PACIFICNET INC
Form 10-Q
May 31, 2007

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

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2007

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

FOR THE TRANSITION PERIOD FROM __________ TO ___________

COMMISSION FILE NUMBER: 000-24985

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

Delaware	**91-2118007**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
23/F, TOWER A, TIMECOURT, NO.6 SHUGUANG XILI, CHAOYANG DISTRICT, BEIJING, CHINA 100028	**N/A**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: 0086-10-59225000

Indicate by check mark whether the registrant (1) has filed all reports required 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 o NO þ

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large Accelerated Filer o Accelerated Filer o Non-accelerated filer þ

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

As of May 30, 2007, there were 11,808,993 shares of the issuer's common stock, par value $0.0001 per share, outstanding.

PACIFICNET INC.
Form 10-Q for the Quarterly Period Ended March 31, 2007

TABLE OF CONTENTS

PART I - FINANCIAL INFORMATION

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of Pacific Net Inc.

We have reviewed the accompanying consolidated balance sheet of Pacific Net Inc. (a Delaware Corporation) and Subsidiaries as of March 31, 2007, and the related statements of income, and cash flows for the three month period then ended. These consolidated financial statements are the responsibility of the Company's management. The financial statements of Pacific Net Inc. and Subsidiaries for the three month period ended March 31, 2006 was reviewed by the Company's prior auditor. The prior auditor has withdrawn their audit opinions.

We conducted our review in accordance with the standards of the Public Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the consolidated condensed financial statements referred to above for them to be in conformity with U. S. generally accepted accounting principles.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As on March 31, 2007, the company's accumulated deficit was $47,431,000. In addition, the Company is in default on its convertible debenture obligation. These factors, among others, as discussed in Note 1 to the consolidated financial statements, raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1.The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As discussed in Note 16, the financial statements for the two years ended December 31, 2005 and 2004 have been restated.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Pacific Net Inc. and subsidiaries (a Delaware Corporation) as of December 31, 2006 and the related consolidated statements of operations, changes in stockholders" equity and cash flows for the year then ended (not presented herein); and in our report dated March 30, 2007 we expressed an unqualified opinion on these consolidated financial statements.

Such report includes a paragraph that emphasizes facts that raise substantial doubt about the Company's ability to continue as a going concern. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2006, is fairly presented, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Kabani & Company, Inc.

Los Angeles, CA
May 30, 2007

ITEM 1. FINANCIAL STATEMENTS

PACIFICNET INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands of United States dollars, except par values and share numbers)

	March 31, 2007 (Unaudited)	December 31, 2006 (Audited)
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 4,041	$ 1,799
Restricted cash - pledged bank deposit	235	234
Accounts receivables, net of allowances for doubtful accounts of $1,579 and $2,023	8,411	7,297
Inventories	428	201
Loan receivable from related parties	713	1,706
Loan receivable from third parties	178	128
Marketable equity securities - available for sale	568	558
Other current assets	4,552	4,012
Total Current Assets	19,126	15,935
Property and equipment, net	6,656	4,711
Investments in affiliated companies and subsidiaries	34	115
Intangible assets, net	400	323
Goodwill	7,400	6,552
Other assets	-	471
Net assets held for disposition	11,795	12,822
TOTAL ASSETS	**$ 45,411**	**$ 40,929**
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Bank line of Credit	$ 404	$ 855
Bank loans-current portion	933	576
Capital lease obligations - current portion	110	120
Accounts payable	1,277	417
Accrued expenses and other payables	1,964	2,059
Income tax payable	88	17
Loans payable to related party	577	638
Convertible Debenture	6,909	8,000
Liquidated damages liability	2,697	2,837
Total Current Liabilities	14,959	15,519
Bank loans - non current portion	2,280	1,635
Capital lease obligations - non current portion	104	124
Convertible debenture- non current portion, net of issuance cost, $193, and $0	3,252	945
Warrant liabilities	844	904
Total long-term liabilities	6,480	3,608
TOTAL LIABILITIES	**21,439**	**19,127**
Commitments & contingencies	-	-

Minority interest in consolidated subsidiaries		7,126		6,874
Stockholders' Equity:				
Preferred stock, par value $0.0001, Authorized - 5,000,000 shares				
Issued and outstanding - none				
Common stock, par value $0.0001, Authorized - 125,000,000 shares; Issued and outstanding:				
March 31, 2007 - 14,355,041shares issued, 11,808,993 Outstanding				
December 31, 2006 - 14,155,597 issued, 11,538,664 outstanding		1		1
Treasury stock, at cost (2007 Q1: 2,546,048 shares, 2006: 2,616,933)		(130)		(257)
Additional paid-in capital		64,560		63,124
Cumulative other comprehensive income (loss)		249		220
Accumulated deficit		(47,431)		(47,739)
Less stock subscription receivable		(403)		(421)
TOTAL STOCKHOLDERS' EQUITY		**16,846**		**14,928**
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	**$**	**45,411**	**$**	**40,929**

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

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

	FOR THE THREE MONTH PERIODS ENDED March 31,			
	2007		2006	
	(unaudited)		(unaudited, restated)	
Net revenues				
Services	$	4,565	$	3,736
Product sales		4,702		2,936
Total net revenues		9,267		6,672
Cost of revenues				
Services		(3,353)		(2,577)
Product sales		(3,375)		(2,743)
Total cost of revenues		(6,728)		(5,320)
Gross Profit		2,539		1,352
Operating expenses:				
Selling, general and administrative expenses		(1,567)		(1,079)
Stock-based compensation expenses		-		(182)
Depreciation and amortization		(172)		(29)
Total operating expenses		(1,739)		(1,290)
Income from continued operations		800		62
Other income (expenses)				
Interest expenses, net		(200)		(52)
Gain/(loss) in change in fair value of derivatives		61		-
Sundry income, net		19		15
Total other expenses		(120)		(37)
Income from continued operations before income taxes, minority interests		680		25
Provision for income taxes		(68)		(17)
Share of earnings of associated companies		-		(3)
Minority interests		(534)		(86)
Income/(loss) from continued operations		78		(81)
Income from discontinued operations		230		882
Net income		308		801
Other comprehensive income/(loss):				
Foreign exchange gain/(loss)		29		(20)
Net comprehensive income	$	337	$	781
Basic earnings per share	$	0.03	$	0.07
Diluted earnings per share	$	0.03	$	0.07
Weighted average number of shares - Basic		11,719,168		10,855,761

Weighted average number of shares - Diluted	12,013,109	11,526,945

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

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

	FOR THE THREE MONTH PERIODS ENDED March 31, 2007	FOR THE THREE MONTH PERIODS ENDED March 31, 2006 (Restated)
Cash Flows from operating activities		
Net income	$ 308	$ 801
Adjustments to reconcile net income to net cash used in operating activities:		
Equity loss of associated company	-	3
Provision for allowance for doubtful accounts	(378)	-
Minority Interest	534	86
Depreciation and amortization	306	196
(Gain) loss from discontinued operations	(230)	(882)
Stock-based compensation	-	182
Change in fair value of derivatives	(61)	-
Liquidated damages expense	-	-
Changes in current assets and liabilities net of effects from purchase of subsidiaries:		
Accounts receivable and other current assets	307	(1,070)
Inventories	(227)	(83)
Accounts payable and other accrued expenses	(659)	610
Net cash used in operating activities	(100)	(157)
Cash flows from investing activities		
Decrease in restricted cash	(1)	(1)
Increase in purchase of marketable securities	(10)	(24)
Acquisition of property and equipment	(819)	(1,142)
Acquisition of subsidiaries and affiliated companies	-	(390)
Loans receivable from third parties	(50)	37
Loans receivable from related party	(33)	(670)
Net cash provided by (used in) investing activities	(913)	(2,190)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Loan payable to related party	(61)	144
Repayments under bank line of credit	(451)	(49)
Repayments of amount borrowed under capital lease obligations	(30)	(34)
(Purchase) sale of treasury shares	282	(124)
Proceeds from subscription received, exercise of stock options and warrants	18	29
Net proceeds from issuance of convertible debenture	2,296	7,500
Advances under bank loans	217	153
Net cash provided by(used in) financing activities	2,271	7,619
Effect of exchange rate change on cash and cash equivalents	29	18
Net increase (decrease) in cash from subsidiaries held for disposition	955	(1,512)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	2,242	3,778
	1,799	3,487

CASH AND CASH EQUIVALENTS, BEGINNING OF THE PERIOD				
CASH AND CASH EQUIVALENTS, END OF THE PERIOD	$	4,041	$	7,265
CASH PAID FOR:				
Interest	$	221	$	87
Income taxes	$	-	$	32
NON-CASH INVESTING AND FINANCING ACTIVITIES:				
Property & equipment acquired under banking loan	$	785	$$	1,082
Investments in subsidiaries acquired through the issuance of common stock	$	190	$	397

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

6

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

1. BASIS OF PRESENTATION

Description of Operations - PacificNet Inc. (referred to herein as "PacificNet" or the "Company") is a leading provider of gaming technology, e-commerce, and Customer Relationship Management (CRM) in China. Our gaming products are specially designed for the Chinese and Asian gamers, and we focus on integrating localized Chinese and Asian themes and content, advanced graphics, digital sound effects and popular domestic music, with secondary bonus games and jackpots. Our gaming products include: Multi-player Electronic Table Games - Baccarat, Sicbo, Fish-Prawn-Crab, and Roulette machines, server based games (SBG) with multiple client betting stations, slot and bingo machines, video lottery terminals (VLTs), amusement with prices (AWP) machines, gaming cabinet and client/server system designs, online i-gaming software design, and multimedia entertainment kiosks. PacificNet's gaming clients include the leading hotels, casinos, and gaming operators in Macau, Asia, and Europe, and our ecommerce and CRM clients include the leading telecom companies, banks, insurance, travel, marketing and business services companies and telecom consumers in Greater China such as China Telecom, China Mobile, Unicom, PCCW, Hutchison Telecom, Bell24, Motorola, Nokia, SONY, TCL, Huawei, American Express, Citibank, HSBC, Bank of China, Bank of East Asia, DBS, TNT, China and Hong Kong government. PacificNet employs about 1,200 staff in its various subsidiaries throughout China with offices in Hong Kong, Beijing, Shanghai, Shenzhen, Guangzhou, Macau and Zhuhai China, USA, and the Philippines.

Consolidated Interim Financial Statements - The consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial reporting consistent in all material respects with those applied in the Company's Annual Report on Form 10-K, as amended, for the year ended December 31, 2006, but do not include all disclosures required by GAAP. You should read these interim 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, as amended, for the year ended December 31, 2006. The unaudited consolidated financial statements include the accounts of PacificNet Inc. and its subsidiaries and variable interest entities ("VIEs") for which the Company is the primary beneficiary. All significant intercompany balances and transactions have been eliminated in consolidation. In the opinion of management, all material adjustments considered necessary for a fair presentation of the Company's interim results have been reflected. PacificNet's 2006 Annual Report on Form 10-K includes certain definitions and a summary of significant accounting policies and should be read in conjunction with this report. The results for interim periods are not necessarily indicative of annual results.

Use of Estimates - 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.

Reclassification - Certain items in the accompanied consolidated financial statements have been re-classed for comparative purposes.

Going Concern

As shown in the accompanying consolidated financial statements, the Company incurred accumulated losses of $47 million and $47.7 million as of March 31, 2007 and December 31, 2006, respectively. These matters raise substantial doubt about the Company's ability to continue as a going concern.

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

The Company has taken certain restructuring steps to provide the necessary capital to continue its operations. These steps included, but not limited to: 1) accelerate disposal and spin-off of unprofitable or unfavorable return-on-investment non-gaming operations; 2) focus on execution of the new high potential gaming business initiatives; 3) acquisition of profitable and/or strategic operations through issuance of equity instruments; 4) formation of strategic relationship with key gaming operators in Asia; 5) issuance and/or restructure of new long-term convertible debentures. In this regard, on April 30, 2007, the Company entered into a sale and purchase agreement to dispose of its interest in Guangzhou3G for a consideration of US$6 million, on May 5, 2007, the Company entered into a sale and purchase agreement to dispose of the real estate in HK for approximately US$1 million and on May 18 & 20, 2007, the Company entered into various definitive agreements to reduce its equity interests in certain unprofitable subsidiaries to 15%, namely: Linkhead, PacTelso, PacSo and PacPower.

2. RECENT PRONOUNCEMENTS

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

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

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

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

In March 2007, the Emerging Issues Task Force ("EITF") reached a consensus on issue number 06-10, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements," ("EITF 06-10"). EITF 06-10 provides guidance to help companies determine whether a liability for the postretirement benefit associated with a collateral assignment split-dollar life insurance arrangement should be recorded in accordance with either SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions" (if, in substance, a postretirement benefit plan exists), or Accounting Principles Board Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract). EITF 06-10 also provides guidance on how a company should recognize and measure the asset in a collateral assignment split-dollar life insurance contract. EITF 06-10 is effective for fiscal years beginning after December 15, 2007 (Novell's fiscal 2008), though early adoption is permitted. The management is currently evaluating the effect of this pronouncement on financial statements.

3. EARNINGS PER SHARE

Basic and diluted earnings or loss per share (EPS) amounts in the financial statements are computed in accordance with SFAS No. 128, "Earnings Per Share." Basic EPS is based on the weighted average number of common shares outstanding. Diluted EPS is based on the weighted average number of common shares outstanding plus dilutive common stock equivalents. Basic EPS is computed by dividing net income/loss available to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) during the period Diluted EPS is calculated by dividing net earnings by the weighted average number of common shares outstanding and other dilutive securities. Dilutive earnings per share for the period ended March 31, 2007 exclude the potential dilutive effect of 889,456 warrants because their impact would be anti-dilutive based on current market prices. 690,909 convertible debentures are tested by using if-converted method. The result shows when convertible debentures are included in the computation, diluted EPS increases. According to SFAS No.128, those convertible debentures are ignored in the computation of diluted EPS. All per share and per share information are adjusted retroactively to reflect stock splits and changes in par value.

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

	Three Months Ended March 31	
	2007	2006
	(IN THOUSANDS OF UNITED STATES DOLLARS, EXCEPT WEIGHTED SHARES AND PER SHARE AMOUNTS)	
Numerator: earnings/(loss)	$ 308	$ 801
Denominator:		
Weighted-average shares used to compute basic EPS	11,719,168	10,855,761
Dilutive potential from assumed exercise of stock options and warrants	293,941	671,184
Weighted-average shares used to compute diluted EPS	12,013,109	11,526,945
Basic earnings per common share:	$ 0.03	$ 0.07

Diluted earnings per common share:	$	0.03	$	0.07

9

4. GOODWILL AND BUSINESS ACQUISITIONS

The changes in the carrying amount of goodwill for the following reporting periods are summarized below:

(US$000s)	Group 1. Outsourcing Services	Group 2. Telecom Value-Added Services	Group 3. Products (Gaming and Technology)	Total goodwill on the restated balance sheet	Goodwill reclassified to net assets for disposal/ to be sold
Balance as of December 31, 2005	$ 3,936	$ -	$ 979	$ 4,915	$ 9,909
Goodwill acquired during the year	--	461	1,176	1,637	
Balance as of December 31, 2006	$ 3,936	$ 461	$ 2,155	$ 6,552	$ 3,655
Goodwill acquired during the first quarter			848		
Balance as of March 31, 2007	$ 3,936	$ 461	$ 3,003	$ 7,400	$ 3,655

5. STOCKHOLDERS' EQUITY

a) COMMON STOCK

For the three month period ended March 31, 2007, the Company had the following equity transactions: (i) 199,444 shares of common stock were issued as the monthly principal redemption shares for 8 million convertible debentures from January to March. Such shares are valued at $ 1,090,914.; (ii) 29,459 shares of common stock were released from escrow (PACT treasury shares) for acquiring additional 31% Ownership in Take 1 Technologies Group Limited valued at $190,305.(iii) 41,426 treasury shares were sold to the open market with total consideration $282,845.

b) STOCK OPTION PLAN

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

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

	OPTIONS OUTSTANDING	WEIGHTED AVERAGE EXERCISE PRICE
OUTSTANDING, DECEMBER 31, 2005	**1,444,500**	$4.29
Granted	500,000	$4.75
Cancelled	(1,180,000)	$5.80
Exercised	(394,000)	$2.12
OUTSTANDING, DECEMBER 31, 2006	**370,500**	$2.00
Granted	**-**	-
Cancelled	**-**	-
Exercised	**-**	-
OUTSTANDING MARCH 31, 2007	**370,500**	$2.00

Following is a summary of the status of options outstanding at March 31, 2007:

Grant Date	Total Options Outstanding	Aggregate Intrinsic Value	Weighted Average Remaining Life (Years)	Total Weighted Average Exercise Price	Option Exercisable	Weighted Average Exercise Price
2004-7-26	370,500	$1,237,470	0.32	$2.00	370,500	$2.00

The 370,500 outstanding options, which granted during year 2004, will be expired at July 26 of 2007. Those options were vested from July 1st of 2005 with 10 months vesting period, and the corresponding compensation cost have been recorded within the vesting period. The weighted-average fair value of such options was $1.41.The assumptions used in calculating the fair value of options granted using the Black-Scholes option- pricing model are as follows:

Risk-free interest rate	2.75%
Expected life of the options	1.65 years
Expected volatility	61.33%
Expected dividend yield	0%

No options were granted, cancelled and exercised during the three month period ended March 31, 2007.

c) WARRANTS

At March 31, 2007, the Company had outstanding and exercisable warrants to purchase an aggregate of 1,007,138 shares of common stock. The weighted average remaining life is 3.09 years and the weighted average exercise price per share is $10.61 per share.

Following is a summary of the warrant activity:

	Warrants outstanding	WEIGHTED AVERAGE EXERCISE PRICE	Aggregate Intrinsic Value
OUTSTANDING, DECEMBER 31, 2005	**591,138**	$ 9.50	$ -
Granted	416,000	-	-
Forfeited	-	-	-
Exercised	-	-	-
OUTSTANDING, DECEMBER 31, 2006	**1,007,138**	$ 10.61	$ -
Granted	**-**	**-**	**-**
Forfeited	**-**	**-**	**-**
Exercised	**-**	**-**	**-**
OUTSTANDING, MARCH 31, 2007	**1,007,138**	$ 10.61	$ -

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

Grant Date	Total warrants Outstanding	Weighted Average Remaining Life (Years)	Total Weighted Average Exercise Price	Warrants Exercisable	Weighted Average Exercise Price
2004-1-15	123,456	1.79	$7.15	123,456	$7.15
2004-11-15	117,682	2.63	$3.89	117,682	$3.89

2004-12-9	350,000	2.69	$12.21	350,000	$12.21
2006-3-13	416,000	3.95	$12.20	416,000	$12.20

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

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

No warrants were granted, cancelled and exercised during quarterly ended March 31 of 2007.

d) TREASURY STOCK

The following is a summary of the movement of the Company's shares held as treasury stock as at March 31 of 2007:

	Number of shares
Escrowed shares returned to treasury in 2003	800,000
Shares purchased in the open market	2,000
Repurchase of shares from Yueshen	24,200
Cancellation of former employee shares	45,000
Termination with ChinaGoHi - Returned shares plus Escrow shares	825,000
Incomplete acquisition of Allink	200,000
Holdback shares as contingent consideration due to performance targets not yet met - Includes shares related to Clickcom (78,000); Guangzhou Wanrong (138,348); iMobile (153,500); Games (160,000); and Take 1 (120,000)	649,848
Balance, March 31, 2007	**2,546,048**
Shares outstanding at March 31, 2007	11,808,993
Shares issued at March 31, 2007	14,355,041

From January 24th, 2007 to Jan 30th, 2007, we sold 41,426 treasury shares to the open market with total consideration $282,845.

On February 4th of 2007 (30 days after deal closing), we released 29,459 shares of common stock from escrow (PACT treasury shares) for acquiring additional 31% Ownership in Take 1 Technologies Group Limited. The remaining 120,000 shares are treated as holdback shares and will be released to Take 1 once they met their future performance targets.

6. CONVERTIBLE DEBENTURES

6.1 Eight Million Convertible Debentures

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

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

In February 2007, upon reaching an agreement on the amount and payment of accrued liquidated damages, the Company signed a Settlement and Release Agreement with each of the investors. Under the terms of the Settlement and Release Agreements, the Company paid an aggregate $140,000 in cash as satisfaction in full of liquidated damages owed to Basso Fund Ltd., Basso Multi-Strategy Holding Fund Ltd., and Basso Private Opportunities Holding Fund Ltd. Partial liquidated damages owed to Whalehaven Capital Fund Ltd. were paid in the amount of $35,000 in cash, with the remaining liquidated damages in the amount of $105,000 paid in the form of a new convertible debenture due February 2009, on substantially the same terms as the original debentures, except that interest only is paid on the new debentures until October 2008 and beginning in November 2008 until February 2009, when the new debentures are due, the monthly redemption amount under the new debentures shall be equal to $315,000. The remaining investors also agreed to accept the aggregate $840,000 in liquidated damages owed to them in the form of the new convertible debentures for the amount of their respective portion of the liquidated damages. The Company also agreed to amend the original debentures to shorten the term for payment of the original principal amount to a 22 month term. As a result the monthly redemption amount for the original debenture increased from $320,000 to $ 363,638. All other terms and conditions of the original debenture remain in full force and effect. The outstanding original principal amount as at March 31, 2007 is $6,909,086.

C.E. Unterberg, Towbin L.L.C. acted as placement agent and received a negotiated cash fee in the amount of $449,500 and a warrant to purchase up to 16,000 shares at an exercise price of $12.20 per share, which expire five years from the date of issuance. The fair value of these warrants totaled $28,141. Such amount was charged to other assets, net, and credited to additional paid-in capital and will be amortized over the life of the debentures. Maxim Group also acted as Placement Agent and received a cash fee in the amount of $50,000.

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

The gross proceeds of $8,000,000 are recorded as a current debenture liability. In addition, fair values attributed to the Investors’ warrants in accordance with EITF issue No. 00-19 “Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company’s Own Stock” are recorded as liabilities. The initial value related to the Investors’ warrants is $690,642. An aggregate gain of $60,694 representing the change in fair value of warrants was recognized during the three months ended March 31, 2007.

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

PROBABLE EVENT OF DEFAULT

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

a) "If, during the Effectiveness Period, either the effectiveness of the Registration Statement lapses for any reason or the Holder shall not be permitted to resell Registrable Securities under the Registration Statement for a period of more than 20 consecutive Trading Days or 60 non-consecutive Trading Days during any 12 month period, the Company has to pay ‘Mandatory Default Amount’ as the sum of (i) the greater of (A) 130% of the outstanding principal amount of this Debenture, plus all accrued and unpaid interest hereon, or (B) the outstanding principal amount of this Debenture, plus all accrued and unpaid interest hereon, divided by the Conversion Price on the date the Mandatory Default Amount is either (a) demanded (if demand or notice is required to create an Event of Default) or otherwise due or (b) paid in full, whichever has a lower Conversion Price, multiplied by the VWAP on the date the Mandatory Default Amount is either (x) demanded or otherwise due or (y) paid in full, whichever has a higher VWAP, and (ii) all other amounts, costs, expenses and liquidated damages due in respect of this Debenture."

b) "If any Event of Default occurs, the outstanding principal amount of this Debenture plus accrued but unpaid interest, liquidated damages and other amounts owing in respect thereof through the date of acceleration, shall become, at the Holder's selection, immediately due and payable in cash at the Mandatory Default Amount. Commencing 5 days after the occurrence of any Event of Default that results in the eventual acceleration of this Debenture, the interest rate on this Debenture shall accrue at an interest rate equal to the lesser of 18% per annum or the maximum rate permitted under applicable law."

Due to the provisions mentioned above and as per the terms of the Debenture, the Company has reclassified the principal amount of the Debenture of $8,000,000 and the principal amount of the new Debenture of $945,000 and the interest accrued thereon to current liabilities.

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

($,000)	2006		
Liquidated damages	2%	$	450
Mandatory default	30%		2,247
Total		$	2,697

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

6.2 Five Million Convertible Note

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

The $5 million convertible secured note issued to Pope matures on February 6, 2010. Subject to reaching certain net income milestones during fiscal year 2007, the note is convertible into an equity interest of PacGames ranging between 26% to 32% . The interest rate of the convertible note has initially been set at 8%, and shall increase to 15% if the note is not converted prior to maturity. PacGames received the first payment of $2.5 million during the first quarter of 2007.

In connection with the issuance of the note, PacGames incurred issuance costs of $204,121, which primarily consisted of investment banker fees, legal and other professional fees. These costs have been capitalized and will be amortized over three years, the life of the note.

7. SEGMENT INFORMATION

The Company has classified its operating segments in accordance with SFAS No. 131 "DISCLOSURES ABOUT SEGMENTS OF AN ENTERPRISE AND RELATED INFORMATION." Operating segments comprise reporting entities that exhibit similar long-term financial performance based on the nature of the products and services with similar economic characteristics such as margins, business practices and target market. The four operating segments are as follows:

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

(2) Telecom Value-Added Services (VAS) - primarily involves machine voice services such as Interactive Voice Response, SMS and related VAS, which are conducted through our subsidiaries such as ChinaGoHi (discontinued), Linkhead (discontinued), Clickcom (discontinued) and Guangzhou 3G/Sunroom. For example, Linkhead is a master reseller of NMS hardware and software platforms in China, and its voice cards are used as an integral part of voice hardware using CPCI industry control machines, and also by Media Servers to support access from PSTN and VoIP, Softswitch and 3G networks.

(3) Product (Telecom & Gaming) Services Group - involves communication and gaming products, GSM/CDMA/3G Products, Multimedia Communication Kiosks. This Group includes the following subsidiaries: PacificNet Communications Limited, iMobile, Allink, Take1 and PacificNet Games. PacificNet Games Limited (PacGames) is a leading developer of Asian electronic gaming machines, multi-player electronic gaming technology solutions and gaming related maintenance, IT, and distribution services for the leading hotel and casino operators based in the Macau and other Asian gaming markets.

(4) Other Business - other administrative, financial and investment services and non-core businesses such as PacificNet Power Limited (PacPower), Pacific Financial Services Limited, etc.

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

For the three months ended March 31, 2007 (in thousands, except percentages)	Group 1. Outsourcing Services ($)	Group 2. Telecom Value-Added Services ($)	Group 3. Products (Telecom & Gaming) ($)	Group 4. Other Business ($)	Total ($)
Revenues	3,963	527	4,773	4	9,267
(% of Total Rev)	(42.8%)	(5.7%)	(51.5%)	(0%)	(100%)
Earnings / (Loss) from Operations	400	-3	1,196	-793	800
(% of Total Profit)	(50.0%)	(-0.4%)	(149.5%)	(-99.1%)	(100%)
Total Assets	8,270	1,510	17,045	18,586	45,411
(% of Total Assets)	(18.2%)	(3.3%)	(37.5%)	(40.9%)	(100%)
Goodwill	3,936	461	3,003	-	7,400
Geographic Area	HK, PRC	HK, PRC	HK, PRC, Macau	HK,PRC	

17

For the three months ended March 31, 2006 (in thousands, except percentages)	Group 1. Outsourcing Services ($)	Group 2. Telecom Value-Added Services ($)	Group 3. Products (Telecom & Gaming) ($)	Group 4. Other Business ($)	Total (Restated) ($)
Revenues	3,022	295	3,355	0	6,672
(% of Total Rev)	(45.3%)	(4.4%)	(50.3%)	(0%)	(100%)
Earnings / (Loss) from Operations	206	15	359	-518	62
% of Total Profit)	(332.3%)	(0.0%)	(579.0%)	(-835.5%)	(100%)
Total Assets	7,347	1,010	14,566	35,807	58,730
(% of Total Assets)	(12.5%)	(1.7%)	(24.8%)	(61.0%)	(100%)
Goodwill	3,936	461	979	-	5,376
Geographic Area	HK,PRC	HK,PRC	HK,PRC, Macau	HK,PRC	

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

For the three months ended March 31, 2007	Hong Kong, Macau	PRC	United States	Total
Product revenues	$2,137	$1,550	$1,015	$ 4,702
Service revenues	$3,492	$1,073	-	$ 4,565

For the three months ended March 31, 2006	Hong Kong, Macau	PRC	United States	Total (Restated)
Product revenues	$2,936	-	-	$2,936
Service revenues	$3,027	$709	$	$3,736

8. RELATED PARTY TRANSACTIONS

LEASE AGREEMENT

In November 2004, the Company entered into a lease agreement with EPRO for rental space in the amount of $1,923 per month. The term of the lease was one year and renewable by either party.

LOAN DUE FROM RELATED PARTIES

At March 31, 2007, there was a total loan receivable of approximately $713,000 due from related parties. Included in which were $279,000 from MOABC, an affiliated company that is 15% owned by PacificNet, and $434,000 from shareholders and directors of certain of the Company’s subsidiaries in connection with the acquisition of those subsidiaries. The amounts due from shareholders and directors of subsidiaries are comprised of $254,000 due from a shareholder of Yueshen, $64,000 due from a director of Soluteck and $115,000 due from a director of PACT Communications. Terms of these related parties loan receivables and payables are summarized below:

LOAN TO MOABC
MOABC is an affiliated company, 15% owned by PacificNet, as of March 31, 2007. A convertible loan of $279,000 is outstanding from MOABC as of March 31, 2007. Terms of the convertible loan provide PacificNet an option at any time during the term of the loan to convert in part or in whole of the then outstanding loan principle into equity interest of MOABC, at $23,160 for each 1% of MOABC shares.

LOAN TO YUESHEN’S SHAREHOLDER
As of March 31, 2007, there was a loan outstanding of $254,000 receivable from the shareholder of Yueshen. This loan is secured by 106,240 PacificNet shares. Further discussion of the Company’s legal dispute with Yueshen can be found under Part II of this 10Q document - Item1: Legal Proceedings.

LOAN TO SOLUTECK’S DIRECTOR
As of March 31, 2007, there was a loan outstanding of $64,000 receivable from a director of Soluteck, due on December 14 for three consecutive years ending 2007. The interest rate for the loan is 8% per annum plus 5% penalty interest in case it has not been timely paid. The loan is collateralized with 100,000 PacificNet’s shares owned by the borrowing director and Ms Iris Lo, and the remaining assets of Smartime Holding Ltd.

LOAN TO COMMUNICATIONS' DIRECTOR
As of March 31, 2007, there was a loan outstanding of $115,000 receivable from a director of Communications, due on August 31, 2007. The interest rate for the loan is 10% per annum plus 1% penalty interest per month in case of delinquency. The loan is secured by 30,000 PacificNet shares.

LOAN DUE TO RELATED PARTIES

As of March 31, 2007, there was an outstanding loan payable of $577,000 due to related parties. Included in which was a loan payable of $292,000 to a shareholder of EPRO. The loan was advanced to Epro by a shareholder of EPRO on behalf of the Company for working capital purposes. The loan is due on August 4, 2010. Interest is charged at Hong Kong prime lending rate.

As of March 31, 2007, a loan of $285,000 was payable to a shareholder of Smartime. The loan was advanced to Smartime by a shareholder of Smartime on behalf of the Company for working capital purposes.

9. COMMITMENTS AND CONTINGENCIES

OPERATING LEASES - The Company leases warehouse and office space under operating leases with fixed monthly rentals. None of the leases included contingent rentals. Lease expense charged to operations for 2007 Q1 amounted to $152,000 (2006 Q1: $128,000). Future minimum lease payments under non-cancelable operating leases are $655,000 for the period from January 2007 to December 2008 and $684,000 for the period from January 2008 to December 2011, respectively.

RESTRICTED CASH - Term deposit of $235,000 has been pledged to certain financial institutions for bank line overdraft protection of Epro.

BANK LINE OF CREDIT - As of March 31, 2007, the Company's outstanding bank line of credit were as follows:

(i) Epro has an overdraft banking facility of up to $294,000 with certain banking institutions, which is secured by a pledge of its fixed deposits of $235,000. Interest is charged at Hong Kong Prime Rate and payable at the end of each calendar month or the date of settlement, whichever is earlier.

(ii) Smartime has an overdraft banking facility of up to $110,000 with a Hong Kong banking institution. This overdraft facility is secured by a personal deposit account of a director of Smartime.

BANK LOANS - Tabulated below are bank loans outstanding (in thousands):

	March 31, 2007 (Unaudited)	December 31, 2006
Secured [1]	$ 2,476	$ 1,668
Unsecured	$ 737	$ 543
Less: Current portion	$ (933)	$ (576)
Noncurrent portion	$ 2,280	$ 1,635

[1] The loans were secured by the following: joint and several personal guarantees executed by certain directors of the subsidiary of the Company; corporate guarantee executed by a subsidiary of the Company; second legal charge over a property owned by a subsidiary of the Company; and pledged bank deposits of $235,000 (2006: $234,000) of a subsidiary of the Company.

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

US$	**April 2007 to March 2008**	**April 2008 to March 2009**	**April 2009 to March 2010**	**April 2010 to March 2011**	**April 2011 to March 2012**	**Thereafter**	**TOTAL**
Beijing PACT office mortgage (1)	50,954	53,806	56,845	42,871	80,635	761,625	1,046,736
Shenzhen PACT office mortgage (2)	21,673	23,045	24,505	26,056	27,706	648,420	771,405
Sub-total	72,627	76,851	81,350	68,927	108,342	1,410,044	1,818,141
Bank line of credit (3)	436,841	403,754	130,996	-	-	-	971,590
AR factoring loans (3)	423,802	-	-	-	-	-	423,802
Sub-total	860,642	403,754	130,996	-	-	-	1,395,392
TOTAL	933,270	480,604	212,346	68,927	108,342	1,410,044	3,213,533

20

(1) Fixed mortgages expiring in 2012 at interest rate of 5.5% per annum.
(2) Fixed mortgage expiring in 2012 at interest rate of 6.2% per annum.
(3) Interest rates charged range from Hong Kong Prime Lending Rate to Prime + 2%.

CAPITAL LEASE OBLIGATIONS - The Company leases various equipments under capital leases expiring in 2008. Aggregate minimum future lease payments under capital leases for each of the next two years are as follows: 2007: $80,000; 2008: $24,000, and thereafter: none.

Liquidated damages: Refer to Note 6 for details

10. OTHER CURRENT ASSETS

Other current assets comprises of the following (in thousands):

	March 31, 2007 (Unaudited)	December 31, 2006
Loans to employees	$ 367	$ 411
Advances to sales representatives	1,127	358
Receivable from Lion Zone Holdings	385	485
Prepayment	725	887
Deposit-utilities	1,327	1,292
Prepaid expense	360	408
Others	261	171
Total	$ 4,552	$ 4,012

11. INCOME TAXES

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

The income taxes expenses for the Company's subsidiaries were $68,000 for the 3-month period ended March 31, 2007. The provision of income taxes depends on the tax rate and tax exemption. Pursuant to the PRC Income Tax Laws, the Company's subsidiaries and VIEs are generally subject to Enterprise Income Taxes ("EIT") at a statutory rate of 33%, which comprises 30% national income tax and 3% local income tax. Certain subsidiaries and VIEs are qualified for preferred high technology or software enterprise tax status, and they are subject to preferential tax rate of 15% under PRC Income Tax Rules.

For operations in the United States of America and Hong Kong the Company has incurred net accumulated operating loss for income tax purposes. The Company believes that it is more likely than not that these net accumulated operating loss will not be utilized in the future. Therefore, the Company has provided full valuation allowance for the deferred tax assets arising from the losses at these locations as of March 31, 2007. Accordingly, the Company has no net deferred tax assets as of March 31, 2007.

12. SUBSEQUENT EVENTS

Sale of Interest in Linkhead Technology Bejing Limited. ("Linkhead")
On May 20, 2007, the Company entered into a definitive agreement to sell its 36% equity interest in Linkhead, a PRC limited liability corporation engaged in the business of resaling of NMS hardware and software platforms in China, to Mr. Mu Yingliang, a resident of People’s Republic of China. Consideration for the 36% interest of Linkhead was RMB10,000 (or US$1,295), to be paid within 90 days after signing of the agreement. The Company’s interest in Linkhead decreased from 51% to 15% after the transaction.

Sale of Interest in PacificNet Telecom Solution Inc. ("PacTelso")
On May 20, 2007, the Company entered into a definitive agreement to sell its 36% equity interest in PacTelso, an intermediate holding company registered under the laws of British Virgin Islands, to Mr. Mu Yingliang, a resident of People’s Republic of China. Consideration for the 36% interest of PacTelso was RMB10,000 (or US$1,295), to be paid within 90 days after signing of the agreement The Company’s interest in PacTelso decreased from 51% to 15% after the transaction.

Sale of Interest in PacificNet Solutions Limited. ("PacSo")
On May 18, 2007, the Company entered into a definitive agreement to sell its 45% equity interest in PacSo, a company registered under the laws of Hong Kong SAR, China and engaged in systems integration, software application, and e-business solutions services, to Mr. Alex Au, a resident of Hong Kong SAR, China. Consideration for the 45% interest of PacSo was HK$4,500 (or US$583), to be paid within 90 days after signing of the agreement. The Company’s interest in PacSo decreased from 60% to 15% after the transaction.

Sale of Interest in PacificNet Power Limited ("PacPower")
On May 18, 2007, the Company entered into a definitive agreement to sell its 36% equity interest in PacPower, a company registered under the laws of Hong Kong SAR, China and engaged in air-conditioning contracting and consulting businesses, to Mr. Alex Au, a resident of Hong Kong SAR, China. Consideration for the 36% interest of PacPower was HK$3,600 (or US$466), to be paid within 90 days after signing of the agreement. The Company’s interest in PacPower decreased from 51% to 15% after the transaction.

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

Sale of Interest in Guangzhou 3G Information Technology Co., Ltd. ("Guangzhou 3G")
On April 30, 2007, the Company entered into a definitive agreement to sell its 51% interest in Guangzhou 3G to HeySpace International Limited, a BVI company owned by founders of Guangzhou 3G, for consideration of US$6 million, to be paid in cash in 5 installments over 7 months. The Company acquired a controlling interest in Guangzhou 3G, a PRC registered wholly owned foreign enterprise, through the purchase of a 51% interest in Guangzhou 3G's parent company, Pacific 3G Information & Technology Co. Limited, a British Virgin Islands Company, in March 2005 for a consideration of US$5.5 million, which was paid partly in cash and partly in PACT stock.

Guangzhou 3G was one of the largest value-added telecom and information services providers in China. It conducts its VAS operations with Guangzhou Sunroom Information Industrial Co., Ltd., a PRC registered Domestic Enterprise (DE), through a series of contractual agreements. Its business and profitability were severely impacted by certain adverse billing policies implemented by China Mobile during 2006.

Information relating to the operations of the subsidiaries up to the periods of disposal during the three month period ended March 31, 2007 is as follows:

(In US$ thousands)	Linkhead	G3G	Clickcom	Power	Solutions	MOABC	Total
Income/(loss) from discontinued operations	($8)	$261	($1)	-	$1	($23)	$230
Net assets held for disposition	$1,387	$10,230	$138	$106	($23)	($43)	$11,795

13. ACQUISITION

TAKE 1 TECHNOLOGIES GROUP LIMITED

On January 05, 2007, we entered into an agreement for PacificNet to exercise the option to acquire an additional 31% interest in Take 1. The completion date for the new Securities Subscription Agreement was January 05, 2007, with a consideration of $965,505 (paid entirely with shares of PacificNet: 149,459 PACT Shares, valued at $6.46 per share). As a result, PacificNet has become the majority and controlling shareholder of Take1 with our ownership percentage increasing from 20% to 51%.

An initial equity investment of 30% in Take 1 was made in April 2004 by the Company, through its subsidiary PacificNet Strategic Investment Holdings Limited, for a consideration of $1,156,812, comprising $385,604 in cash and $771,208 in 149,459 PacificNet shares at $5.16 per share. PacificNet's interest in Take 1 was reduced to 20% in the year 2005 from 30% as a result of PacificNet repurchasing an aggregate of 149,459 at nominal value.

Summarized below is the assets acquired and liabilities assumed for Take 1 in the acquisition:

Estimated fair values:	
Current Assets	$106,422
Intangible asset	$64,665
Total Assets Acquired	$171,087
Liabilities assumed	($728,156)
Net assets acquired	($557,069)
Investment on equity method (20%)	$385,604
Loss from Investment	$(285,260)
Additional Consideration (31%)-partially paid	$190,305
Goodwill	$847,718

At March 31, 2007, goodwill of $847,718 represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired and is not deductible for tax purposes and the total amount of goodwill is reported under reportable segment for Products (Telecom & Gaming)..

In accordance with SFAS 142, goodwill is not amortized but is tested for impairment at least annually. The purchase price allocation for Take 1 acquisition is based on a management's estimates and overall industry experience. Immediately after the signing of the definitive agreement, the Company obtained effective control over Take 1. Accordingly, the operating results of Take 1 have been consolidated with those of the Company starting January 05, 2007. Pursuant to SFAS 141 "Business Combinations", the earn-out consideration is considered contingent consideration, which will not become certain until the audited combined after-tax profit of US$128,205 for the quarter ended March 31, 2007 is available. Accordingly, the contingent consideration of 120,000 shares has not been reflected in the consolidated financial statements of the Company as of March 31, 2007.

UNAUDITED PRO FORMA CONSOLIDATED FINANCIAL INFORMATION DISCLOSURE FOR THE QUARTER ENDED MARCH 31, 2007 AND 2006

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

	Quarter ended March 31	
	2007	2006
	(un-audited and in thousands of U.S. dollars except for earnings per share)	
Revenue	$9,267	$6,916
Operating income	$800	$47
Net profit	$308	$796
Earnings per share - basic	$0.03	$0.07
Earnings per share - diluted	$0.03	$0.07

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

24

14 INVESTMENTS IN AFFILIATED COMPANIES

Investments in affiliated companies consists of the following as of March 31, 2007:

(US$ thousands)	COLLATERAL/OWNERSHIP % AND BUSINESS DESCRIPTION	
	AMOUNT	DESCRIPTION
INVESTMENTS IN AFFILIATED COMPANIES:		
Glad Smart	$30	15% ownership interest
Community media co.	$4	5% ownership interest
Total	$ 34	

15. LEGAL PROCEEDINGS.

1. Legal Proceeding and Judgment Against Guangzhou Yueshen Taiyang Network Science and Technology Limited, Ms. Li Yan Kuan, and Mr.Wu Yi Wen

On August 12, 2006, we commenced a law suit in the High Court of the Hong Kong Special Administrative Region ("HKSAR") against Guangzhou Yueshen Taiyang Network Science and Technology Limited ("Yueshen"), Ms. Li Yan Kuan and Mr.Wu Yi Wen for failure to pay amounts owed under a promissory note. On May 15, 2005, we loaned RMB2,000,000 ("Debt Sum") to Yueshen to cover operating costs, evidenced by a promissory note due on November 15, 2005. Ms. Kuan and Mr. Wen guaranteed repayment of the note by Yueshen. The Debt Sum together with the agreed interest rate calculated at 6% per annum was due on November 15, 2005.

On March 28, 2007, the High Court of HKSAR had adjudged that the three defendants should pay us the Debt Sum together with interest sum at the rate of 6% per annum from May 15, 2005 to March 28, 2007, and additional interest charged at the rate of 5% per annum for the Debt Sum and accrued interest within 90 days overdue and thereafter at the judgment rate until payment and fixed costs of HK$3,405.

2. Lawsuit between PacificNet Power Limited and Johnson Controls Hong Kong Limited (JCHKL), a subsidiary of Johnson Controls Inc. (NYSE:JCI) (www.jci.com)

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

In connection with the claim, PacificNet Power reviewed a letter from its client, China Weal Property Management Ltd., dated January 22, 2007 stating that the construction work by JCHKL had not been completed as of the date of the letter, and that certain violations itemized in a letter issued by the Hong Kong Environment Protection Department (EPD) (Noise Abatement Notice No. N806030) addressed to JCHKL with respect to acoustic problems with JCHKL's equipment had not been abated. Further, JCHKL was to pay penalties between HK$100,000 and HK$200,000 assessed by the JCHKL for failing to fix the noise problem on the roof of Fortress Tower.

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

On February 7, 2007, we instructed our Hong Kong legal counsel to issue a Defense and Counterclaim to JCHKL to counter-claim that (i) JCHKL's construction work has not complied with the applicable rules and regulations of various government authorities in Hong Kong; (ii) the Chiller System provided by JCHKL was defective and merchantable unfit and JCHKL has failed and/or refused to rectify such defective works; and (iii) JCHKL shall return the work deposit in the amount of HK$1,500,000 to PacificNet Power Limited and shall compensate and keep PacificNet Power Limited indemnified against all the loss and damages suffered as a result of any claims from the China Weal Property Management Ltd, the employer and the potential tenants of Fortress Tower. The case is under review by Hong Kong High Court and we have not received any judgment from the High Court of the Hong Kong Special Administrative Region as of date of this report. We are currently proceeding with discovery and counter-claims, and we intend to vigorously defend ourselves against the allegations. We are unable to predict the outcome of these actions, or a reasonable estimate of the range of possible loss, if any.

16. RESTATEMENT

On March 19, 2007 our predecessor auditor withdrew their opinion on our previously filed financial statements for the years ended December 31, 2005 and 2004 due to uncertainties around certain option grants during the said period. An independent investigation in this connection has been performed by our Audit Committee to address this matter.

In its May 3, 2007 Report, the Audit Committee concluded that, "…the Audit Committee did indeed find that, although the number and terms of option grants were being fixed by the Compensation Committee who deferred to the Board merely for a secondary review approval; whereby the Board of Directors still maintained the authority to cancel a prerequisite grant consummated by the Compensation Committee, therefore that Grant could likely be interpreted only as final at the date of approval of the company's Board of Directors. Hence, with this approach which seems to be more aligned with the SEC interpretation, financial restatement would be required to account for the granting of options that were "in the money" due to procedural administrative delay and the difference in the Compensation Committee grant date and the Board of Directors approval date. Accordingly, the Audit Committee recommended to the Board of Directors of Pacificnet, Inc. to charge additional stock based compensation expense to the company's financial statements for the fiscal years ended December 31, 2003, 2004 and 2005 respectively..."

Based on the Audit Committee Recommendations, extra stock-based compensation charges of approximately $0.3 million, $1.2 million and $0.1 million were charged to each of the years ended December 31, 2005, 2004 and 2003, respectively, Also, for the years ended December 31, 2005 and 2004, approximately $2.4 million and $0.2 million have been reclassified from Selling, General & Administrative expenses to Discontinued Operations for financial statement presentation purposes. Following are the effects of the restatement:

Fiscal years ended December 31 (In thousands, except share and share amounts)	2005 As reported	2005 As restated	2004 As reported	2004 As restated	2003 As reported	2003 As restated
Consolidated balance sheets:						
Additional paid-in capital	$ 57,690	$ 59,346	$ 53,916	$ 55,290	$ 31,790	$ 31,918
Accumulated deficit	(25,990)	(27,646)	(28,479)	(29,853)	(29,253)	(29,381)
TOTAL STOCKHOLDERS' EQUITY	31,785	31,785	25,310	25,310	2,509	2,509
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 51,203	$ 44,598	$ 33,250	$ 32,660	$ 7,770	$ 7,740
Consolidated income statements:						
Selling, General and Administrative expenses	$ (5,811)	$ (3,411)	$ (3,435)	$ 3,245	$ (1,572)	$ (1,569)
Stock-based compensation expenses	-	(282)	-	(1,246)	-	(128)
Income/(loss) from operations	4,569	289	1,937	(904)	(1,337)	(1,475)
Income/(loss) before income taxes, minority interest and discontinued operations	5,645	783	2,438	(989)	(1,256)	(1,394)
Income/(loss) before discontinued operations	-	(81)	817	(1,537)	(1,281)	(1,414)
Net income available to common stockholders	$ 2,489	$ 2,207	$ 774	$ (472)	$ (1,281)	$ (1,409)
Earnings/(loss) per common share:						
Basic	$ 0.25	$ 0.22	$ 0.11	$ (0.06)	$ (0.24)	$ (0.27)
Diluted	$ 0.23	$ 0.21	$ 0.09	$ (0.06)	$ (0.24)	$ (0.27)
Shares used in computing earnings per share						
Basic	10,154,271	10,154,271	7,268,374	7,268,374	5,234,744	5,234,744
Diluted	10,701,211	10,701,211	8,241,996	8,241,996	5,234,744	5,234,744
Consolidated statements of cash flows						
Net earnings (loss)	$ 2,489	$ 2,207	$ 774	$ (472)	$ (1,281)	$ (1,409)
Stock-based compensation	-	282	-	1,246	-	128
Net cash provided by (used in) operating activities	$ 9,250	$ 2,980	(4,431)	(2,491)	(905)	(905)
NET INCREASE (DECREASE) IN CASH AND CASH	$ 2,815	$ (2,866)	$ 2,941	$ 2,572	$ 129	$ 87

EQUIVALENTS

27

17. CURRENT VULNERABILITY DUE TO CERTAIN CONCENTRATIONS

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

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

THE FOLLOWING DISCUSSION SHOULD BE READ IN CONJUNCTION WITH THE INFORMATION CONTAINED IN THE FINANCIAL STATEMENTS OF THE COMPANY AND THE NOTES THERETO APPEARING ELSEWHERE HEREIN AND IN CONJUNCTION WITH THE MANAGEMENT'S DISCUSSION AND ANALYSIS SET FORTH IN THE COMPANY'S ANNUAL REPORT ON FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 2006, AS AMENDED.

PRELIMINARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements contained in this Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These include statements about the Company's expectations, beliefs, intentions or strategies for the future, which are indicated by words or phrases such as "anticipate," "expect," "intend," "plan," "will," "the Company believes," "management believes" and similar words or phrases. The forward-looking statements are based on the Company's current expectations and are subject to certain risks, uncertainties and assumptions, including those set forth in the discussion under "Description of Business," including the "Risk Factors" described in that section, and "Management's Discussion and Analysis or Plan of Operation." The Company's actual results could differ materially from results anticipated in these forward-looking statements. All forward-looking statements included in this document are based on information available to the Company on the date hereof, and the Company assumes no obligation to update any such forward-looking statements.