issuance cost	514	514
Amortization of intangible assets	2,684	2,451
Gain on sale of business	(1,487)	
Loss on investments and investment in Tidetime Sun	2,740	1,616
Changes in assets and liabilities (net of effect of acquisition):		
Accounts receivable	7,096	(21,439)
Prepaid expenses and other current assets	1,823	(2,715)
Other assets	(1,222)	24
Accounts payable	(144)	1,324
Income taxes payable	(1,088)	555
Accrued liabilities	(6,148)	7,144
Net cash provided by operating activities	43,902	44,453
Cash flows from investing activities:		
Acquisition of property and equipment	(12,593)	(9,678)
Cash paid for business acquisition, net of cash acquired	(26,141)	(27,233)
Equity investments	(3,024)	(1,435)
Deposit for equity investment and business acquisition	(800)	(241)
Purchase of short-term investments	(52,674)	(58,865)
Proceeds from sale of investments in Tidetime Sun		295
Proceeds from sale of business, net	1,787	
Proceeds from sale of equity investments	286	347
Net cash used in investing activities	(93,159)	(96,810)
Cash flows from financing activities:		
Proceeds from issuance of ordinary shares	5,898	9,456
Net cash provided by financing activities	5,898	9,456
Effect of exchange rate change on cash and cash equivalents	2,896	

Net decrease in cash and cash equivalents	(40,463)	(42,901)
Cash and cash equivalents at the beginning of the period	153,768	158,148
Cash and cash equivalents at the end of the period	\$ 113,305	\$ 115,247

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**SINA CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)**  
**(Unaudited, in thousands)**

	<b>Nine months ended September 30,</b>	
	<b>2005</b>	<b>2004</b>
Supplemental disclosure of investing activities:		
Cash paid for business acquisition*	\$ (26,141)	\$ (28,760)
Cash acquired		1,527
Cash paid for business acquisition, net	\$ (26,141)	\$ (27,233)
Supplemental disclosure of significant noncash activities:		
Ordinary shares issued for business acquisition *	\$ 11,235	\$ 9,884
Ordinary shares subject to subsequent issuance for business acquisition	\$ 1,098	\$ 2,400
Non-advertising services exchanged for equity interest in joint venture	\$	\$ 3,430

\* Cash paid (\$16,853) and ordinary shares issued (\$11,235) for business acquisition during the nine months ended September 30, 2005 were related to the additional consideration paid to Crillion Corporation for its achievement of the 2004 performance target which were accrued as of December 31, 2004. Cash paid (\$38) was for direct acquisition cost.

\* Cash paid (\$8,400) during the nine months ended September 30, 2005 and ordinary shares subject to

subsequent issuance  
(\$1,098) for  
business acquisition  
were related to the  
additional  
consideration to  
Davidhill Capital  
Inc. for its  
achievement of  
simultaneous online  
user targets.

- \* Cash paid (\$850)  
during the nine  
months ended  
September 30, 2005  
for business  
acquisition was  
related to the  
additional  
consideration to  
Bravado  
Investments  
Limited.

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

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**SINA CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**1. Business**

SINA Corporation ( SINA or the Company ), a Cayman Islands corporation, is a leading online media company and value-added information service provider in the People's Republic of China (the PRC or China ) and the global Chinese communities. With a branded network of localized websites targeting Greater China and overseas Chinese, the Company provides services through five major business lines including SINA.com (online news and content), SINA Mobile (mobile value-added services or MVAS ), SINA Online (community-based services and games), SINA.net (search and enterprise services) and SINA E-Commerce (online shopping and auctions). Together these business lines provide an array of services including region-focused online portals, MVAS, search and directory, interest-based and community-building channels, free and premium email, online games, virtual ISP, classified listings, fee-based services, e-commerce and enterprise e-solutions.

**2. Summary of Significant Accounting Policies***Principles of consolidation and basis of presentation*

The accompanying interim condensed consolidated financial statements have been prepared in conformity with the generally accepted accounting principles in the United States of America ( GAAP ), consistent in all material respects with those applied in the Company's Annual Report on Form 10-K for the year ended December 31, 2004. The interim financial information is unaudited but reflects all adjustments which are, in the opinion of management, necessary to provide fair condensed consolidated balance sheets, condensed consolidated statements of operations, condensed consolidated statements of shareholders' equity and comprehensive income and condensed consolidated statements of cash flows for the interim periods presented. Such adjustments are normal and recurring except as otherwise noted. The Condensed Consolidated Balance Sheet as of December 31, 2004 is derived from the December 31, 2004 audited financial statements. You should read these interim condensed consolidated financial statements in conjunction with the audited financial statements, including the notes thereto, and the other information set forth in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

The condensed consolidated financial statements include the accounts of the Company, its subsidiaries and variable interest entities ( VIEs ) for which the Company is the primary beneficiary. All significant intercompany accounts and transactions have been eliminated. Investments in entities in which the Company can exercise significant influence, but which are less than majority owned and not otherwise controlled by the Company, are accounted for under the equity method. The Company has adopted FASB Interpretation No. ( FIN ) 46R Consolidation of Variable Interest Entities ( FIN 46R ), an Interpretation of Accounting Research Bulletin No. 51. FIN 46R requires a VIE to be consolidated by a company if that company is subject to a majority of the risk of loss for the VIEs or is entitled to receive a majority of the VIE's residual returns. To comply with PRC laws and regulations, the Company provides substantially all its Internet content provision, MVAS and advertising services in China via its VIEs. These VIEs are wholly or partially owned by certain employees of the Company. The capital for the VIEs are funded by the Company and recorded as interest-free loans to these PRC employees. These loans were eliminated with the capital of the VIEs during consolidation. As of September 30, 2005, the total amount of interest-free loans to these PRC employees was \$9.5 million. The aggregate accumulated losses of all VIEs were approximately \$3.2 million and have been included in the condensed consolidated financial statements.

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

*Allowances for doubtful accounts*

The Company determines the allowance for doubtful accounts based on actual bad debt rate in the prior year and other factors. The Company also provides specific provisions for bad debts when facts and circumstances indicate that the receivable is unlikely to be collected. If the financial condition of the Company's customers were to deteriorate,

resulting in an impairment of their ability to make payments, additional allowances may be required.

**Table of Contents*****Available-for-sale securities investments***

Investments classified as available-for-sale securities are reported at fair value with unrealized gains (losses), if any, recorded as accumulated other comprehensive income in shareholders' equity. Realized gains or losses are charged to the income during the period in which the gain or loss is realized. If the Company determines a decline in fair value is other-than-temporary, the cost basis of the individual security is written down to fair value as a new cost basis and the amount of the write-down is accounted for as a realized loss. The new cost basis will not be changed for subsequent recoveries in fair value. Determination of whether declines in value are other-than-temporary requires significant judgment. Subsequent increases and decreases in the fair value of available-for-sale securities will be included in comprehensive income through a credit or charge to shareholders' equity except for an other-than-temporary impairment, which will be charged to the income.

Investments classified as available-for-sale securities include marketable equity securities of Tidetime Sun (Group) Limited ( Tidetime Sun ), previously called Sun Media Group (see Note 4 - Investment in Tidetime Sun ), and marketable debt securities included in the short-term investments. The Company invests in marketable debt securities that are readily available for operating or acquisition purposes and, accordingly, classifies them as short-term investments.

***Goodwill and intangible assets, net***

Goodwill represents the excess of the purchase price over the fair value of the identifiable assets and liabilities acquired as a result of the Company's acquisitions of interests in its subsidiaries and VIEs. Under Statement of Financial Accounting Standards ( SFAS ) No. 142, Goodwill and Other Intangible Assets ( SFAS 142 ), goodwill is no longer amortized, but tested for impairment upon first adoption and annually thereafter, or more frequently if events or changes in circumstances indicate that it might be impaired. The Company assesses goodwill for impairment periodically in accordance with SFAS 142.

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

***Revenue recognition******Advertising***

Advertising revenues are derived principally from online advertising and sponsorship arrangements. Online advertising arrangements allow advertisers to place advertisements on particular areas of the Company's websites, in particular formats and over particular periods of time. Advertising revenues from online advertising arrangements are recognized ratably over the displayed period of the contract when the collectibility is reasonably assured. Sponsorship arrangements allow advertisers to sponsor a particular area on its websites in exchange for a fixed payment over the contract period. Advertising revenues from sponsorship are recognized ratably over the contract period. Advertising revenues derived from the design, coordination and integration of online advertising and sponsorship arrangements to be placed on the Company's websites are recognized ratably over the term of such programs. In accordance with Emerging Issues Task Force ( EITF ) No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables, advertising arrangements involving multiple deliverables are broken down into single-element arrangements based on



their relative fair value for revenue recognition purposes, when possible. The Company recognizes revenue on the elements delivered and defers the recognition of revenue for the fair value of the undelivered elements until the remaining obligations have been satisfied.

Revenues from barter transactions are recognized during the period in which the advertisements are displayed on the Company's properties. Barter transactions are recorded at the lower of the fair value of the goods and services received or the fair value of the advertisement given, provided the fair value of the transaction is reliably measurable. Revenues from barter transactions were minimal for all periods presented.

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*MVAS*. *MVAS* revenues are derived principally from providing mobile phone users with short messaging service ( SMS ), multimedia messaging service ( MMS ), ring back tone ( RBT ), wireless application protocol ( WAP ) and interactive voice response system ( IVR ). These services include news and other content subscriptions, mobile dating service, picture and logo download, ring tones, ring back tones, mobile games, chat rooms and access to music files. Revenues from *MVAS* are charged on a monthly or per-usage basis. Such revenues are recognized in the period in which the service is performed, provided that no significant Company obligations remain, collection of the receivables is reasonably assured and the amounts can be accurately estimated.

The Company contracts with mobile operators China Mobile Communication Corporation ( China Mobile ) and its subsidiaries, China Unicom Co., Ltd. ( China Unicom ) and its subsidiaries, and telecom operators, which constitute a minimal percentage to the Company's *MVAS* operation, for billing and transmission services related to the *MVAS* transmitted to its users. In accordance with EITF No. 99-19, Reporting Revenues Gross as a Principal Versus Net as an Agent, revenues are recorded on a gross basis when the Company is considered the primary obligor to the *MVAS* users. Under the gross method, the amounts billed to *MVAS* users are recognized as revenues and the fees charged or retained by the third party mobile operators are recognized as cost of revenues. Revenues on *MVAS* where the Company is not considered the primary obligor to the user are recorded on a net basis. Under the net method, revenues are recorded net of fees charged or retained by the third party mobile operators.

Due to the time lag between when the services are rendered and when the mobile operator billing statements are received, *MVAS* revenues are estimated based on our internal records of billings and transmissions for the month, adjusting for prior periods' confirmation rates with mobile operators and prior periods' discrepancies between internally estimated revenues and actual revenues confirmed by mobile operators. The confirmation rate applied to the estimation of revenue is determined at the lower of the latest confirmation rate available and the average of six-months' historical rates available, provided that the Company has obtained confirmation rates for six months. If the Company has not yet received confirmation rates for six months, revenues would be deferred until billing statements are received from the mobile operators. Historically, there have been no significant true up adjustments to the revenue estimates.

Historically, due to the time lag of receiving billing statements from mobile operators and the lack of adequate information to make estimates, the Company has adopted a one-month lag reporting policy for *MVAS* revenues. Such policy has been applied on a consistent basis and does not apply to *MVAS* revenues from acquired entities Memestar Limited and Crillion Corporation. For the three and nine months ended September 30, 2005, the Company recorded *MVAS* revenues in the amount of \$24.1 million and \$73.3 million, respectively. If the Company had not used the one-month lag reporting policy, its revenues from *MVAS* for these periods would have been \$23.4 million and \$71.7 million, respectively.

China Mobile, China Unicom and most of their subsidiaries have transitioned *MVAS* providers to a new billing platform for SMS and MMS. The new billing platforms resulted in more controls by the mobile operators in the operation, a higher failure rate for fee collection from the Company's users and made it more difficult for the Company to recruit new users. As a result, the Company's revenues from *MVAS* have been reduced significantly. The Company has been monitoring the extent of the impact of the new billing platforms to its business and its confirmation rates used. In addition, the Company has been evaluating the current *MVAS* revenue recognition policy. If there were no consistent trends with respect to confirmation rates or there were continuous significant true up adjustments to its estimates under the new billing platforms, its current policy of estimating *MVAS* revenues may not be appropriate and the Company may have to record the *MVAS* revenues when it receives the billing statements from third-party mobile operators. Due to the time lag of receiving the billing statements, its *MVAS* revenues may fluctuate with the collection of billing statements if the Company were to record the *MVAS* revenues when it received the billing statements.

The Company purchases certain contents from third-party content providers for its *MVAS*. In most of these arrangements, the fees payable to the third-party content providers are calculated based on certain percentages of the revenue earned by their contents after deducting the fees paid to the third-party mobile operators. The Company's *MVAS* revenues are inclusive of such fees since the Company acts as the principal in these arrangements by having

the ability to determine the fees charged to end users and being the primary obligor to the end users with respect to providing such services.

*Fee-based services.* Fee-based services allow the Company's users to subscribe to services on its websites including online games, virtual ISP and paid email services. Revenues from these services are recognized in the period in which the service is performed, and provided that no significant Company obligations remain, collection of the receivables is reasonably assured and the amounts can be accurately estimated.

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*E-commerce.* E-commerce revenues are derived principally from slotting fees charged to merchants for selective positioning and promotion of their goods or services within the Company's online mall, SinaMall, and from commissions calculated as a percentage of the online sales transaction value of the merchants. Slotting fee revenue is recognized ratably over the period the products are shown on the Company's website while the commission revenue is recognized on a net basis after both successful online verification of customers' credit cards and shipment of products. Product returns have not been significant and are assumed by vendors.

*Enterprise services.* Enterprise services mainly include paid search and directory listings, corporate emails, classified listings and enterprise e-solutions. Revenues are recognized in the period in which the service is performed, and provided that no significant Company obligations remain, collection of the receivables is reasonably assured and the amounts can be accurately estimated.

In accordance with GAAP, the recognition of these revenues is partly based on the Company's assessment of the probability of collection of the resulting accounts receivable balance. As a result, the timing or amount of revenue recognition may have been different if the Company's assessment of the probability of collection of accounts receivable had been different.

**Stock-based compensation**

The Company accounts for stock-based employee compensation arrangements in accordance with provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25) as amended by FIN 44, Accounting for Certain Transactions Involving Stock Compensation an Interpretation of APB Opinion No. 25 and EITF No. 00-23, Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44 and complies with the disclosure provisions of SFAS 123, Accounting for Stock-Based Compensation (SFAS 123), as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (SFAS 148). Under APB No. 25, as amended, compensation cost is, in general, recognized based on the difference, if any, on the date of grant between the fair value of the Company's stock and the amount an employee must pay to acquire the stock. Total compensation cost as determined at the grant date of option is recorded in shareholders' equity as additional paid-in capital with an offsetting entry recorded to deferred stock compensation. Deferred stock compensation is amortized over the vesting period of 4 years on an accelerated basis using the model presented in paragraph 24 of FIN 28. Accordingly, the percentages of the deferred compensation amortized in the first, second, third and fourth years following the option grant date are approximately 52%, 27%, 15% and 6%, respectively. SFAS 148 amends SFAS 123 to provide alternative methods of transition for companies that voluntarily change to the fair value-based method of accounting for stock-based employee compensation. SFAS 148 also amends the disclosure provisions of SFAS 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.

Had compensation cost for the Company's stock-based compensation plans been determined based on the fair value at the grant dates for the awards under a method prescribed by SFAS 123, the Company's net income per share would have been adjusted to the pro forma amounts as follows:

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
	<b>(Unaudited, in thousands)</b>			
Net income:				
As reported	\$ 9,093	\$ 14,503	\$ 29,356	\$ 48,563
Deduct: Employee stock purchase plan related compensation expenses determined under fair value based method		(56)	(73)	(122)
Deduct: Stock-based employee compensation expenses determined under	(2,938)	(2,142)	(7,969)	(7,471)

fair value based method

Pro forma	\$ 6,155	\$ 12,305	\$ 21,314	\$ 40,970
Basic net income per share:				
As reported	\$ 0.17	\$ 0.29	\$ 0.56	\$ 0.98
Pro forma	\$ 0.12	\$ 0.24	\$ 0.41	\$ 0.82
Diluted net income per share:				
As reported	\$ 0.16	\$ 0.25	\$ 0.51	\$ 0.85
Pro forma	\$ 0.11	\$ 0.22	\$ 0.37	\$ 0.72

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The Company calculated the fair value of each option grant on the date of grant using the Black-Scholes pricing method with the following assumptions:

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Risk-free interest rate	4.09%	1.92% - 3.32%	2.93% - 4.09%	1.19% - 3.32%
Expected life (in years)	2	1 - 4	1 - 4	1 - 4
Expected dividend yield				
Volatility	61%	90%	61% - 87%	90% - 91%

**Advertising expenses**

Advertising expenses consist primarily of costs of promotion for corporate image and product marketing and costs of direct advertising. The Company expenses all advertising costs as incurred. The nature of the Company's direct advertising activities is such that they are intended to acquire subscribers for subscription-based and usage-based SMS. The Company considered Statement of Position 93-7 Reporting on Advertising Costs (SOP 93-7) issued by the American Institute of Certified Public Accountants (AICPA) and concluded that the criteria specified for capitalizing the costs of direct response advertising for subscription-based SMS were not met.

**Income taxes**

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

Accounting for Income Taxes, will not more-likely-than-not be realized.

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

**Recent accounting pronouncements**

In December 2004, the Financial Accounting Standards Board (the FASB) issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which replaces SFAS 123 and supersedes APB No. 25. SFAS 123R requires share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values, beginning with the first interim or annual period after June 15, 2005. In April 2005, the Securities and Exchange Commission announced that the accounting provisions of SFAS 123R are effective at the beginning of a company's next fiscal year that begins after June 15, 2005. The Company is now required to adopt SFAS 123R in the first quarter of fiscal year 2006. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. See the Stock-based compensation section above for the pro forma net income and net income per share amounts for the three and nine months ended September 30, 2005 and September 30, 2004, as if the Company had used a fair-value-based method, similar to the methods required under SFAS 123R, to measure compensation expense for employee stock incentive awards. Although the Company has not yet determined the transition method or whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, the Company is evaluating the requirements under SFAS 123R and expects the adoption to have a significant adverse impact on the Company's consolidated statements of operations and net income per share.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154) which replaces APB Opinion No. 20 Accounting Changes and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements - An Amendment of APB Opinion No. 28. SFAS 154 provides guidance on the accounting for

and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005, and is required to be adopted by the Company in the first quarter of fiscal year 2006. The Company is currently evaluating the effect that the adoption of SFAS 154 will have on its consolidated results of operations and financial condition but does not expect it to have a material impact.

**Table of Contents****3. Short-Term Investments**

The investments in marketable debt securities are classified as available for sale securities. The Company invests in these securities with the intent to make such funds readily available for operating or acquisition purposes and, accordingly, classifies them as short-term investments. The aggregate fair value of marketable debt securities is summarized as follows:

	<b>September 30, 2005 (unaudited)</b>	<b>December 31, 2004 (audited)</b>
	<b>(In thousands)</b>	
Time deposits	\$ 84,067	\$ 1,329
Marketable debt securities due within one year	46,762	56,473
Marketable debt securities due after one year through five years	44,502	64,065
	\$ 175,331	\$ 121,867

During the three and nine months ended September 30, 2005, the Company recorded an unrealized loss of \$31,000 and an unrealized gain of \$109,000, respectively, and recorded an unrealized gain of \$1.7 million and an unrealized loss of \$0.4 million, in the same periods of 2004, respectively, on its marketable debt securities as a component of comprehensive income.

**4. Investment in Tidetime Sun**

Investment in Tidetime Sun, previously called Sun Media Group, was accounted for as an investment in marketable equity securities under the provisions of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, and was classified as available for sale and reported at fair value with unrealized gains (losses), if any, recorded as a component of comprehensive income (loss) included in shareholder's equity. The fair value of this investment as of September 30, 2005 was \$1.1 million as compared to its cost basis of \$2.6 million. The Company considered the decline in the fair value of this investment to be other-than-temporary and recorded an impairment loss of approximately \$1.5 million. At November 4, 2005, the fair value of this investment was approximately \$0.9 million. The Company will continue to monitor the investment, and if there is a decline in fair value that is deemed to be other-than-temporary, the Company may have to recognize additional impairment charges in future periods.

**5. Equity Investments**

Equity investments, comprised of investments primarily in joint ventures, were accounted for using the equity method of accounting. As of September 30, 2005, the carrying value of equity investments of \$5.1 million mainly comprise investments in the following: i) a joint venture of Shanghai NC-SINA Information Technology Co. Ltd. (Shanghai NC-SINA) in the PRC with NC Soft, a Korean online game company and ii) a joint venture of China Online Auction Limited (COAL) in the PRC with Yahoo! Inc. The following summarizes the Company's equity investments as of September 30, 2005:

	<b>Shanghai NC-SINA</b>	<b>COAL</b>	<b>Others</b>	<b>Total</b>
Balances at December 31, 2004 (audited)	\$ 1,384	\$ 1,932	\$ 1,225	\$ 4,541
Additional investment		1,749	1,275	3,024
Gain (loss) on equity investments	146	(2,187)	(188)	(2,229)
Amortization expenses of intangible assets			(191)	(191)
Balances at September 30, 2005	\$ 1,530	\$ 1,494	\$ 2,121	\$ 5,145



In August 2005, Yahoo! announced its investment in Alibaba.com, a Chinese company. As part of its investment, Yahoo! intends to transfer its shares in COAL (a.k.a. 1Pai.com) to Alibaba.com. The Company owns 33% of the joint venture in COAL. It is in negotiations with Yahoo! and Alibaba.com as to the settlement of its investment in the joint venture. As of November 4, 2005, no agreement has been reached.

**Table of Contents****6. Sale of Bravado**

The Company completed the sale of Bravado Investments Limited (a.k.a. Fortune Trip), an online travel business, during the three months ended September 30, 2005. The sale price was approximately \$3.8 million less certain liabilities that the buyer agreed to assume. As a result of this transaction, the Company recognized a gain of \$1.5 million during the three months ended September 30, 2005 and is entitled to an additional gain of approximately \$0.6 million within the next 18 months, assuming certain conditions are satisfied.

**7. Goodwill and Intangible Assets**

The following table summarizes goodwill from the Company's acquisitions:

	<b>September 30, 2005 (unaudited)</b>	<b>December 31, 2004 (audited)</b>
<b>(In thousands)</b>		
Davidhill Capital Inc. ( Davidhill )	\$ 13,772	\$ 4,273
Crillion Corporation ( Crillion )	37,984	37,984
Bravado Investments Limited ( Bravado )*		824
Memestar Limited ( Memestar )	18,091	18,091
 Total goodwill	 \$ 69,847	 \$ 61,172

The following table summarizes the intangible assets acquired from Davidhill, Crillion, Bravado and Memestar:

	<b>September 30, 2005 (unaudited)</b>	<b>December 31, 2004 (audited)</b>
<b>(In thousands)</b>		
<i>(i) Davidhill:</i>		
Non-Compete agreements	\$ 480	\$ 480
Technology	10,300	10,300
	10,780	10,780
Less: Accumulated amortization	(1,554)	(622)
 Net	 9,226	 10,158
 <i>(ii) Crillion:</i>		
Non-Compete agreements	1,891	1,891
Customer list	2,494	2,494
Content provision contracts	81	81
	4,466	4,466
Less: Accumulated amortization	(3,525)	(1,960)
 Net	 941	 2,506

*(iii) Bravado:\**

Non-Compete agreements		121
Hotel reservation contracts		774
		895
Less: Accumulated amortization		(341)
Net		554

*(iv) Memestar*

Non-Compete agreements	1,256	1,256
Customer lists	972	972
	2,228	2,228
Less: Accumulated amortization	(2,228)	(2,228)
Net		

*Total intangible assets, net* \$ 10,167 \$ 13,218

\* During the three months ended September 30, 2005, the Company completed the sale of Bravado and exited the online travel business (see Note 6).

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Amortization expense related to intangible assets was \$0.6 million and \$2.7 million in the three and nine months ended September 30, 2005, respectively, and \$1.0 million and \$2.5 million in the three and nine months ended September 30, 2004, respectively. As of September 30, 2005, estimated amortization expenses in future periods are expected to be as follows:

<b>Fiscal year</b>	<b>Amortization expenses (In thousands)</b>
Remainder of 2005	\$ 476
2006	1,820
2007	1,176
2008	1,030
2009	1,030
2010	1,030
Thereafter	3,605
Total expected amortization expense	\$ 10,167

**8. Related Party Transactions**

*Transactions with joint ventures.* The Company sold advertising space to Shanghai NC-SINA to allow the joint venture to promote its online game on the Company's website. The contract terms are at rates and terms that are comparable with those entered into with independent third parties. Revenues derived from the advertising arrangements with Shanghai NC-SINA were approximately \$17,000 and \$0.5 million for the three and nine months ended September 30, 2005, respectively. The Company also provides a payment platform for customers of Shanghai NC-SINA to purchase virtual point cards to play its online game. Payments from its customers are recorded as customer advances received on behalf of Shanghai NC-SINA. As of September 30, 2005, the balance for such customer advances was \$2.2 million.

As part of the joint venture arrangement with COAL, the Company agreed to divert a certain number of users to COAL's auction site in exchange for an equity interest in COAL. Such obligation was recorded as deferred revenue at the time the Company recorded the equity investment in COAL. Non-advertising revenues from this arrangement are recognized on a pro-rated basis, based on the number of users diverted to COAL's auction site. Non-advertising revenue from this arrangement were \$0.2 million and \$0.9 million for the three and nine months ended September 30, 2005, respectively. As of September 30, 2005, deferred revenue from COAL was \$2.1 million, \$1.3 million of which related to long-term liabilities.

**9. Income Taxes**

The Company is registered in the Cayman Islands and has operations in four tax jurisdictions, including the PRC, the United States of America, Hong Kong and Taiwan. The operations in Taiwan represent a branch office of the subsidiary in the United States. For operations in the United States of America, Hong Kong and Taiwan, the Company has incurred net accumulated operating losses for income tax purposes. The Company believes that it is more likely than not that these net accumulated operating losses will not be utilized in the future and therefore the Company has not recorded income tax provisions or benefits for these locations as of September 30, 2005. The Company generated substantially all of its net income from its PRC operations for the three and nine months ended September 30, 2005 and 2004, and has recorded income tax provisions for the periods as follows:

<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
<b>(Unaudited, in thousands, except percentage)</b>			

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Loss subject to non PRC operations	\$ (1,217)	\$ (4,062)	\$ (7,318)	\$ (6,480)
Income subject to the PRC operations	10,957	19,293	38,534	57,547
Income before taxes	\$ 9,740	\$ 15,231	\$ 31,216	\$ 51,067
Income tax expenses subject to the PRC operations	\$ 647	728	1,860	2,504
Effective tax rate for the PRC operations	6%	4%	5%	4%

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Pursuant to PRC Income Tax Laws, the Company's subsidiaries and VIEs are generally subject to Enterprise Income Taxes ( EIT ) at a statutory rate of 33%, which comprises 30% national income tax and 3% local income tax. Some of these subsidiaries and VIEs are qualified new technology enterprises and under PRC Income Tax Laws, they are subject to preferential tax rate of 15%. In addition, some of the Company's subsidiaries are Foreign Investment Enterprise and under PRC Income Tax Laws, they are entitled to either a three-year tax exemption followed by three years with a 50% reduction in the tax rate, commencing the first operating year, or a two-year tax exemption followed by three years with a 50% reduction in the tax rate, commencing the first profitable year. The VIEs are wholly owned by the Company's employees and controlled by the Company through various contractual agreements. To the extent that the VIEs have undistributed after-tax net income, the Company would have to pay a dividend tax of 20% on behalf of its employees when dividends are distributed from these local entities in the future.

The provision for income taxes for the three and nine months ended September 30, 2005 and 2004 differs from the amounts computed by applying the EIT primarily due to the tax holidays and preferential tax rate enjoyed by certain of the Company's entities in the PRC. The effective tax rate for the PRC operations for the three months ended September 30, 2005 was higher than the same period of the prior year primarily due to higher non-deductible marketing expenses in the current quarter.

**10. Net Income Per Share**

Basic net income per share is computed using the weighted average number of the ordinary shares outstanding during the period. Diluted net income per share is computed using the weighted average number of ordinary share and ordinary share equivalents outstanding during the period.

The following table sets forth the computation of basic and diluted net income per share for the periods presented:

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
	<b>(Unaudited, in thousands, except per share amounts)</b>			
Numerator:				
Net income	\$ 9,093	\$ 14,503	\$ 29,356	\$ 48,563
Amortization of convertible debt issuance cost	172	172	514	514
Net income used in computing diluted net income per share	\$ 9,265	\$ 14,675	\$ 29,870	\$ 49,077
Denominator:				
Weighted average ordinary shares used in computing basic net income per share	53,099	50,387	52,214	50,043
Weighted average ordinary share equivalents:				
Stock options	1,798	3,499	2,589	4,075
Convertible debt	3,877	3,877	3,877	3,877
	5,675	7,376	6,466	7,952
Shares used in computing diluted net income per share	58,774	57,763	58,680	57,995
Basic net income per share	\$ 0.17	\$ 0.29	\$ 0.56	\$ 0.98

Diluted net income per share	\$ 0.16	\$ 0.25	\$ 0.51	\$ 0.85
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**Table of Contents****11. Segment Information**

Based on the criteria established by SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, the Company currently operates in three principal business segments globally. The Company does not allocate any operating costs or assets to its advertising, MVAS and other segments as management does not use this information to measure the performance of these operating segments. Management does not believe that allocating these expenses or assets is necessary in evaluating these segments' performance.

The following is a summary of revenues and cost of revenues by segments:

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2005</b>	2004	2005	2004
	<b>(Unaudited, in thousands, except percentages)</b>			
<b>Revenues:</b>				
Advertising	\$ 22,968	\$ 18,516	\$ 59,989	\$ 47,146
MVAS	24,134	31,290	73,267	88,207
Other	2,522	2,699	8,346	7,735
	\$ 49,624	\$ 52,505	\$ 141,602	\$ 143,088
<b>Cost of revenues:</b>				
Advertising	\$ 7,410	\$ 7,144	\$ 19,845	\$ 16,437
MVAS	8,279	9,389	24,323	26,463
Other	391	322	1,181	778
	\$ 16,080	\$ 16,855	\$ 45,349	\$ 43,678
<b>Gross profit margins:</b>				
Advertising	68%	61%	67%	65%
MVAS	66%	70%	67%	70%
Other	84%	88%	86%	90%
Overall	68%	68%	68%	69%

The following is a summary of the Company operations by geography:

	<b>PRC</b>	<b>U.S.</b>	<b>Hong Kong</b>	<b>Taiwan</b>	<b>Total</b>
	<b>(Unaudited, in thousands)</b>				
<b>Three months ended and as of</b>					
<b>September 30, 2005:</b>					
Revenue	\$ 48,445	\$ 508	\$ 546	\$ 125	\$ 49,624
Long-lived assets	21,756	121	179	146	22,202
<b>Three months ended and as of</b>					
<b>September 30, 2004:</b>					
Revenues	\$ 51,310	\$ 577	\$ 397	\$ 221	\$ 52,505
Long-lived assets	13,879	48	119	493	14,539
<b>Nine months ended and as of</b>					
<b>September 30, 2005:</b>					
Revenue	\$ 138,290	\$ 1,556	\$ 1,353	\$ 403	\$ 141,602



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Long-lived assets	21,756	121	179	146	22,202
<b>Nine months ended and as of September 30, 2004:</b>					
Revenues	\$ 139,274	\$ 1,707	\$ 1,333	\$ 774	\$ 143,088
Long-lived assets	13,879	48	119	493	14,539
		17			

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**Table of Contents****12. Concentration of Credit Risk and Major Customers**

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash and cash equivalents, marketable debt securities and accounts receivable. The Company limits its exposure to credit loss by depositing its cash and cash equivalents with financial institutions in the U.S., the PRC, Hong Kong and Taiwan which management believes are of high credit quality. The Company usually invests in marketable debt securities with A ratings or above.

Accounts receivable consist primarily of advertising agencies, direct advertising customers and third-party mobile operators. As of September 30, 2005 and December 31, 2004, respectively, approximately 97% and 98% of the net accounts receivable were derived from the Company's operations in the PRC. Regarding its advertising operations, no individual advertising customer accounted for more than 10% of total net revenues for the three and nine months ended September 30, 2005 and 2004. Also, no individual advertising customer accounted for more than 10% of accounts receivables as of September 30, 2005 and December 31, 2004. For its MVAS operations in the PRC, the Company mainly contracts with China Mobile and its subsidiaries and China Unicom and its subsidiaries for utilizing their transmission gateways for message delivery and billing systems to collect subscription or usage fees from its subscribers. MVAS fees charged to users via these operators accounted for 48% and 51% of the Company's net revenues for the three and nine months ended September 30, 2005, respectively, and 60% and 62% of the Company's net revenues for the three and nine months ended September 30, 2004, respectively. SMS revenue accounted for 35% and 38% of the Company's net revenues for the three and nine months ended September 30, 2005, respectively, and 46% and 52% of the Company's net revenues for the three and nine months ended September 30, 2004, respectively. Accounts receivable from the mobile operators represent MVAS fees collected on behalf of the Company after deducting their billing services and transmission charges. The Company maintains allowances for potential credit losses. Historically, the Company has not had any significant direct write-off of bad debts.

The following table summarizes operator(s) with 10% or more of the Company's total net revenues and accounts receivable:

Operator(s)	% of total net revenues			
	Three months ended		Nine months ended September	
	September 30,	September 30,	30,	2004
	2005	2004	2005	2004
China Mobile and its subsidiaries	46%	52%	46%	54%

Operator(s)	% of total accounts receivable, net	
	As of	As of December 31,
	September	2004
	30, 2005	
China Mobile and its subsidiaries	34%	47%

The Company operates in business segments which are characterized by rapid technological advances, changes in customer requirements and evolving regulatory requirements and industry standards. Any failure by the Company to anticipate or to respond adequately to technological changes in its industry segments, changes in customer requirements or changes in regulatory requirements or industry standards, could have a material adverse effect on the Company's business and operating results. The Company relies on a number of third-party suppliers for various other services, including web server hosting, banner advertising delivery software, Internet traffic measurement software and transmission and billing of MVAS. Any failure of these suppliers to provide services to the Company or any termination of these services with the Company could have a material adverse effect on the Company's business and operating results.

The majority of the Company's net income was derived from China. The operations in China are carried out by the subsidiaries and VIEs. The Company depends on dividend payments from its subsidiaries in China for its revenues after these subsidiaries receive payments from VIEs in China under various services and other arrangements. In addition, under Chinese law, its subsidiaries are only allowed to pay dividends to the Company out of their

accumulated profits, if any, as determined in accordance with Chinese accounting standards and regulations. Moreover, these Chinese subsidiaries are required to set aside at least 10% of their respective accumulated profits, if any, up to 50% of their registered capital to fund certain mandated reserve funds that are not payable or distributable as cash dividends. The appropriation to mandated reserve funds are assessed annually. As of December 31, 2004, the Company is subject to a maximum appropriation of \$4.8 million to these non-distributable reserve funds. The Company's subsidiaries and VIEs in China are subject to different tax rates. See Note 9 Income Taxes to the Condensed Consolidated Financial Statements.

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The majority of the Company's revenues derived and expenses incurred were in Chinese renminbi. The functional currency for the subsidiaries and VIEs in China is in Chinese renminbi, whereas the Company's reporting currency is U.S. dollars. As of September 30, 2005, the Company's cash, cash equivalents and short-term investment balance denominated in Chinese renminbi was approximately \$172.9 million, which accounted for approximately 60% of its total cash, cash equivalents and short-term investment balance. As of September 30, 2005, the Company's accounts receivable balance denominated in Chinese renminbi was approximately \$31.9 million, which accounted for approximately 97% of its total accounts receivable balance. Also as of September 30, 2005, the Company's liabilities balance denominated in Chinese renminbi was approximately \$35.6 million, which accounted for approximately 25% of its total liabilities balance. Accordingly, exchange rate fluctuations in Chinese renminbi may impact comprehensive income and equity. For example, the value of Chinese renminbi depends to a large extent on Chinese government policies and China's domestic and international economic and political developments, as well as supply and demand in the local market. Since 1994, the official exchange rate for the conversion of Chinese renminbi to the U.S. dollars had generally been stable and Chinese renminbi had appreciated slightly against the U.S. dollar. However, on July 21, 2005, the Chinese government changed its policy of pegging the value of Chinese renminbi to the U.S. dollar. Under the new policy, Chinese renminbi may fluctuate within a narrow and managed band against a basket of certain foreign currencies. As a result of this policy change, Chinese renminbi appreciated approximately 2.1% against the U.S. dollar. It is possible that the Chinese government could adopt a more flexible currency policy, which could result in more significant fluctuations of Chinese renminbi against the U.S. dollar.

Moreover, the Chinese government imposes controls on the convertibility of Chinese renminbi into foreign currencies and, in certain cases, the remittance of currency out of the PRC. The Company may experience difficulties in completing the administrative procedures necessary to obtain and remit foreign currency. In accordance with Securities and Exchange Commission Regulation S-X Rule 210.4-08 (e) (3), General Notes to Financial Statements, the Company performed tests on the restricted net assets of consolidated subsidiaries and VIEs (the restricted net assets) and concluded that the restricted net assets did not exceed 25% of the consolidated net assets of the Company as of December 31, 2004, which is the most recently completed fiscal year.

**13. Convertible Debt**

As of September 30, 2005, the Company has \$100 million of zero coupon convertible subordinated notes (the Notes) due 2023. The Notes were issued at par and bear no interest. The Notes will be convertible into SINA ordinary shares upon satisfaction of certain conditions at an initial conversion price of \$25.79 per share, subject to adjustments for certain events. One of the conditions for conversion of the Notes to SINA ordinary shares is that the market price of SINA ordinary shares reaches a specified threshold for a defined period of time. The specified thresholds are as follows: i) during the period from issuance to July 15, 2022, if the sale price of SINA ordinary shares, for each of any five consecutive trading days in the immediately preceding fiscal quarter, exceeds 115% of the conversion price per ordinary share, and ii) during the period from July 15, 2022 to July 15, 2023, if the sale price of SINA ordinary shares on the previous trading day is more than 115% of the conversion price per ordinary share. For the three months ended September 30, 2005, the sale price of SINA ordinary shares did not exceed the threshold set forth in Item (i) above for the required period of time. Therefore, the Notes are not convertible into SINA ordinary shares during the three months ending December 31, 2005.

Upon a purchaser's election to convert the Notes in the future, the Company has the right to deliver cash in lieu of ordinary shares, or a combination of cash and ordinary shares. The Company may redeem for cash all or part of the Notes on or after July 15, 2012, at a price equal to 100% of the principal amount of the Notes being redeemed. The purchasers may require the Company to repurchase all or part of the Notes for cash on July 15 annually from 2007 through 2013, and on July 15, 2018, or upon a change of control, at a price equal to 100% of the principal amount of the Notes.

**Table of Contents****14. Commitments and Contingencies**

The following table sets forth the contractual commitments and obligations of the Company as of September 30, 2005:

	Total	Payments due by period			
		Less than one year	One to three years	Three to five years	More than five years
( Unaudited, in thousands)					
Contractual obligations:					
Long-term debt obligations	\$ 100,000	\$	\$ 100,000	\$	\$
Operating lease obligations	3,655	1,327	2,328		
Purchase obligations	33,011	29,511	3,366	47	87
Other long-term liabilities	1,286		1,286		
Total contractual obligations	\$ 137,952	\$ 30,838	\$ 106,980	\$ 47	\$ 87

Long-term debt obligations represent the zero-coupon convertible subordinated notes issued on July 7, 2003. Please see Note 13 Convertible debt to the Condensed Consolidated Financial Statements for further information.

Operating lease obligations include the commitments under the lease agreements for the Company's office premises. The Company leases office facilities under non-cancelable operating leases with various expiration dates through 2007. Rental expenses were \$0.9 million and \$2.9 million for the three and nine months ended September 30, 2005, respectively, and were \$0.9 million and \$2.1 million for the three and nine months ended September 30, 2004, respectively. During the three months ended September 30, 2005, the Company prepaid approximately \$2.4 million in rental payments for its premises in Beijing. Based on the current rental lease agreements, future minimum rental payments required as of September 30, 2005 are \$3.7 million, or \$0.3 million, \$1.5 million and \$1.9 million for the three months ending December 31, 2005 and each of the succeeding two years ending December 31, 2006 and 2007, respectively. A majority of the commitment is from the Company's office lease agreements in the PRC.

Purchase obligations mainly include the commitments for Internet connection fees associated with websites production, content fees associated with websites production and MVAS, advertising serving services and marketing activities.

In addition to the above contractual obligations, the Company is also obligated to pay contingent consideration on its acquisition of Crillion in addition to the initial consideration with respect to such acquisition. The contingent consideration of the Crillion acquisition is based on Crillion's financial performances in 2005. The contingent consideration would roughly be 1.5 to 2.0 times 2005 earnings, provided that Crillion's pretax net income for 2005 is at least \$13.3 million. The total consideration is subject to a cap of \$125.0 million and will be paid 60% in cash and 40% in SINA ordinary shares.

In February 2005, multiple purported securities class action complaints were filed against the Company and certain officers and directors of the Company in the United States District Court for the Southern District of New York, following the Company's announcement of anticipated financial results for the first quarter of 2005 ending on March 31, 2005. On July 1, 2005, Judge Naomi Buchwald consolidated the cases under the caption *In re SINA Corporation Securities Litigation* and appointed City of Sterling Heights General Employee's Retirement System, City of St. Clair Shores Police and Fire Retirement System, and Charter Township of Clinton Police and Fire Retirement System (collectively the MAPERS Funds Group) as lead plaintiff. The MAPERS Funds Group filed an amended consolidated complaint on September 9, 2005. The Company intends to take all appropriate action in response to these lawsuits. The Company cannot estimate any possible loss at this time. From time to time, the Company may also be subject to legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of copyrights and other intellectual property rights in connection with the content published on our websites.



**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Exchange Act, including, without limitation, statements regarding our expectations, beliefs, intentions or future strategies that are signified by the words expect, anticipate, intend, believe, the negative of such terms or other comparable terminology. All forward-looking statements included in this document are based on information available to us on the date hereof, and we undertake no obligation to update any such forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. In evaluating our business, you should carefully consider the information set forth below under the caption Factors that May Impact Future Performance set forth herein. We caution you that our businesses and financial performance are subject to substantial risks and uncertainties, including the factors identified in Factors that May Impact Future Performance that could cause actual results to differ materially from those in the forward-looking statements.*

**Overview**

We are a leading online media company and value-added information services provider in the People's Republic of China (the PRC or China) and the global Chinese communities. With a branded network of localized websites targeting China, Hong Kong and Taiwan (Greater China) and overseas Chinese, we provide services through five major business lines including SINA.com (online news and content), SINA Mobile (mobile value-added services or MVAS), SINA Online (community-based services and games), SINA.net (search and enterprise services) and SINA E-Commerce (online shopping and auctions). Together they provide an array of services including region-focused online portals, MVAS, search and directory, interest-based and community-building channels, free and premium email, online games, virtual ISP, classified listings, fee-based services, e-commerce and enterprise e-solutions. In turn, we generate revenues through advertising, MVAS, fee-based services, e-commerce and enterprise services. Advertising and MVAS are currently the major sources of our revenues, and we expect this trend to continue in the near future periods.

**Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations are based upon our unaudited interim condensed consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States of America (GAAP). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to customer programs and incentives, bad debts, investments, intangible assets, income taxes, financing operations, restructuring, employee benefits, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. For further information on our critical accounting policies, see the discussion in the section titled Recent Accounting Pronouncements below and Note 2 to the Condensed Consolidated Financial Statements.

We believe the following critical accounting policies affect the more significant judgments and estimates used in the preparation of our consolidated financial statements.

**Revenue recognition**

**Advertising.** Advertising revenues are derived principally from online advertising and sponsorship arrangements. Online advertising arrangements allow advertisers to place advertisements on particular areas of our websites, in particular formats and over particular periods of time. Advertising revenues from online advertising arrangements are recognized ratably over the displayed period of the contract when the collectibility is reasonably assured. Sponsorship arrangements allow advertisers to sponsor a particular area on our websites in exchange for a fixed payment over the contract period. Advertising revenues from sponsorship are recognized ratably over the contract period. Advertising revenues derived from the design, coordination and integration of online advertising and sponsorship arrangements to be placed on our websites are recognized ratably over the term of such programs. In accordance with Emerging Issues Task Force (EITF) 00-21, Accounting for Revenue Arrangements with Multiple Deliverables, advertising arrangements involving multiple deliverables are broken down into single-element arrangements based on their

relative fair value, if possible, for revenue recognition purposes. We recognize revenue on the elements delivered and defer the recognition of revenue for the fair value of the undelivered elements until the remaining obligations have been satisfied. Significant judgment may be required to determine how the consideration of an arrangement should be allocated among potential multiple elements. Changes in judgments on the assumptions and estimates could materially impact the timing or amount of revenue recognition.



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*MVAS*. We mainly contract with third-party mobile operators for billing and transmission services related to the *MVAS* transmitted to our users. In accordance with EITF 99-19, Reporting Revenue Gross as a Principal Versus Net as an Agent ( EITF 99-19 ), revenues are recorded on a gross basis when we are considered the primary obligor to the *MVAS* users. Under the gross method, the amount billed to *MVAS* users is recognized as revenues and the fees charged or retained by the third party mobile operators are recognized as cost of revenues. Revenues on *MVAS* where we are not considered the primary obligor to the user are recorded on a net basis. Under the net method, revenues are recorded net of fees charged or retained by the third party mobile operators. During the three and nine months ended September 30, 2005, respectively, 89% and 90% of our *MVAS* revenues were recorded on a gross basis. The determination of whether the Company is the primary obligor for a particular type of service is subjective in nature and is based on an evaluation of the terms of the arrangement. If the terms of the arrangement with mobile operators were to change and cause us to no longer be the primary obligor to the users, we would have to record our *MVAS* revenues on a net basis. Consequently, this would cause a significant decline in our net revenues, but should not have a significant impact on our gross margin.

Due to the time lag between when the services are rendered and when the mobile operator billing statements are received, *MVAS* revenues are estimated based on our internal records of billings and transmissions for the month, adjusting for prior periods' confirmation rates with mobile operators and prior periods' discrepancies between internally estimated revenues and actual revenues confirmed by mobile operators. The confirmation rate applied to the estimation of revenue is determined at the lower of the latest confirmation rate available and the average of six months historical rates available, provided that we have obtained confirmation rates for six months. If we have not yet received confirmation rates for six months, revenues would be deferred until billing statements are received from the mobile operators. If subsequent billing statements from the mobile operators differ significantly from management's estimates, our revenues could be materially impacted.

***Allowances for doubtful accounts***

We determine the allowance for doubtful accounts based on actual bad debt rate in the prior year and other factors. We also provide specific provisions for bad debts when facts and circumstances indicate that the receivable is unlikely to be collected. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

***Available-for-sale securities investments***

Investments classified as available-for-sale securities are reported at fair value with unrealized gains (losses), if any, recorded as accumulated other comprehensive income (loss) in shareholders' equity. Realized gains or losses are charged to income during the period in which the gain or loss is realized. If we conclude that a decline in fair value is other-than-temporary, the cost basis of the individual security is written down to fair value as a new cost basis and the amount of the write-down is accounted for as a realized loss. The new cost basis will not be changed for subsequent recoveries in fair value. A determination of whether declines in value are other-than-temporary requires significant judgment.

***Purchase price allocation***

We account for our business combinations using the purchase method of accounting. This method requires that the acquisition cost be allocated to the assets and liabilities we acquired based on their relative fair values. We make estimates and judgments in determining the fair value of the acquired assets and liabilities based on independent appraisal reports for material purchases, as well as our experience with similar assets and liabilities in similar industries. If different judgments or assumptions were used, the amounts assigned to the individual acquired assets or liabilities could be materially different.

***Goodwill and other intangible assets***

Goodwill represents the excess of the purchase price over the fair value of the identifiable assets and liabilities acquired as a result of our acquisitions of interests in its subsidiaries and variable interest entities. Under SFAS 142, goodwill is no longer amortized, but tested for impairment upon first adoption and annually thereafter, or more frequently if events or changes in circumstances indicate that it might be impaired.

In accordance with SFAS 142, intangible assets with definite lives are amortized over their estimated useful life and reviewed for impairment in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of

Long-lived Assets ( SFAS 144 ). Intangible assets, such as purchased technology, trademark, customer list, user base and non-compete agreements, arising from the acquisitions of subsidiaries and variable interest entities are recognized and measured at fair value upon acquisition. Intangible assets are amortized over their estimated useful lives from one to ten years. We review the amortization methods and the estimated useful

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lives of intangible assets at least annually or when events or changes in circumstances indicate that it might be impaired. The recoverability of an intangible asset to be held and used is evaluated by comparing the carrying amount of the intangible asset to its future net undiscounted cash flows. If the intangible asset is considered to be impaired, the impairment loss is measured as the amount by which the carrying amount of the intangible asset exceeds the fair value of the intangible asset calculated using a discounted future cash flow analysis. We use estimates and judgments in our impairment tests, and if different estimates or judgments had been utilized, the timing or the amount of the impairment charges could be different.

***Advertising expenses***

Advertising expenses consist primarily of costs of promotion for corporate image and product marketing and costs of direct advertising. We expense all advertising costs as incurred. The nature of our direct advertising activities is such that they are intended to acquire subscribers for subscription-based and usage-based SMS. We considered Statement of Position 93-7 Reporting on Advertising Costs ( SOP 93-7 ) issued by the American Institute of Certified Public Accountants ( AICPA ) and concluded that the criteria specified for capitalizing the costs of direct response advertising for subscription-based SMS were not met.

***Income taxes***

Income taxes are accounted for using an asset and liability approach, which requires the recognition of income taxes payable or refundable for the current year and deferred tax liabilities and assets for future tax consequences of events that have been recognized in different periods in the Company's consolidated financial statements or tax returns. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax laws; the effects of future changes in tax laws or rates are not anticipated. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence assessed using the criteria in SFAS No. 109, Accounting for Income Taxes, will not more-likely-than-not be realized. Management uses assumptions, judgments and estimates to determine our current provision for income tax, taking into account current tax laws, our interpretation of current tax laws and possible outcomes of future audits conducted by tax authorities.

***Foreign currency***

Our reporting currency is the U.S. dollar and our operations in China, Hong Kong and Taiwan use their respective currencies as their functional currencies. The financial statements of these subsidiaries are translated into U.S. dollars using period-end rates of exchange for assets and liabilities and average rates of exchange in the period for revenues and expenses. Translation gains and losses are recorded in accumulated other comprehensive income or loss as a component of shareholders' equity. Net gains and losses resulting from foreign exchange transactions are included in interest and other income, net. During the quarter ended September 30, 2005, the foreign currency translation adjustments to our comprehensive income were \$4.2 million and the currency translation loss was approximately \$97,000, primarily as a result of the Chinese renminbi appreciating against the U.S. dollar. Historically, the Chinese renminbi was pegged to the U.S. dollar. On July 21, 2005, the Chinese government changed its policy to allow the renminbi to fluctuate within a narrow and managed band against a basket of certain foreign currencies.

**Recent Accounting Pronouncements**

In December 2004, the Financial Accounting Standards Board (the FASB) issued SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS 123R ), which replaces SFAS No. 123, Accounting for Stock-Based Compensation ( SFAS 123 ) and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS 123R requires share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values, beginning with the first interim or annual period after June 15, 2005. In April 2005, the Securities and Exchange Commission announced that the accounting provisions of SFAS 123R are effective at the beginning of a company's next fiscal year that begins after June 15, 2005. We are now required to adopt SFAS 123R in the first quarter of fiscal year 2006. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. See the Stock-based compensation section under Note 2 to our Condensed Consolidated Financial Statements for the pro forma net income and net income per share amounts for the three and nine months ended September 30, 2005 and September 30, 2004, respectively, as if we had used a fair-value-based method similar to the methods required under SFAS 123R, to measure compensation expense for employee stock incentive awards. Although we have not yet determined the transition method or whether

the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, we are evaluating the requirements under SFAS 123R and expect the adoption to have a significant adverse impact on our consolidated statements of operations and net income per share.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections ( SFAS 154 ) which replaces APB Opinion No. 20 Accounting Changes and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements An Amendment of APB Opinion No. 28. SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 and is required to be adopted by us in the first quarter of fiscal year 2006. We are currently evaluating the effect that the adoption of SFAS 154 will have on our consolidated results of operations and financial condition but do not expect it to have a material impact.

**Table of Contents****Results of Operations***Three and nine months ended September 30, 2005 and 2004**Net revenues*

	Three months ended September 30, 2005		2004		% of Change
	(Unaudited, in thousands, except percentages)				
		% of total net revenues		% of total net revenues	
Net Revenues					
Advertising	\$ 22,968	46%	\$ 18,516	35%	24%
Non-advertising					
Mobile value-added services	24,134	49%	31,290	60%	-23%
Other	2,522	5%	2,699	5%	-7%
Subtotal	26,656	54%	33,989	65%	-22%
Total net revenues	\$ 49,624	100%	\$ 52,505	100%	-5%

	Nine months ended September 30, 2005		2004		% of Change
	(Unaudited, in thousands, except percentages)				
		% of total net revenues		% of total net revenues	
Net Revenues					
Advertising	\$ 59,989	42%	\$ 47,146	33%	27%
Non-advertising					
Mobile value-added services	73,267	52%	88,207	62%	-17%
Other	8,346	6%	7,735	5%	8%
Subtotal	81,613	58%	95,942	67%	-15%
Total net revenues	\$ 141,602	100%	\$ 143,088	100%	-1%

During the three and nine months ended September 30, 2005, total net revenues decreased by \$2.9 million, or 5%, and \$1.5 million, or 1%, respectively, compared to the same periods of 2004. Advertising revenues in absolute amount and as a percentage of total net revenues grew while MVAS revenues declined.

*Advertising.* Advertising revenues grew in the third quarter year over year and nine-months year over year primarily due to increase in the number of advertisers and higher average spending by advertisers. Total number of advertiser was 571 in the third quarter, compared to 515 in the prior quarter and 547 in the third quarter of prior year. Average spending per advertiser was \$40,000 in the third quarter, compared to \$39,600 in the second quarter and \$33,900 in the third quarter of prior year.

During the three and nine months ended September 30, 2005, China accounted for 96% and 95% of our total advertising revenues, respectively, compared to 95% and 94%, respectively, in the same periods of 2004. Increase in advertising revenues in the third quarter of 2005 year over year was noted primarily in the real estate, education, fast moving consumer goods ( FMCG ) and automobile industries, while sequential growth came primarily from IT and real estate industries. Average spending per advertising customer in the PRC grew from \$46,000 and \$67,000 in the three and nine months ended September 30, 2004, respectively, to \$54,000 and \$84,000 for the three and nine months ended September 30, 2005, respectively. Our top ten customers in aggregate generated 15% and 13% of our advertising revenues in the PRC during the three and nine months ended September 30, 2005, respectively, compared to 21% and 20% in the same periods of 2004, respectively.

*MVAS.* MVAS revenues consist of revenues from short messaging service ( SMS ), ring back tone ( RBT ) and 2.5G products such as multimedia messaging service ( MMS ), wireless application protocol ( WAP ), as well as interactive voice response

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system ( IVR ). Declines in MVAS revenues for the third quarter year over year and for nine-months year over year were primarily attributed to the decline in SMS revenues.

	<b>Three months ended September 30,</b>		<b>2005</b>		<b>2004</b>		<b>% of Change</b>
	<b>(Unaudited, in thousands, except percentages)</b>						
		<b>% of MVAS revenues</b>		<b>% of MVAS revenues</b>		<b>% of MVAS revenues</b>	
SMS	\$ 17,445	72%	\$ 24,320	78%			-28%
2.5G products and others	3,510	15%	4,291	14%			-18%
RBT	1,295	5%	921	3%			41%
IVR	1,884	8%	1,758	5%			7%
<b>Total MVAS revenues</b>	<b>\$ 24,134</b>	<b>100%</b>	<b>\$ 31,290</b>	<b>100%</b>			<b>-23%</b>

	<b>Nine months ended September 30,</b>		<b>2005</b>		<b>2004</b>		<b>% of Change</b>
	<b>(Unaudited, in thousands, except percentages)</b>						
		<b>% of MVAS revenues</b>		<b>% of MVAS revenues</b>		<b>% of MVAS revenues</b>	
SMS	\$ 53,340	73%	\$ 74,447	84%			-28%
2.5G products and others	10,921	15%	8,276	10%			32%
RBT	3,634	5%	1,046	1%			247%
IVR	5,372	7%	4,438	5%			21%
<b>Total MVAS revenues</b>	<b>\$ 73,267</b>	<b>100%</b>	<b>\$ 88,207</b>	<b>100%</b>			<b>-17%</b>

SMS is the largest component of our MVAS revenues. Our SMS products are offered on a monthly subscription basis and usage basis. Usage-based SMS revenue accounted for approximately 6% and 17% of our SMS revenue in the three and nine months ended September 30, 2005, respectively. These compared to approximately 22% and 23%, respectively, of our SMS revenue in both the same periods of 2004. Sequential decrease in usage-based SMS revenues from the prior quarter was primarily caused by the ban on the advertising of fortune-telling related SMS via direct radio and television. In late January 2005, the Chinese State Administration of Radio, Film and Television ( SARFT ), which regulates radio and television stations in China, issued a notice prohibiting commercials for MVAS relating to fortune-telling from airing on radio and television stations, effective in February 2005. Such prohibition has negatively affected our revenues. This notice reflects the difficulty of determining or predicting the manner in which content might be restricted or prohibited under evolving regulations that are in many cases vague and subjective. SMS revenue generated via direct radio and television advertising fell sequentially by approximately \$5.7 million in the first quarter of 2005 and further fell by approximately \$4.3 million in the second quarter of 2005. In late June 2005, we started a new wave of television campaigns for our newly developed SMS products, which are offered on a monthly subscription basis. We are depending on the continuing increase of these new products promoted primarily through television commercials to grow our SMS revenues in the near future. However, there is no guarantee that such new products will receive market acceptance or that such products will not be prohibited by future rules and regulations.

The year-over-year decline in SMS revenue was also caused by other changes in the regulatory environment of the PRC and the policies of the mobile operators, including the transition onto new billing platforms by China Mobile Communication Corporation ( China Mobile ), and increased market competition. During 2004, mobile operators started transitioning SMS providers to a new billing platform. As of March 2005, almost all significant provincial subsidiaries of China Mobile have been moved onto the new billing platform for SMS. These new billing platforms have resulted in added operational controls and procedures in areas such as customer subscription and customer billing. As a result, recruitment of new users is more difficult, and our fee collection rates have declined.

Third quarter 2005 revenues from 2.5G products and others, including MMS, WAP and Kjava were approximately \$3.5 million, a decrease of 18% from the prior year, primarily due to the decline in MMS. Starting in January 2005, China Mobile stopped its MMS Album service. MMS Album allows users to receive their subscribed MMS messages from China Mobile's website when the subscribed MMS messages could not be successfully delivered to their mobile phones if their mobile phones do not support MMS. With the termination of such service, we are no longer able to collect fees from users when the MMS messages could not be delivered to the users' mobile phones. In addition, China Mobile began migrating MMS onto new billing platforms in the first quarter of 2005.



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As is the case with SMS, MMS's migration onto new billing platforms has resulted in added operational controls and procedures and, correspondingly, increased difficulties for new user recruitment and increased failure rate for fee collection from our users. Our MMS revenue in the third quarter of 2005 was \$1.3 million, a decline of 37% from the prior quarter, and a decline of 57% from the third quarter of the prior year. As of September 30, 2005, all significant provincial subsidiaries of China Mobile, with whom we have arrangements to offer MMS services, have migrated to the new billing platforms, but we were not able to estimate the full impact of this migration.

Revenues from other 2.5G products, including WAP and Kjava, were \$2.2 million in the third quarter of 2005, an increase quarter over quarter and 66% increase year over year. For the first nine months of 2005, revenues from other 2.5G products in aggregate grew to \$5.4 million from \$3.4 million in the same period of the prior year. China Mobile has begun implementing a policy to disallow billing to WAP end users who have been inactive for four months or more. This policy change could negatively impact our WAP revenues.

Revenue from RBT was \$1.3 million in the third quarter of 2005, a decline of 4% from the prior quarter and an increase of 41% from the same period in prior year.

Revenue from IVR was \$1.9 million in the third quarter of 2005, a decrease of 4% from the prior quarter and an increase of 7% from the prior year. IVR revenue for the nine months ended September 30, 2005 increased by \$0.9 million to \$5.4 million from the same period last year. Our IVR service was temporarily suspended by China Mobile during the third quarter of 2004 due to the violation of certain operating procedures and was resumed in October 2004. The mobile operators could again decide to enforce operating standards that are often vague and subjective, resulting in a negative impact to our IVR revenue.

For the three and nine months ended September 30, 2005, 89% and 90% of our MVAS revenues, respectively, were recorded on a gross basis. In accordance with EITF 99-19, revenues are recorded on a gross basis when we are considered the primary obligor to the MVAS users. Under the gross method, the amount billed to MVAS users are recognized as revenues and the fees charged or retained by the third party mobile operators are recognized as cost of revenues. Revenues on MVAS where we are not considered the primary obligor to the user are recorded on a net basis. Under the net method, revenues are recorded net of fees charged or retained by the third party mobile operators. If we were to enter into new arrangements with mobile operators, or if mobile operators were to request that we change the existing arrangements that would cause us to no longer be the primary obligor to the users, we would have to record our MVAS revenues on a net basis. Consequently, this would cause a significant decline in our MVAS revenues, but should not have significant impact on our gross margin.

*Other non-advertising revenues.* Other non-advertising revenues include enterprise services such as paid search and directory listings, fee-based services such as virtual ISP and paid email services, and e-commerce. Revenues from paid search and directory listings in aggregate were \$1.6 million and \$4.5 million for the three and nine months ended September 30, 2005, respectively, compared to \$1.3 million and \$4.0 million for same periods last year, respectively. These revenues accounted for approximately 50% to 60% of our other non-advertising revenues in the periods presented.

**Cost of revenues**

	<b>Three months ended September 30,</b>		
	<b>2005</b>	<b>2004</b>	
	<b>(Unaudited, in thousands, except</b>		
	<b>percentages)</b>		
			<b>% of</b>
			<b>change</b>
Cost of revenues:			
Advertising	\$ 7,410	\$ 7,144	4%
Non-advertising			
Mobile value-added services	8,279	9,389	-12%



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Total cost of revenues in the third quarter of 2005 decreased by 5% from the prior year primarily due to the decrease in cost of revenues from MVAS, which was partially offset by the increase in cost of revenues from advertising. Total cost of revenues for the first nine months ended September 30, 2005 increased year over year due to the increase in cost of revenues from advertising, which is partially offset by a decrease in the cost of revenues from MVAS.

*Advertising.* Cost of advertising revenues consists mainly of expenses associated with the production of our websites, which include fees paid to third parties for Internet connection, content and services, personnel related costs and related equipment depreciation expenses. Cost of advertising revenues also includes the business taxes on advertising sales in the PRC. Business taxes levied on advertising sales are approximately 8.5% of the advertising revenues. The content fee for the third quarter of 2004 included a \$1.1 million payment to an exclusive Olympics content partner and \$0.1 million for some other one-time content purchases relating to Olympics coverage. Excluding the Olympics event, cost of revenues from advertising increased 25% and 30%, respectively, compared to the three and nine months ended September 30, 2004. The increase was primarily due to the increase in website production costs, including an increase in web production personnel, content fees, Internet connection costs and business taxes. These increases were driven by the need to provide additional resources to support our web traffic and advertising revenue growth.

*Non-advertising.* Cost of non-advertising revenues consists mainly of fees paid to: 1) third party mobile operators for their services relating to the collection of our MVAS revenues and for using their transmission gateways, 2) fees or royalties paid to third-party content providers for services and content associated with our MVAS and 3) costs for providing our enterprise services. Cost of non-advertising revenues also includes business taxes levied on non-advertising sales in the PRC. Business taxes levied on MVAS are at 3% of mobile related revenues and at 5% for other non-advertising revenues. The year over year decrease of the cost of non-advertising revenues was mainly due to MVAS-related expenses, including the decrease in fees paid to mobile operators and third-party mobile content providers. Fees retained by or paid to mobile operators were \$6.0 million (25% of MVAS revenues) and \$6.8 million (22% of MVAS revenues) in the third quarter of 2005 and 2004, respectively, and \$18.1 million (25% of MVAS revenues) and \$19.4 million (22% of MVAS revenues) in the nine months ended September 30, 2005 and 2004, respectively. The increases in mobile operator fees as a percentage of MVAS revenues for the three months and nine months ended September 30, 2005 were primarily due to higher transmission costs related to monthly subscription SMS. Fees paid to third-party content providers were \$1.5 million (6% of MVAS revenues) and \$1.8 million (6% of MVAS revenues) for the third quarter of 2005 and 2004, respectively, and \$4.3 million (6% of MVAS revenues) and \$4.9 million (6% of MVAS revenues) for the nine months ended September 30, 2005 and 2004, respectively.

During the first quarter of 2005, our cooperation arrangements with certain provincial subsidiaries of China Unicom Co. Ltd. ( China Unicom ) were renewed. Under the renewed arrangements, effective April 1, 2005, the service fee they charge has been revised to a flat rate of 20% of the fees we charged to our users. Historically, service fees from China Unicom were set based on the volume of business with the mobile operator and mainly fluctuated between 10 - 40%, depending on the period and arrangement, but typically around 12%. This change from China Unicom did not have a material impact on our MVAS revenue and gross margin in the third quarter of 2005. In July 2005, China Mobile introduced a three-tier scheme to revenue sharing on new arrangements, the effective date of which is currently unknown. Under the new scheme, China Mobile will continue to charge 15% for only using its billing services, 30% for using its billing and customer support services and 50% for using its billing, customer support and marketing services. Since certain details from the new three-tier scheme were not yet clear, we were unable to determine if such changes will have significant negative impact to our operations and if the impact would be on revenues, cost of revenues or operating expenses. Such determination would be contingent on factors such as which MVAS will be impacted by the new scheme, whether we can still be considered the primary obligor if customer services and/or marketing activities are performed by China Mobile and whether the additional costs for services provided by China Mobile can be considered our operating expenses. However, it is clear that if we choose to or are required to use China Mobile's customer servi