PACIFICNET INC
Form 10QSB
August 13, 2004

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

FORM 10-QSB

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

FOR THE PERIOD ENDED JUNE 30, 2004

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

FOR THE TRANSITION PERIOD FROM __________ TO __________

COMMISSION FILE NUMBER: 000-24985

PACIFICNET INC.

(Exact name of small business issuer in its charter)

DELAWARE	91-2118007
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
UNIT 2710, HONG KONG PLAZA, 188 CONNAUGHT ROAD WEST, HONG KONG	N/A
(Address of principal executive offices)	(Zip Code)

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

(Former Name and Address)

Check whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES /X/ NO / /

There were 7,036,168 shares of the Company's common stock outstanding on August 11, 2004.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

	JUNE 30, 2004	DECEMBER 31, 2003 (AUDITED)
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 3,201	$ 3,823
Restricted cash - pledged bank deposit	212	212
Accounts Receivables (net of allowance for doubtful accounts of $0 as of June 30, 2004 and $0 as of December 31, 2003	3,709	1,890
Inventories	1,051	76
Other Current Assets	1,273	286
Total Current Assets	9,446	6,287
Property and Equipment, net	604	466
Goodwill	6,108	420
Investment - at equity	518	--
TOTAL ASSETS	$ 16,676	$ 7,173

LIABILITIES AND STOCKHOLDERS' EQUITY
Current Liabilities:

Bank Line of Credit	$ 190	$ 1,199
Bank Loans - current portion	1,485	1,405
Capital Lease Obligations - current portion	61	152
Accounts Payable	1,892	1,007
Accrued Expenses	597	360
Subscription Payable	--	722
Total Current Liabilities	4,225	4,845
Long-term liabilities:		
Bank Loans - non current portion	384	377
Capital Lease Obligations - non current portion	147	149
Shareholders' Loan	116	--
Total Long-Term Liabilities	647	526
Minority Interest in Consolidated Subsidiaries	1,093	(110)

Commitments and Contingencies		
Stockholders' Equity:		
Preferred stock, par value $0.0001, Authorized - 5,000,000 shares		
Issued and outstanding - none	--	--
Common Stock, par value $0.0001, Authorized - 125,000,000 shares		
Issued and outstanding: June 30, 2004 - 8,370,762 issued; 7,036,168 outstanding December 31, 2003 - 6,163,977 issued; 5,363,977 outstanding	1	1
Treasury Stock, at cost June 30, 2004 - 834,594 shares; December 31, 2003 - 800,000 shares	(101)	(5)
Additional Paid-In Capital	40,493	31,790
Cumulative Other Comprehensive Loss	(24)	(24)
Accumulated Deficit	(29,658)	(29,850)
Total Stockholders' Equity	10,711	1,912
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 16,676	$ 7,173

See condensed notes to consolidated financial statements.

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

	THREE MONTHS ENDED JUNE 30, 2004	THREE MONTHS ENDED JUNE 30, 2003	SIX MONTHS ENDED JUNE 30, 2004	SIX MONTHS ENDED JUNE 30, 2003
Revenues	$ 8,084	$ 123	$ 11,586	$ 220
Cost of Revenues	(6,789)	(47)	(9,042)	(83)
Gross Margin	1,295	76	2,544	137
Selling, General and Administrative expenses	(875)	(321)	(1,652)	(740)
Depreciation and amortization	(73)	(2)	(140)	(3)
Provision for written off of fixed assets	--	--	--	(91)
PROFIT/(LOSS) FROM OPERATIONS	347	(247)	752	(697)
Interest Income	7	8	10	15
Sundry income	3	--	64	--
Equity earnings in undistributed earnings of investee company	17	--	17	--
PROFIT/(LOSS) BEFORE INCOME TAXES, MINORITY INTEREST AND DISCONTINUED OPERATIONS	374	(239)	843	(682)
Provision for income taxes	--	--	--	--
Minority Interest	(323)	7	(651)	21
PROFIT/(LOSS) BEFORE DISCONTINUED OPERATIONS	51	(232)	192	(661)
LOSS FROM DISCONTINUED OPERATIONS	--	--	--	(185)
NET PROFIT/(LOSS) AVAILABLE TO COMMON STOCKHOLDERS	$ 51	$ (232)	$ 192	$ (846)

BASIC AND DILUTED PROFIT/(LOSS) PER COMMON SHARE:				
Profit/(Loss) from continuing operations	$ 0.01	$ (0.04)	$ 0.03	$ (0.13)
Profit/(Loss) from discontinued operations	$ --	$ --	$ --	$ (0.04)
Net Profit/(Loss)	$ 0.01	$ (0.04)	$ 0.03	$ (0.17)

See condensed notes to consolidated financial statements.

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

	SIX MONTHS ENDED JUNE 30, 2004	SIX MONTHS ENDED JUNE 30, 2003
CASH FLOWS FROM OPERATING ACTIVITIES		
Net profit/(loss)	$ 192	$ (846)
Adjustment to reconcile net profit/(loss) to net cash used in operating activities:		
Expenses settled by issuance of warrants	--	15
Expenses settled by issuance of common shares	--	12
Equity earnings of investee company	(17)	--
Provision for written off of fixed assets	--	91
Loss from discontinued operations	--	185
Minority Interest	1,203	(20)
Depreciation and amortization	140	1
Accounts receivable and other current assets	(2,804)	94
Inventories	(975)	--
Accounts payable and accrued expenses	1,122	(67)
Net cash used in operating activities	(1,139)	(535)
CASH FLOWS FROM INVESTMENT ACTIVITIES		
Acquisition of property and equipment	(278)	--
Acquisition of subsidiaries	(1,160)	--
Acquisition of investee company	(385)	--
Net cash used in investing activities	(1,823)	--
CASH FLOWS PROVIDED BY FINANCING ACTIVITIES:		
(Repayments)/advances under bank line of credit	(1,009)	305
Repayment of amount borrowed under bank loans and capital lease obligations	(1,919)	--
Proceeds from sale of common stock	2,813	--
Post acquisition of share capital - subsidiaries	564	--
Repurchase of treasury shares	(96)	--
Proceeds from exercise of stock options	74	210
Advances under bank loans	1,913	--
Net cash provided by financing activities	2,340	515
NET DECREASE IN CASH AND CASH EQUIVALENTS	(622)	(20)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	3,823	3,694
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 3,201	$ 3,674

CASH PAID FOR:		
Interest	$ 109	$ 19
Income taxes	--	--
NONCASH INVESTING AND FINANCING ACTIVITIES:		
Investment in subsidiaries and associated company acquired through issuance of common stock	$ 5,250	$ --
Common stock issued to satisfy certain liabilities and to settle expenses	$ --	$ 27
Common stock issued as a result of exercise of stock options	$ 2	$ --

See condensed notes to consolidated financial statements.

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

1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-QSB. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows for all periods presented have been made. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns and impairment losses, accounting for income taxes, bad debts, and property, plant and equipment lives for depreciation purposes. Actual results may differ from these estimates. The results of operations for the six-month period ended June 30, 2004 are not necessarily indicative of the operating results that may be expected for the entire year ending December 31, 2004. These financial statements should be read in conjunction with the Management's Discussion and Analysis and financial statements and notes thereto included in the Company's financial statements and accompanying notes thereto as of and for the year ended December 31, 2003, filed with the Company's Annual Report on Form 10-KSB.

2. EARNINGS (LOSS) PER SHARE

Basic earnings (loss) per share are based on the weighted average number of shares of common stock outstanding. Diluted earnings or loss per share is based on the weighted average number of shares of common stock outstanding and dilutive common stock equivalents. All earnings per share amounts in these financial statements are basic earnings (loss) per share as defined by SFAS No. 128, "Earnings Per Share." Diluted weighted average shares outstanding for both periods in 2003 exclude the potential issuances of common stock upon exercise of options and warrants because to do so would be antidilutive. Total potential common shares not included in the computation of dilutive EPS for both periods in 2004 was 154,320 warrants to purchase common stock because their impact would be antidilutive based on current market prices.

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

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

	THREE MONTHS ENDED		SIX MONTHS E	
	JUNE 30, 2004	JUNE 30, 2003	JUNE 30, 2004	JU
Numerator-net profit /(loss)	$ 51	$ (232)	$ 192	$
Denominator:				

Weighted average number of shares used in computed basic EPS	6,880,329	5,227,310	6,757,307	
Net effect of dilutive common shares	969,427	--	604,364	
Weighted average shares used in computed diluted EPS	7,849,756	5,227,310	7,361,671	
Basic profit/(loss) per share	$ 0.01	$ (0.04)	$ 0.03	$
Diluted profit/(loss) per share	$ 0.01	$ (0.04)	$ 0.03	$

3. BUSINESS ACQUISITIONS AND DISPOSITIONS

BUSINESS ACQUISITIONS.

GUANGZHOU YUESHEN TAIYANG TECHNOLOGY LIMITED

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

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

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

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

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

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

CHEER ERA LIMITED

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

(i) approximately USD$771,208 by delivery of 149,459 shares of Common Stock as consideration for the purchase of 100 of the Shares from Apex Legend Limited, a company incorporated in the British Virgin Islands ("Apex") within

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thirty (30) days of the signing of the agreement for the purchase of the Shares. All of the Common Stock deliverable to Apex is being held in escrow pursuant to the terms of an escrow agreement, which provides that the Common Stock will be released in installments over the twelve month period following the consummation of the purchase and sale of the Shares, provided, that Cheer Era attains certain net income milestones during such period. In the event there is a shortfall in the net income during the period, Apex shall return to the Company shares of the Common Stock equivalent to the dollar amount of such shortfall divided by $6.00; and

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

BUSINESS DISPOSITIONS.

In May 2003, the Company decided not to further invest in the Customer Service Support Center in the U.S. As of June 30, 2003, all activities have significantly slowed down due to the economic slowdown in the U.S. During the six months ended June 30, 2003, the Company wrote off property and equipment of $150,000. Revenues and net loss information related to Customer Service Support Center operations are as follows (in thousands):

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	JUNE 30, 2004 (UNAUDITED)	JUNE 30, 2003 (AUDITED)	JUNE 30, 2004 (UNAUDITED)	JUNE 30, 2003 (AUDITED)
Revenues	$ --	$ --	$ --	$ 4
Net Loss	$ --	$ --	$ --	$ (185)

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

4. JOINT VENTURE OPERATIONS

The Company ceased its participation with International Elite Limited (IEL) in the joint venture company, PacificNet Communications Limited - Macao Commercial Offshore (the "Joint Venture"). Pursuant to the terms of the Equity Joint Venture Agreement, signed on December 21, 2002, the Company was required to obtain the requisite regulatory and shareholder approval to issue 34 million shares of the Company's common stock in connection with the Joint Venture transaction. The Company did not receive the necessary regulatory and shareholder approval to issue the shares. Since the Company was unable to obtain the appropriate approvals, the board of directors of the Company determined that it was in the best interest of the Company to terminate its interest in the Joint Venture. Since the Company did not obtain regulatory and shareholder approval of the joint venture transaction and the Company does not control the operating and financing decisions of the joint venture, the Company does not consolidate the assets, liabilities, revenues and expenses of the joint venture. The original 800,000 deposit shares held in escrow were canceled and returned to the Company's treasury. The termination agreement was signed on March 30, 2004. As such, the results of operations for the six months ended June 30, 2003, do not include the activity for the joint venture as previously reported in its June 30, 2003 quarterly filing.

5. STOCKHOLDERS' EQUITY

Common stock issued.

For the period ended June 30, 2004, the Company issued (i) 1,050,000 shares with total consideration of $5,250,000 to acquire subsidiaries representing (a) 100,000 deposit shares of common stock plus 300,000 shares as a result of achievement of certain earnings criteria to Epro; b) 350,000 deposit shares of

common stock plus 300,000 shares as a result of achievement of certain earnings criteria to Linkhead; (ii) 617,285 shares with cash consideration of $3,000,000 pursuant to a private placement, including warrants to purchase up to an aggregate of 154,320 common shares of the Company issued to a group of institutional investors; (iii) 39,500 shares as a result of exercise of stock options with cash consideration of $74,000 and noncash consideration of $2,000; (iv) post-acquisition of share capital from subsidiaries of $564,000; and (v) reduced by repurchase of 27,000 shares with cash consideration of $96,000 by the Company.

Common Stock Repurchase Program.

The Company's Board of Directors has approved a Corporate Stock Repurchase Program to purchase up to US$800,000 worth of outstanding shares of its common stock in open market transactions, from time to time, in compliance with Rule 10b-18 of the Securities Exchange Act of 1934 and all other applicable securities regulations. The purpose of the repurchase program is to enhance shareholder value. During the six months ended June 30, 2004, the Company repurchased 26,784 shares at an average price of $3.56 per share for approximately $96,000.

6. STOCK-BASED COMPENSATION

Stock options.

During the period ended June 30, 2003, the Company granted stock options to purchase the Company's common stock at $1.75 and $2.20 per share, which expire on January 10, 2006 and June 23, 2006, respectively. No options were granted during the first quarter and second quarters of 2004. During the period ended June 30, 2004, no options were canceled or forfeited, and 39,500 options were exercised for cash proceeds of $74,000 and noncash consideration of $2,000. As of June 30, 2004, there were 886,100 stock options outstanding and 303,600 options exercisable. The weighted average exercise price of the options outstanding and exercisable is $3.07 and $2.04, respectively, and the weighted average remaining contractual life is 1.66 and 1.61 and years, respectively.

The Company accounts for stock-based compensation using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," under which no compensation cost for stock options is recognized for stock option awards granted at or above fair market value. Had compensation expense for the Company's stock-based compensation plans been determined under FASB No. 123, based on the fair market value at the grant dates, the Company's pro forma net loss and pro forma net loss per share would have been reflected as follows at June 30:

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	JUNE 30, 2004	JUNE 30, 2003	JUNE 30, 2004	JUNE 30, 2003
Net profit (loss)				
As reported	$ 51	$ (232)	$ 192	$ (614)
Stock-based employee compensation cost, net of tax	--	(819)	--	(1,133)
Pro forma	$ 51	$ (1,051)	$ 192	$ (1,747)
Profit (loss) per share				
As reported	$ 0.01	$ (0.04)	$ 0.03	$ (0.12)
Pro forma	$ 0.01	$ (0.20)	$ 0.03	$ (0.34)

The fair values of options granted during the three and six months period ended June 30, 2003, were $1.62 and $2.04, respectively, and were estimated on the date of grant using the Black-Scholes option pricing model with the following

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weighted-average assumptions: dividend yield of 0%, expected volatility of 266%, risk-free interest rate of 2.5%, and an expected life of 3 years.

Warrants.

During the period ended June 30, 2003, no warrants were granted to purchase the Company's common stock. 154,320 warrants were granted at $7.15 per share during the second quarter of 2004, and no warrants were exercised, canceled or forfeited. As of June 30, 2004, there were 954,320 warrants outstanding. The weighted average exercise price of the warrants outstanding is $2.43 and the weighted average remaining contractual life is 1.57 years.

7. SEGMENT INFORMATION

The Company's reportable segments are operating units, which represent the operations of the Company's significant subsidiaries. The significant accounting policies of the Company's subsidiaries are the same as those of the Company. No information has been presented for the comparative prior period as the acquisitions of the Company's current significant subsidiaries had not occurred as of those dates. The operations for the six months ended June 30, 2003 primarily represent the operations of our subsidiary PacificNet Solutions

Limited. ("PacSo"), which specializes in systems integration, software application, and e-business solutions services in Hong Kong and Greater China

Summarized financial information concerning the Company's reportable segments is shown in the following table. The "Other" column includes the Company's other insignificant subsidiaries and corporate related items, and, as it relates to segment profit (loss), income and expense not allocated to reportable segments (in thousands).

FOR THE SIX MONTHS ENDED JUNE 30, 2004	LINKHEAD	EPRO	YUESHEN	OTHER	TOTAL
Revenues	$ 2,781	$ 4,302	$ 3,805	$ 698	$11,586
Operating gain/(loss)	$ 753	$ 451	$ 52	$ (413)	$ 843
Total assets	$ 3,364	$ 3,733	$ 271	$ 9,308	$16,676

FOR THE THREE MONTHS ENDED JUNE 30, 2004	LINKHEAD	EPRO	YUESHEN	OTHER	TOTAL
Revenues	$ 1,624	$ 2,250	$ 3,805	$ 405	$ 8,084
Operating gain/(loss)	$ 381	$ 241	$ 52	$ (300)	$ 374
Total assets	$ 3,364	$ 3,733	$ 271	$ 9,308	$16,676

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

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

PRELIMINARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis or plan of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to accounts receivable reserves, provisions for impairment losses of affiliated companies and other intangible assets, income taxes and contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies reflect our more significant estimates and assumptions used in the preparation of our consolidated financial statements:

ALLOWANCE FOR DOUBTFUL ACCOUNTS

We evaluate the collectibility of our trade receivables based on a combination of factors. We regularly analyze our significant customer accounts, and, when we become aware of a specific customer's inability to meet its financial obligations to us, such as in the case of bankruptcy filings or deterioration in the customer's operating results or financial position, we record a specific reserve for bad debt to reduce the related receivable to the amount we reasonably believe is collectible. The allowances are calculated based on detailed review of certain individual customer accounts, historical rates and an estimation of the overall economic conditions affecting our customer base. We review a customer's credit history before extending credit. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

INCOME TAXES

We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. We have considered future market growth, forecasted earnings, future taxable income, and prudent and feasible tax

planning strategies in determining the need for a valuation allowance. We currently have recorded a full valuation allowance against net deferred tax assets as we currently believe it is more likely than not that the deferred tax assets will not be realized.

CONTINGENCIES

We may be subject to certain asserted and unasserted claims encountered in the normal course of business. It is our belief that the resolution of these matters will not have a material adverse effect on our financial position or results of operations, however, we cannot provide assurance that damages that result in a material adverse effect on our financial position or results of operations will not be imposed in these matters. We account for contingent liabilities when it is probable that future expenditures will be made and such expenditures can be reasonably estimated.

LONG-LIVED ASSETS

We periodically assesses the need to record impairment losses on long-lived assets, such as property, plant and equipment, goodwill and purchased intangible assets, used in operations and its investments when indicators of impairment are present indicating the carrying value may not be recoverable. An impairment loss is recognized when estimated undiscounted future cash flows expected to result from the use of the asset plus net proceeds expected from disposition of the asset (if any) are less than the carrying value of the asset. When an impairment is identified, the carrying amount of the asset is reduced to its estimated fair value. All goodwill will no longer be amortized and potential impairment of goodwill and purchased intangible assets with indefinite useful lives will be evaluated using the specific guidance provided by SFAS No. 142 and SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This impairment analysis will be performed at least annually. For investments in affiliated companies that are not majority-owned or controlled, indicators or value generally include revenue growth, operating results, cash flows and other measures. Management then determines whether there has been a permanent impairment of value based upon events and circumstances that have occurred since acquisition. It is reasonably possible that the impairment factors evaluated by management will change in subsequent periods, given that the Company operates in a volatile environment. This could result in material impairment charges in future periods.

COMPANY OVERVIEW.

PacificNet Inc. (referred to herein as "PacificNet" or the "Company") was incorporated in the state of Delaware in 1999. The Company is focused on providing value-added telecom services and products, customer relationship management (CRM) solutions, systems integration, network communications, information technology solutions and telecommunications in Asia. Through its subsidiaries, the Company invests, operates and provides value-added telecom services (VAS) in Greater China. The Company's VAS includes operating call centers, providing telemarketing services, customer relationship management services (CRM), interactive voice response systems (IVR), short messaging services (SMS), multimedia messaging services (MMS), voice over internet protocol (VoIP) services, mobile applications and calling cards. In addition, the Company sells and distributes telecom services. The Company intends to continue to grow by acquiring and managing growing technology and network communications businesses with established products and customers in Asia. The Company employs over 800 staff in various subsidiaries throughout Greater China.

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

I. Beijing Linkhead Technologies Co., Limited ("Linkhead"), subsidiary, a private PRC company. Linkhead is a leading provider of VAS, IVR systems, mobile chatting, and voice-portal services in greater China. Linkhead is in the business of providing VAS, IVR system development

and integration, voice internet portals, computer telephony integration (CTI), VoIP, internet and mobile application development and CRM services for China's telecom operators. Linkhead also provides telecom related management and consulting services, mobile consumer analytics, mobile data-mining, internet e-commerce and mobile commerce, mobile applications based on WAP, K-Java, BREW, EMS, SMS, MMS, outsourced software development, and other mobile VAS in greater China. Linkhead's major clients and profit-sharing partners include some of the leading telecom operators such as China Telecom (NYSE: CHA), China Mobile (NYSE: CHL), China Unicom (NYSE: CHU), UTStarcom (Nasdaq: UTSI). Linkhead is also channel partner, or a master reseller, of NMS Communications (Nasdaq: NMSS), a leading provider of communications technologies and solutions.

II. Epro Telecom Holdings Limited ("Epro"), subsidiary, one of the largest providers of value-added telecom services (VAS), interactive voice response (IVR), mobile chatting, and voice-portal services in Greater

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

III. Guangzhou YueShen TaiYang Technology Limited ("YueShen"), subsidiary, a newly formed company incorporated in the People's Republic of China. YueShen is engaged in the business of distributing telecom services, including calling cards, mobile SIM cards, prepaid stored-value cards, VoIP, IDD calling cards, bundled insurance cards and customer loyalty membership cards in China.

IV. Cheer Era Limited ("Cheer Era"), investee company, a newly formed company incorporated in Hong Kong SAR. Cheer Era is engaged in the business of designing, developing and manufacturing multimedia entertainment and communication kiosk products, including photo and video entertainment kiosks, digital camera photo development stations, MMS, ring-tone and mobile content download, payment and delivery stations for mobile phones, and other coin-operated kiosks and kiosk consumables.

V. PacificNet Communications Limited. ("PacComm") and PacificNet Strategic Investment Holdings Limited ("PSI"), subsidiaries, are holding companies. In December 2003, PacComm and PSI completed agreements to acquire a 50% controlling interest in Epro and 51% of the shares of Linkhead, respectively. In April 2004, PSI completed agreements to acquire a 30% interest in Cheer Era and a 51% controlling interest in YueShen.

VI. PacificNet Limited ("PNL") and PacificNet Solutions Limited. ("PacSo"), subsidiaries, distributors and resellers of telecommunication, networking and computer equipment, which complements our telecommunication services. They specialize in systems integration, software application, and e-business solutions services in Hong Kong and Greater China. The scope of products and services includes smart card solutions, web based user applications and web based connections to remote or fixed database services, which are also referred to as backend enterprise planning systems.

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

RESULTS OF OPERATIONS

THREE MONTHS ENDED JUNE 30, 2004 COMPARED TO THREE MONTHS ENDED JUNE 30, 2003

REVENUES. Revenues for the three months ended June 30, 2004 were $8,084,000, an increase of $7,961,000 from $123,000 for the three months ended June 30, 2003. The significant increase in this quarter is mainly due to the recent acquisition of YueShen, which is engaged in the business of distributing telecom services, including calling cards in Greater China. YueShen contributes 47% of total revenues while the Company's other newly acquired subsidiaries, Epro and Linkhead, in the aggregate contribute 48% of total revenues. These three subsidiaries make up in the aggregate 95% of the Company's total revenues.

COST OF REVENUES. Cost of revenues for the three months ended June 30, 2004 was $6,789,000, an increase of $6,742,000 from $47,000 for the three months ended June 30, 2003. This significant increase in cost of revenues is directly associated with the increase in revenues. Our three newly acquired subsidiaries generated in the aggregate, 94% of the total cost of revenues.

GROSS MARGIN AND GROSS MARGIN RATIO. Gross margin for the three months ended June 30, 2004 was $1,295,000, an increase of $1,219,000 from $76,000 for the three months ended June 30, 2003. Gross margins for the three months ended June 30, 2004, comprised 16% of revenues. The significant decrease in gross margin ratio in this quarter is mainly due to the low gross margin ratio, which is one of the characteristics of YueShen's calling card distribution business. We expect both our gross margin and gross margin ratio to increase gradually as a result of cost reduction and efficient utilization of assets.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Selling, general and administrative expenses totaled $875,000 for the three months ended June 30, 2004, an increase of $554,000, from $321,000 for the three months ended June 30, 2003. This increase resulted from increasing the size of our operations, which included increased premises costs and staff costs, mainly attributable to the operations of Epro and Linkhead.

INTEREST INCOME. Interest income was $7,000 for the three months ended June 30, 2004, as compared to $8,000 for the three months ended June 30, 2003. The decrease is due to a lower average outstanding bank balance in 2004 than 2003.

EQUITY EARNINGS IN UNDISTRIBUTED EARNINGS OF INVESTEE COMPANY. The Company recorded $17,000 in equity earnings in its investee company for the three month period ended June 30, 2004 compared with nil for the same period in the prior year representing the Company's 30% ownership interest in its recent acquisition of Cheer Era Limited in April 2004.

INCOME TAXES. No tax provision has been recorded for the three months ended June 30, 2004, as a result of the cumulative operating losses generated by the Company. Interim income tax provisions are based upon management's estimate of taxable income and the resulting consolidated effective income tax rate for the full year. As a result, such interim estimates are subject to change as the year progresses and more information becomes available.

MINORITY INTEREST. Minority interest for the three months ended June 30, 2004 totaled $323,000, compared with $(7,000) for the same period in the prior year, which represents the Company's existing interest in its subsidiary PacSo of $(7,000), and its interest in newly acquired subsidiaries, Epro of $116,000, Linkhead of $189,000 and YueShen of $25,000 respectively.

SIX MONTHS ENDED JUNE 30, 2004 COMPARED TO SIX MONTHS ENDED JUNE 30, 2003

REVENUES. Revenues for the six months ended June 30, 2004 were $11,586,000, an increase of $11,366,000 from $220,000 for the six months ended June 30, 2003. For the six months ended June 30, 2004, revenues derived from the value-added telecom services rendered by the Company's newly acquired subsidiaries, YueShen, Epro and Linkhead, in the aggregate, contributed to 94% of total revenues.

COST OF REVENUES. Cost of revenues for the six months ended June 30, 2004 was $9,042,000, an increase of $8,959,000 from $83,000 for the six months ended June 30, 2003. This significant increase is directly associated with the increase in revenues. Our three newly acquired subsidiaries, in the aggregate, comprise 93% of total cost of revenues.

GROSS MARGIN AND GROSS MARGIN RATIO. Gross margin for the six months ended June 30, 2004 was $2,544,000, an increase of $2,407,000 from $137,000 for the six months ended June 30, 2003. Gross margins for the six months ended June 30, 2004 were comprised of 22% in revenues compared to 62% for the same period in the prior year. The significant decrease in gross margin ratio is attributable to the change in our mode of operations from systems integration and software application in 2003 to value-added telecom services and products providers in 2004. We expect both our gross margin and gross margin ratio to increase gradually as a result of cost reduction and efficient utilization of assets.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Selling, general and administrative expenses totaled $1,652,000 for the six months ended June 30, 2004, an increase of $912,000, from $740,000 for the six months ended June 30, 2003. This increase resulted from increasing the size of our operations, which included increased premises costs and staff costs, mainly attributable to the operations of Epro and Linkhead.

INTEREST INCOME. Interest income was $10,000 for the six months ended June 30, 2004, as compared to $15,000 for the six months ended June 30, 2003. The decrease is due to a lower average outstanding bank balance in 2004 than 2003.

EQUITY EARNINGS IN UNDISTRIBUTED EARNINGS OF INVESTEE COMPANY. The Company recorded $17,000 in equity earnings in its investee company for the six month ended June 30, 2004 compared with nil for the same period in the prior year representing the Company's 30% ownership interest in its recent acquisition of Cheer Era Limited in April 2004.

INCOME TAXES. No tax provision has been recorded for the six months ended June 30, 2004, as a result of the cumulative operating losses generated by the Company. Interim income tax provisions are based upon management's estimate of taxable income and the resulting consolidated effective income tax rate for the full year. As a result, such interim estimates are subject to change as the year progresses and more information becomes available.

MINORITY INTEREST. Minority interest for the three months ended June 30, 2004 totaled $651,000, compared with $(21,000) for the same period in the prior year, which represents the Company's existing interest in its subsidiary PacSo of $(4,000), and its interest in newly acquired subsidiaries, Epro of $258,000, Linkhead of $372,000 and YueShen of $25,000 respectively.

LIQUIDITY AND CAPITAL RESOURCES

WORKING CAPITAL. The Company's working capital increased to $5,221,000 at June 30, 2004 as compared to $1,442,000 at December 31, 2003. When compared to balances at December 31, 2003, the increase in working capital at June 30, 2004 reflects an increase in current assets primarily resulting from the Company's completion of a $3,000,000 private placement and a decrease in current liabilities of $3,159,000 and $620,000, respectively.

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NET CASH USED IN OPERATING ACTIVITIES. Net cash used in operating activities was

$1,139,000 for the six months ended June 30, 2004. Net cash used in operating activities in the six months ended June 30, 2004 was primarily the result of a net profit of $192,000, increased by noncash items totaling $1,326,000 and decreased by changes in operating assets of $2,657,000.

NET CASH USED IN INVESTING ACTIVITIES. Net cash used in investing activities for the six months ended June 30, 2004 was $1,823,000 representing the acquisition of subsidiary companies, interest in investee company, and property and equipment of $1,160,000, $385,000 and $278,000, respectively. The additions to property and equipment were for the expansion of the CRM and call centre business in Hong Kong.

NET CASH PROVIDED BY FINANCING ACTIVITIES. Net cash provided by financing activities for the six months ended June 30, 2004 was $2,340,000 representing net proceeds from issuance of common stock of $2,813,000, net proceeds from post acquisition of share capital - subsidiaries of $564,000, net cash proceeds received from the exercise of stock options of $74,000 and advances under bank loans of $1,913,000, and reduced by repayments on debt of $2,928,000 and repurchase of treasury shares of $96,000.

ISSUANCE OF COMMON STOCK. For the period ended June 30, 2004, we issued (i) 1,050,000 shares with total consideration of $5,250,000 to acquire subsidiaries and associated company, (ii) 617,285 shares with cash consideration of $3,000,000 pursuant to a private placement, (iii) 39,500 shares as a result of exercise of share options with cash consideration of $74,000 and noncash consideration of $2,000.

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

CONCENTRATION OF CREDIT RISK. All of the Company's revenues are derived in Asia and Greater China. The Company does not have any single customer that accounts for more than 10% of its revenues or 10% of its purchases. If the Company was unable to derive any revenue from Asia and Greater China, it would cause a significant, financially disruptive effect on the normal operations of the Company. Based on the current economic environment in China, the Company does not expect any material adverse impact to its business, financial condition and results of operations.

ITEM 3. CONTROLS AND PROCEDURES

Under the supervision and with the participation of the Company's management, including our principal executive officer and the principal accounting officer, the Company conducted an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as of the end of the period covered by this report (the "Evaluation Date"). Based on this evaluation, the Company's principal executive officer and principal accounting officer concluded as of the Evaluation Date that the Company's disclosure controls and procedures were effective such that the material information required to be included in our Securities and Exchange Commission ("SEC") reports is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms relating to the Company, including our consolidating subsidiaries, and was made known to them by others within those entities, particularly during the period when this report was being prepared.

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

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

None.

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

PERIOD	(a) TOTAL NUMBER OF SHARES PURCHASED	(b) AVERAGE PRICE PAID PER SHARE	(c) TOTAL NUMBER OF SHARES PURCHASED AS PART OF PUBLICLY ANNOUNCED PLANS OR PROGRAMS (1)	(d) MAXIMUM NUMBER (OR APPROXIMATE DOLLAR VALUE) SHARES THAT MA YET BE PURCHAS UNDER THE PLAN OR PROGRAMS
April 1 - April 30	-0-	N/A	N/A	N/A
May 1 - May 31	21,084	$ 3.66	21,084	$722,804
June 1 - June 30	5,700	$ 3.16	5,700	$704,777
Total	26,784	$ 3.56	26,784	$704,777

(1) The Company's Corporate Stock Repurchase Program was announced to the public on May 4, 2004. The Company is authorized to purchase up to USD$800,000 of its outstanding shares of common stock.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

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

(a) Exhibits

31.1 Certification of Chief Executive Officer Pursuant to Section 302 of theSarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) REPORTS ON FORM 8-K

None.

SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, as amended, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PACIFICNET INC.

DATE: AUGUST 13, 2004

/S/ TONY TONG

TONY TONG
CHIEF EXECUTIVE OFFICER
(PRINCIPAL EXECUTIVE OFFICER)

DATE: AUGUST 13, 2004

/S/ WANG SHAO JIAN

WANG SHAO JIAN
CHIEF FINANCIAL OFFICER
(PRINCIPAL FINANCIAL OFFICER)