

ASIAINFO HOLDINGS INC  
Form 10-Q  
August 06, 2008  
Table of Contents

**UNITED STATES**  
**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 June 30, 2008

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-15713

**ASIAINFO HOLDINGS, INC.**

(Exact name of registrant as specified in its charter)

**DELAWARE** **752506390**  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)  
**4TH FLOOR, ZHONGDIAN INFORMATION TOWER**

**6 ZHONGGUANCUN SOUTH STREET, HAI DIAN DISTRICT**

**BEIJING 100086, CHINA**

(Address of principal executive offices, including zip code)

**+8610 8216 6688**

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if smaller reporting company) Smaller reporting company

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

The number of shares outstanding of the Registrant's common stock as of August 5, 2008 was 46,159,480.

**Table of Contents**

ASIAINFO HOLDINGS, INC.  
FORM 10-Q  
FOR THE QUARTER ENDED June 30, 2008  
TABLE OF CONTENTS

	<b>Page</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	<b>3</b>
<b>Item 1. <u>Financial Statements (unaudited)</u></b>	<b>3</b>
a) <u>Condensed Consolidated Statements of Operations for the three months and six months ended June 30, 2008 and 2007</u>	3
b) <u>Condensed Consolidated Balance Sheets as of June 30, 2008 and December 31, 2007</u>	5
c) <u>Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2008 and 2007</u>	6
d) <u>Notes to Condensed Consolidated Financial Statements for the six months ended June 30, 2008 and 2007</u>	8
<b>Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	<b>20</b>
<b>Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u></b>	<b>27</b>
<b>Item 4. <u>Controls and Procedures</u></b>	<b>27</b>
<b><u>PART II. OTHER INFORMATION</u></b>	<b>28</b>
<b>Item 1. <u>Legal Proceedings</u></b>	<b>28</b>
<b>Item 1A. <u>Risk Factors</u></b>	<b>28</b>
<b>Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u></b>	<b>34</b>
<b>Item 3. <u>Defaults Upon Senior Securities</u></b>	<b>35</b>
<b>Item 4. <u>Submission of Matters to a Vote of Security Holders</u></b>	<b>35</b>
<b>Item 5. <u>Other Information</u></b>	<b>35</b>
<b>Item 6. <u>Exhibits</u></b>	<b>35</b>
<b><u>SIGNATURES</u></b>	<b>36</b>
<b><u>Exhibit Index</u></b>	<b>37</b>

**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****ASIAINFO HOLDINGS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)****(In thousands, except share and per share amounts)**

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
<b>Revenues:</b>				
Software products and solutions	\$ 30,013	\$ 22,406	\$ 57,152	\$ 42,006
Service	4,209	4,011	7,550	7,580
Third-party hardware	7,836	3,153	12,362	10,039
<b>Total revenues</b>	<b>42,058</b>	<b>29,570</b>	<b>77,064</b>	<b>59,625</b>
<b>Cost of revenues:</b>				
Software products and solutions (including cost of purchases from related parties of \$nil and \$nil, amortization of other acquired intangible assets of \$152 and \$163 for the three months ended June 30, 2008 and 2007, respectively; cost of purchases from related parties of \$nil and \$1, amortization of other acquired intangible assets of \$300 and \$358 for the six months ended June 30, 2008 and 2007, respectively)	13,660	10,116	24,816	19,089
Service	1,704	1,980	3,418	3,676
Third-party hardware (including cost of purchases from related parties of \$nil and \$583 for the three months ended June 30, 2008 and 2007, respectively; including cost of purchases from related parties of \$nil and \$583 for the six months ended June 30, 2008 and 2007, respectively)	7,644	2,995	11,940	9,537
<b>Total cost of revenues</b>	<b>23,008</b>	<b>15,091</b>	<b>40,174</b>	<b>32,302</b>
<b>Gross profit</b>	<b>19,050</b>	<b>14,479</b>	<b>36,890</b>	<b>27,323</b>
<b>Sales and marketing</b> (including sales and marketing expenses incurred from transactions with related parties of \$16 and \$18, amortization of other acquired intangible assets of \$246 and \$360 for the three months ended June 30, 2008 and 2007, respectively; sales and marketing expenses incurred from transactions with related parties of \$35 and \$43, amortization of acquired intangible assets of \$545 and \$717 for the six months ended June 30, 2008 and 2007, respectively)	8,212	6,653	16,107	12,723
<b>General and administrative</b>	2,248	2,470	4,857	4,418
<b>Research and development</b> (including research and development expenses incurred from transactions with related parties of \$1 and \$1 for the three months ended June 30, 2008 and 2007, respectively; research and development expenses incurred from transactions with related parties of \$2 and \$2 for the six months ended June 30, 2008 and 2007, respectively)	5,029	4,161	9,687	8,247
<b>Total operating expenses</b>	<b>15,489</b>	<b>13,284</b>	<b>30,651</b>	<b>25,388</b>



**Table of Contents**

Gain on settlement of escrow				2,734
Income from operations	3,561	1,195	6,239	4,669
<b>Other income</b>				
Interest income	1,067	1,156	2,282	2,278
Dividend	84	93	303	528
Gain from sales of short-term investments	2,359	556	3,533	581
Other (expenses) income, net	(256)	52	(530)	(20)
Total other income, net	3,254	1,857	5,588	3,367
Income before provisions for income taxes and discontinued operations	6,815	3,052	11,827	8,036
Provisions for income taxes	1,594	554	2,327	587
Income from continuing operations	5,221	2,498	9,500	7,449
Income from discontinued operations, net of taxes			980	1,445
Net income	5,221	2,498	10,480	8,894
<b>Income from continuing operations per share:</b>				
Basic	\$ 0.12	\$ 0.06	\$ 0.21	\$ 0.17
Diluted	\$ 0.11	\$ 0.06	\$ 0.20	\$ 0.17
<b>Income from discontinued operations per share:</b>				
Basic	\$	\$	\$ 0.02	\$ 0.04
Diluted	\$	\$	\$ 0.02	\$ 0.03
<b>Net income per share</b>				
Basic	\$ 0.12	\$ 0.06	\$ 0.23	\$ 0.21
Diluted	\$ 0.11	\$ 0.06	\$ 0.22	\$ 0.20
<b>Weighted average shares used in computation:</b>				
Basic	45,094,860	43,231,164	44,944,271	43,191,216
Diluted	47,044,412	45,050,920	46,715,304	44,869,741

See accompanying notes to condensed consolidated financial statements.

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

(In thousands, except share and per share amounts)

	June 30, 2008	December 31, 2007(1)
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 163,276	\$ 148,834
Restricted cash	17,202	16,026
Short-term investments available for sale securities	37,313	48,194
Short-term investments held to maturity securities		1,541
Accounts receivable (net of allowances of \$2,590 and \$2,427 as of June 30, 2008 and December 31, 2007, respectively)	46,219	45,233
Inventories	11,801	8,023
Other receivables (including other receivables of \$232 and \$214 due from related parties as of June 30, 2008 and December 31, 2007, respectively)	3,888	3,426
Income tax receivable	342	
Deferred income tax assets current	2,224	1,693
Prepaid expenses and other current assets	6,717	6,526
<b>Total current assets</b>	<b>288,982</b>	<b>279,496</b>
Long-term investment	2,035	1,911
Property and equipment, net	2,498	2,344
Other acquired intangible assets, net	3,740	3,979
Deferred income tax assets, noncurrent	1,032	1,032
Goodwill	20,698	19,707
<b>Total Assets</b>	<b>\$ 318,985</b>	<b>\$ 308,469</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 24,346	\$ 23,095
Accrued expenses	12,884	12,671
Deferred revenue (including deferred revenue of \$386 and \$437 from related parties as of June 30, 2008 and December 31, 2007, respectively)	35,802	29,093
Accrued employee benefits	16,284	20,724
Other payables (including other payables of \$779 and \$732 due to related parties as of June 30, 2008 and December 31, 2007, respectively)	5,136	5,651
Income taxes payable		2,310
Other taxes payable	4,668	4,218
Deferred income tax liabilities		1,976
<b>Total current liabilities</b>	<b>99,120</b>	<b>99,738</b>
Unrecognized tax benefits	1,271	834
Other long term liabilities	114	109
<b>Total liabilities</b>	<b>100,505</b>	<b>100,681</b>

Commitments and contingencies (Note 18)

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

<b>Stockholders' Equity:</b>		
Common stock (100,000,000 shares authorized; \$0.01 par value; 46,109,970 shares and 45,026,203 shares issued as of June 30, 2008 and December 31, 2007, respectively; 45,699,270 shares and 44,781,903 shares outstanding as of June 30, 2008 and December 31, 2007, respectively)	461	450
Additional paid-in capital	212,598	207,865
Treasury stock, at cost (410,700 shares and 244,300 shares as of June 30, 2008 and December 31, 2007, respectively)	(3,617)	(1,953)
Statutory reserve	14,820	13,874
Accumulated deficit	(21,484)	(31,018)
Accumulated other comprehensive income	15,702	18,570
Total stockholders' equity	218,480	207,788
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 318,985</b>	<b>\$ 308,469</b>

- (1) December 31, 2007 balances were extracted from audited financial statements.  
     See accompanying notes to condensed consolidated financial statements.



**Table of Contents****ASIAINFO HOLDINGS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)****(In thousands, except share and per share amounts)**

	Six Months Ended June 30,	
	2008	2007
Cash flows from operating activities:		
Net income	\$ 10,480	\$ 8,894
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation of property and equipment	589	410
Stock-based compensation expense	1,340	1,851
Amortization of other acquired intangible assets	845	1,075
Loss on disposal of property and equipment	32	2
Gain from sale of available for sale securities and trading securities	(3,533)	(581)
Gain on settlement of escrow		(2,734)
Provision (reversal of provision) for bad debt	188	(182)
Provision (reversal of provision) for inventory	40	(146)
Gain on sale of discontinued operations, net of taxes	(1,515)	(1,536)
Proceeds from sales of trading securities	121	171
Purchase of trading securities	(76)	(105)
Changes in operating assets and liabilities:		
Accounts receivable	(1,174)	(4,561)
Inventories	(3,817)	762
Other receivables	(174)	1,391
Deferred income taxes	(624)	
Prepaid expenses and other current assets	(144)	(488)
Accounts payable	1,251	(5,452)
Accrued expenses	214	(54)
Deferred revenue	6,709	(5,735)
Accrued employee benefits	(4,440)	(4,759)
Other payables	(119)	661
Other taxes payable	450	(303)
Income taxes payable	(2,210)	(381)
Net cash provided by (used in) operating activities	4,433	(11,800)
Cash flows from investing activities:		
Increase in restricted cash	(1,176)	(412)
Purchases of available for sale securities	(3,068)	(23,690)
Proceeds from sales of available for sale securities	7,320	14,588
Purchases of held to maturity securities		(1,541)
Proceeds from maturity of held to maturity securities	1,541	
Purchases of property and equipment	(531)	(273)
Proceeds from disposal of property and equipment	7	3
Purchase of business, net of cash acquired	(1,502)	(706)
Proceeds from disposal of discontinued operations	1,515	1,477
Net cash provided by (used in) investing activities	4,106	(10,554)
Cash flows from financing activities:		
Proceeds from exercise of stock options	3,115	4,130
Repurchase of common stock	(1,664)	

Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Net cash provided by financing activities	1,451	4,130
Effect of exchange rate changes on cash and cash equivalents	4,452	1,317
Net increase (decrease) in cash and cash equivalents	14,442	(16,907)
Cash and cash equivalents at beginning of period	148,834	104,575
Cash and cash equivalents at end of period	\$ 163,276	\$ 87,668
Supplemental cash flow information: Income taxes paid	\$ 3,375	\$ 975

**Table of Contents**

Supplemental disclosure of non-cash financing activities:

On January 24, 2007, the Company entered into a Settlement and Release Agreement (the "Settlement Agreement") with Lenovo Group Limited to resolve certain matters arising out of the Acquisition Agreement dated July 27, 2004 and an Escrow Agreement dated October 19, 2004 between the Company and Lenovo Group Limited. Under the Settlement Agreement, 648,769 shares of the Company's common stock, valued at \$3,632, which had been held in escrow since the closing of the acquisition of Lenovo's information technology services business in October 2004, were returned to the Company. See Note 10 to the Condensed Consolidated Financial Statements for further discussion on this activity.

See accompanying notes to condensed consolidated financial statements.

---

**Table of Contents**

**ASIAINFO HOLDINGS, INC.**

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

(In thousands, except share and per share amounts)

**1. BASIS OF PREPARATION**

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

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X, as promulgated by the Securities and Exchange Commission (the SEC). Accordingly, they do not include all of the information and notes required by US GAAP for completing annual financial statements. However, management believes that the disclosures are adequate to ensure the information presented is not misleading. US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, contingencies and results of operations. While management has based their assumptions and estimates on the facts and circumstances existing as of June 30, 2008, final amounts may differ from these estimates.

In the opinion of the management of the Company, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, which are necessary for a fair presentation of the results for the interim period presented. These financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company's audited financial statements on Form 10-K for the fiscal year ended December 31, 2007. The results of operations for the interim periods presented are not indicative of the operating results to be expected for any subsequent interim period or for the Company's fiscal year ending December 31, 2008.

Revenue from software products and solutions includes the benefit of the rebate of valued-added taxes on sales of software and services received from the Chinese tax authorities as part of the People's Republic of China (PRC) government's policy of encouraging software development in the PRC. The rebate totaled \$2,908 and \$2,775 for the six months ended June 30, 2008 and 2007, respectively.

Revenue in excess of billings is recorded as unbilled receivables and included in accounts receivable. Billings in excess of revenues recognized are recorded as deferred revenue. Billings are rendered based on agreed milestones included in customer contracts. Amounts billed but not yet collected are recorded as unbilled receivables and included in accounts receivable. All billed and unbilled amounts are expected to be collected within one year.

AsiaInfo Holdings, Inc. uses the United States (U.S.) dollar as its reporting currency and functional currency. The financial records of the Company's PRC subsidiaries and VIEs are maintained in Renminbi (RMB), their functional currency and the currency of the PRC. Their balance sheets are translated into U.S. dollars based on the noon buying rate of exchange quoted by the Federal Reserve Bank of New York as of the balance sheet date. Their statements of operations are translated using a weighted average rate for the period. Translation adjustments are reflected in accumulated other comprehensive income in stockholders' equity.

The RMB is not freely convertible into U.S. dollars or other currencies. All foreign exchange transactions involving RMB must take place through the People's Bank of China or other institutions authorized to buy and sell foreign currencies. The exchange rates adopted for the foreign exchange transactions are the rates of exchange quoted by the People's Bank of China.

***Recently Issued Accounting Pronouncements***

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value measurements (SFAS 157), which defines fair value, establishes a framework for measuring fair value under US GAAP, and expands disclosures about fair value measurement. SFAS 157 does not require any new fair value measurements. Instead, it offers guidance on how to measure fair value by providing a fair value hierarchy which may be used to classify the sources of information. In February 2008, the FASB issued FASB Staff Position (FSP) Financial Accounting Standard (FAS) 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements that Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13 and FSP FAS 157-2, Effective Date of FASB Statement No. 157. These FSPs (1) defer the effective date of SFAS 157 for one year for certain non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

statements on a recurring basis (at least annually), (2) exclude certain leasing transactions accounted for under SFAS No. 13, Accounting for Leases, from the scope of SFAS 157, and (3) include several specific examples of items eligible or not eligible for the one-year deferral. The provisions of SFAS 157 are effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. FSP FAS 157-1 is effective upon the initial adoption of SFAS 157. FSP FAS 157-2 defers the effective date of certain provisions of SFAS 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of the FSP. The Company is in the process of assessing the potential impact the adoption of SFAS 157 may have on the Company's consolidated financial position or results of operations.

**Table of Contents**

In February 2007, the FASB issued SFAS No.159 ( SFAS 159 ), The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115 . SFAS 159 provides companies with an option to report selected financial assets and liabilities at fair value. The standard requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company s choice to use fair value on its earnings. It also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. This Statement is effective as of the beginning of an entity s first fiscal year beginning after November 15, 2007. The company does not expect the adoption of SFAS 159 to have a material effect on the Company s consolidated financial statements.

In December 2007, the FASB issued SFAS No.141R ( SFAS 141R ), Business Combination , to improve reporting by creating greater consistency in the accounting and financial reporting of business combinations. The standard requires the acquiring entity in a business combination to recognize all (and only) the assets acquired and liabilities assumed in the transaction; establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the first annual reporting period beginning on or after December 15, 2008. Early adoption is prohibited. The Company is in the process of assessing the potential impact the adoption of SFAS 141R may have on its consolidated financial position or results of operations.

In December 2007, the FASB issued SFAS No.160 ( SFAS 160 ), Non-controlling Interests in Consolidated Financial Statements to improve the relevance, comparability, and transparency of financial information provided to investors by requiring all entities to report non-controlling (minority) interests in subsidiaries in the same way as required in the consolidated financial statements. Moreover, SFAS 160 eliminates the diversity that currently exists in accounting for transactions between an entity and non-controlling interests by requiring they be treated as equity transactions. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is in the process of assessing the potential impact the adoption of SFAS 160 may have on its consolidated financial position or results of operations.

In March 2008, the FASB issued SFAS No.161 ( SFAS 161 ), Disclosures about Derivative Instruments and Hedging Activities to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity s financial position, financial performance, and cash flows. It is effective for financial statements issued for fiscal years and interim periods beginning on or after November 15, 2008, with early application encouraged. The Company is in the process of assessing the potential impact the adoption of SFAS 161 may have on its consolidated financial position or results of operations.

**2. CASH AND CASH EQUIVALENTS**

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

**3. SHORT-TERM INVESTMENTS**

Short-term investments are classified as available-for-sale securities, held-to-maturity securities and trading securities. Available-for-sale securities consist principally of corporate stocks, bond funds, balanced funds and stock funds issued by major financial institutions. Available-for-sale investments are carried at fair value and unrealized holding gains or losses resulting from changes in value associated with such investments are recorded in accumulated other comprehensive income in stockholders equity. Held-to-maturity securities consist of corporate bonds and are accounted for at amortized cost with effective interest rate method. Trading securities consist of corporate stocks and are reported at fair value, with unrealized holding gains and losses, if any, reported as part of net income. As of June 30, 2008 and December 31, 2007, all short-term investments, except corporate stocks, of the Company had maturities of less than one year.

The following table provides additional information concerning the Company s available-for-sale securities:

	June 30, 2008			December 31, 2007				
	Cost	Gross unrealized gains	Gross unrealized (losses)	Fair value	Cost	Gross unrealized gains	Gross unrealized (losses)	Fair value
Bond funds	\$ 22,547	\$ 801	\$	\$ 23,348	\$ 20,964	\$ 1,109	\$	\$ 22,073
Balanced funds					3,562	5,199		8,761

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Stock funds	15,362	1,488	(2,958)	13,892	11,687	5,471	17,158
Corporate stocks	73			73	202		202
<b>Total</b>	<b>\$ 37,982</b>	<b>\$ 2,289</b>	<b>\$ (2,958)</b>	<b>\$ 37,313</b>	<b>\$ 36,415</b>	<b>\$ 11,779</b>	<b>\$ 48,194</b>

As of June 30, 2008, no held-to-maturity securities and trading securities were held. As of December 31, 2007, held-to-maturity securities consisted of corporate bonds that have amortized costs totaling \$1,541 and fair value of \$1,540 and no trading securities were held.

The Company realized total gains of \$2,409 (proceeds from sale of trading securities of \$45 with an aggregate cost of \$24, and proceeds from sale of available-for-sale securities of \$4,993 with an aggregate historical cost of \$2,605) and \$3,583 (proceeds from sale of trading securities of \$121 with an aggregate cost of \$76, and proceeds from sale of available-for-sale securities of \$7,320 with an aggregate historical cost of \$3,782), respectively, during the three-month and six-month periods ended June 30, 2008. For purpose of determining gross realized gains, the cost of securities sold is based on specific identification.

**Table of Contents**

The Company reported \$50 and \$nil impairment losses for its short-term investments for the periods ended June 30, 2008 and 2007, respectively.

**4. ACCOUNTS RECEIVABLE**

Accounts receivable balances included both billed and unbilled amounts at June 30, 2008 and December 31, 2007. Revenue recognized in excess of billings is recorded as unbilled receivables, and amounted to \$25,056 at June 30, 2008 and \$21,988 at December 31, 2007, net of allowances. At June 30, 2008 and December 31, 2007, the balances of billed accounts receivable net of allowances were \$21,163 and \$23,245, respectively. All billed and unbilled amounts are expected to be collected within one year.

Accounts receivable balances included bank acceptance drafts of \$nil and \$334, and commercial acceptance drafts of \$870 and \$2,160 as of June 30, 2008 and December 31, 2007, respectively. These bank acceptance drafts and commercial acceptance drafts were non-interest bearing and were due within six months of issuance.

**5. INVENTORIES**

Inventories are stated at the lower of cost or market. The cost of inventories under the AsiaInfo Technologies segment is determined principally by the specific identification method. The cost of inventories under the Lenovo-AsiaInfo segment is computed using standard cost method, which approximates actual cost, on a first-in, first-out basis. Provision for diminution in value on inventories is made for any inventories with an aging over 360 days. Additional write-downs to market value are made using specific identification method. The components of inventories as of June 30, 2008 and December 31, 2007 are as follows:

	June 30, 2008	December 31, 2007
Raw materials	\$ 581	\$ 1,138
Finished goods	11,721	7,335
Less: Inventory allowance	(501)	(450)
Total inventories	\$ 11,801	\$ 8,023

**6. GOODWILL**

The changes in the carrying amount of goodwill during the six months ended June 30, 2008 were as follows:

	June 30, 2008		
	AsiaInfo Technologies	Lenovo- AsiaInfo	Total
Beginning balance	\$ 17,740	\$ 1,967	\$ 19,707
Acquisitions of businesses		558	558
Foreign exchange difference due to translation	421	12	433
Ending balance	\$ 18,161	\$ 2,537	\$ 20,698

**7. OTHER ACQUIRED INTANGIBLE ASSETS, NET**

	June 30, 2008			December 31, 2007				
	Gross carrying amount	Accumulated amortization	Foreign exchange difference	Net carrying amount	Gross carrying amount	Accumulated amortization	Foreign exchange difference	Net carrying amount
Core technology	\$ 2,331	\$ (2,039)	\$	\$ 292	\$ 2,331	\$ (1,943)	\$	\$ 388



Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Trade name	341	(264)		77	341	(249)		92
Contract backlog	2,451	(2,461)	10		2,451	(2,364)	8	95
Customer list	131	(76)	13	68	131	(61)	8	78
Customer relationship	2,593	(978)	272	1,887	2,519	(695)	150	1,974
Distribution network	870	(758)		112	870	(657)		213
Software	1,758	(970)	150	938	1,679	(764)	89	1,004
Non-compete agreement	436	(91)	21	366	186	(59)	8	135
	\$ 10,911	\$ (7,637)	\$ 466	\$ 3,740	\$ 10,508	\$ (6,792)	\$ 263	\$ 3,979

**Table of Contents**

The future amortization expense for the net carrying amount of intangible assets with definite lives as of June 30, 2008 is expected to be as follows:

The remainder of 2008	\$ 742
2009	1,215
2010	1,017
2011	477
2012	289
	\$ 3,740

**8. COMPREHENSIVE INCOME**

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

	Three Months Ended June 30,		Six months Ended June 30,	
	2008	2007	2008	2007
Net income	\$ 5,221	\$ 2,498	\$ 10,480	\$ 8,894
Unrealized (loss) gain on available-for-sale investments net of tax effect	(3,701)	2,360	(10,183)	3,480
Change in cumulative foreign currency translation adjustment	2,652	1,429	7,315	2,226
Comprehensive income	\$ 4,172	\$ 6,287	\$ 7,612	\$ 14,600

**9. CREDIT FACILITIES**

As of June 30, 2008, the Company had total short-term credit facilities for working capital purposes totaling \$34,579 expiring in December 2009. The credit facilities were secured by bank deposits of \$11,219 as of June 30, 2008. Credit facilities of \$9,782 were pledged as security for issuing standby letters of credit and accounts payable to hardware suppliers and customers. As of June 30, 2008, unused short-term credit facilities were \$24,797. In addition, the Company had standby letters of credit and bank acceptance drafts as of June 30, 2008, which were collateralized by bank deposits of \$5,978. Total bank deposits pledged as security for credit facilities, standby letters of credit, and bank acceptance drafts totaled \$17,197 as of June 30, 2008 and were presented as restricted cash in the consolidated balance sheets. As of December 31, 2007, the Company had total short-term credit facilities totaling \$41,904, which expired in March 2008 and were secured by bank deposits of \$14,335.

**10. GAIN ON SETTLEMENT OF ESCROW**

On July 27, 2004, the Company entered into an acquisition agreement (the Acquisition Agreement) with Lenovo Group Limited and its affiliates (collectively, Lenovo) to acquire Lenovo's non-telecommunications Information Technology (IT) service business. Pursuant to the Acquisition Agreement, AsiaInfo acquired the assets comprising Lenovo's non-telecommunications related IT services business on October 1, 2004. The acquisition included the business now comprising the Company's Lenovo-AsiaInfo reportable segment.

An escrow agreement dated October 19, 2004 (the Escrow Agreement) was entered into among the Company, Lenovo and JPMorgan Chase Bank (the Escrow Agent) in order to satisfy Lenovo's indemnification obligations (if any) under the Acquisition Agreement. On July 1, 2005, the Company instructed its transfer agent to deliver two certificates collectively representing 2,162,562 shares (one representing 1,081,281 shares (the General Escrow), and the other representing 1,081,281 shares), to the Escrow Agent.

On March 24, 2006, the Company delivered an indemnity notice to Lenovo seeking indemnification under the Acquisition Agreement. On January 24, 2007, the Company entered into a Settlement and Release Agreement (the Agreement) with Lenovo to resolve certain matters arising out of the Acquisition Agreement and the Escrow Agreement. Under the Agreement, 648,769 General Escrow Shares were returned to the Company's treasury account on February 9, 2007 and the remaining 432,512 General Escrow Shares were released to Lenovo. The

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Agreement also provides for the mutual release of certain claims that the Company or Lenovo may have had against each other relating to the acquisition as of December 31, 2007.

On March 26, 2007, the Company's Board of Directors (the Board) authorized the retirement of the 648,769 shares of treasury stock. The retired shares resumed the status of authorized and unissued shares of the Company and are presented as a reduction of outstanding shares in the accompanying consolidated statements of stockholders' equity and comprehensive income (loss).

The returned escrow shares were accounted at the historical value of \$3,632 as determined at the date shares were issued to the Escrow Agent. Part of this amount off-sets the released claims of \$898 against Lenovo, and the remaining \$2,734 gain on settlement of escrow was recorded as gain on settlement of escrow.

### **11. DISCONTINUED OPERATIONS**

In January 2007, the Company sold certain assets and liabilities constituting its financial services IT solutions business (FIS), which is grouped under the Company's Lenovo-AsiaInfo reportable segment, to Fidelity Information Systems (Fidelity), a major U.S.-based provider of IT services and information products to financial institutions, for a maximum cash consideration valued at \$3,581 (RMB25,430) which was structured as follows: (1) \$1,653 (RMB11,740) was received from Fidelity upon closing; (2) \$413 (RMB2,934) escrow amount was transferred to an escrow agent by Fidelity upon closing; (3) \$1,515 (RMB10,756) was to be paid subject to adjustment based upon an earn-out calculation and certain other contingencies.

**Table of Contents**

On March 18, 2008, the Company received the \$1,515 contingent payment from Fidelity and recognized the amount as gain on sales of discontinued operations. Certain cost which was related to the contingent payment amounting to \$209 (RMB1,483) was accrued accordingly.

The accompanying condensed consolidated statements of operations reflect FIS as discontinued operation. Results of FIS discontinued operation are summarized as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Revenue from discontinued operations	\$	\$	\$	\$ 167
Loss from operations of discontinued operations				(91)
Gain on sales of discontinued operations			1,306	1,536
Provision for income taxes			(326)	
Gain on discontinued operations	\$	\$	\$ 980	\$ 1,445

**12. ACCOUNTS PAYABLE**

Accounts payable included bank acceptance drafts payable of \$8,336 and \$3,627 and commercial acceptances payable of \$267 and \$550 as of June 30, 2008 and December 31, 2007 respectively. These bank acceptance drafts and commercial acceptances were non-interest bearing and were due within six months of issuance.

**13. INCOME TAXES**

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

Reconciliation between the provision for income taxes computed by applying the U.S. federal tax rate to income before income taxes and the actual provision for income taxes is as follows:

	Six Months Ended June 30,	
	2008	2007
U.S. federal rate	35%	35%
Difference between statutory rate and foreign effective tax rate	(27)	(30)
Change in valuation allowance	1	(4)
Subpart F income inclusion	2	7
Stock-based compensation	2	6
Nontaxable income on settlement of escrow		(5)
Qualified Electing Fund income	7	
Other permanent differences		(2)
	20%	7%

During the six months ended June 30, 2008, the Company recorded a tax benefit of \$557 due to a reduction in the statutory tax rate for AsiaInfo Technologies (China), Inc. (AIBJ) for tax year 2007 as a result of AIBJ qualifying as a Key Software Enterprise for tax year 2007.

The Company's uncertain tax positions are related to inter-company transactions for which it might have under/over charged the related parties for services. The Company is also exposed to certain jurisdictions for carrying on a trade or business in which it has not been so authorized. Aggregate undistributed earnings of the Company's subsidiaries and its VIEs located in the PRC that are available for distribution to the

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Company of approximately \$39,162 as of June 30, 2008 are considered to be indefinitely reinvested under APB opinion No. 23, Accounting for Income Taxes-Special Areas. Accordingly, no provision has been made for the Chinese dividend withholding taxes that would be payable upon the distribution of those earnings to the Company. The Chinese tax authorities have also clarified that distributions made out of pre-January 1, 2008 retained earnings will not be subject to the withholding tax. The Company has not quantified the deferred income tax liability that would arise if earnings in the first and second quarters were to be distributed or were determined to be no longer permanently reinvested.

The Company is subject to taxation in the U.S. and various states and foreign jurisdictions. There are no ongoing examinations by taxing authorities at this time. The Company's various tax years starting from 2000 to 2007 are remaining open in various taxing jurisdictions.

### **14. STOCK-BASED COMPENSATION**

#### *2002 Stock Option Plan and the prior plans*

Under the Company's 2002 Stock Option Plan (the 2002 Plan), the Company was authorized to grant options for the purchase of up to 4,500,000 shares of common stock to employees, directors and consultants at prices not less than the fair market value on the date of grant for incentive stock options and nonqualified options. Shares as to which an option is granted under the 2002 Plan but remains unexercised at the expiration, forfeiture or other termination of such option may be the subject of the grant of further options. Prior to adopting the 2002 Stock Option Plan, the Company adopted annual stock option plans for each of 1995, 1996, 1997, 1998, 1999 and 2000 (such plans, together with the 2002 Stock Option Plan, are referred to hereinafter as the Option Plans).

**Table of Contents**

The vesting periods of the options under the Option Plans are determined based on individual stock option agreements. Options granted prior to 1998 generally vest and become exercisable over three years at an equal annual rate. Exercise terms of options granted in 1998, 1999, 2000 and 2002 are substantially similar to those of options granted prior to 1998 except that the vesting and exercise periods are generally over four one-year cliffs at an annual rate of 20%, 20%, 30% and 30% for the 1999 plan, generally over four years at an annual rate of 25% for the 2000 plan, and are generally no more than four years at an annual rate of 25% from the date of grant for the 2002 Plan.

Activities for the Option Plans are summarized as follows:

	Number of shares	Weighted average exercise price per share	Aggregate Intrinsic Value
Outstanding, January 1, 2008	3,968,020	\$ 8.83	
Granted			
Forfeited	(3,546)	5.00	
Exercised	(131,298)	6.22	
Outstanding, March 31, 2008	3,833,176	8.92	
Granted			
Forfeited	(16,887)	17.19	
Exercised	(362,460)	7.14	
Outstanding, June 30, 2008	3,453,829	9.06	\$ 14,978,801
Vested and expected to vest, June 30, 2008	3,453,829	9.06	\$ 14,978,801
Exercisable, June 30, 2008	3,452,579	9.06	\$ 14,969,164

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the closing stock price of \$11.82 of the Company's common stock on the last trading day on June 30, 2008.

Total intrinsic value of options exercised for each of the three months ended June 30, 2008 and 2007 was \$2,274 and \$983, respectively.

As of June 30, 2008, there was \$3 unrecognized share-based compensation cost relating to share options. This deferred cost is expected to be recognized over a weighted-average vesting period of 0.17 years. To the extent the actual forfeiture rate is different from the original estimate, actual share-based compensation related to these awards may be different from the expectation.

**2005 Stock Incentive Plan- restricted share units (RSUs)**

Under the Company's 2005 Stock Incentive Plan (the 2005 Plan), the Company may grant participants restricted stock awards, stock options, or other types of equity incentives. The number of shares authorized for issuance is (a) 600,000 shares plus (b) any authorized shares of Common Stock that, as of April 21, 2005, were available for issuance under the Company's 2002 Plan, or that thereafter become available for issuance under the 2002 Plan in accordance with its terms.

A restricted stock unit (RSU) is an agreement to issue stock at the time when the award vests. These units are vested on an annual basis equally over four years, 25% on each anniversary of the grant date. The fair value of each RSU is measured on the grant date based on the market price of the stock on the grant date. RSUs as of June 30, 2008 and changes during the three months ended June 30, 2008 were as follows:

	Number of shares	Weighted average grant date fair value
Restricted stock units unvested at January 1, 2008	257,074	\$ 4.29
Granted		
Vested		
Forfeited	(4,950)	4.05

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Restricted stock units unvested at March 31, 2008	252,124	4.29
Granted		
Vested	(2,800)	5.91
Forfeited	(1,500)	4.05
Restricted stock units unvested at June 30, 2008	247,824	4.28

Total intrinsic value of RSUs exercised for each of the three months ended June 30, 2008 and 2007 was \$37 and \$13, respectively.

**Table of Contents**

As of June 30, 2008, there was \$732 unrecognized share-based compensation cost related to RSUs. That deferred cost is expected to be recognized over a weighted-average vesting period of 0.96 years. To the extent the actual forfeiture rate is different from original estimate; actual share-based compensation related to these awards may be different from the expectation.

**2005 Stock Incentive Plan- performance-based restricted share units (PSUs)**

In November 2006, the Compensation Committee of the Board approved another stock unit awards program under the 2005 Plan. Under this program, the Company was approved to grant no more than 2,213,068 shares of performance-based restricted stock units (PSUs) and 1,995,000 PSUs were granted in November 2006. Unlike the previous RSUs, these awards will vest based on certain performance-based criteria, including annual earnings before interest and tax, annual net revenue growth, average stock closing price and new business revenue percentage, provided the award holder continues to be an employee of the Company at the time the performance goals are met. Each PSU represents the contingent right of the participant to receive a payment in respect of a share of common stock.

Performance based PSUs as of June 30, 2008 and changes during the three months ended June 30, 2008 were as follows:

	Number of shares	Weighted average grant date fair value
Performance-based restricted stock units unvested at January 1, 2008	1,099,340	\$ 5.05
Granted		
Vested		
Forfeited	(20,900)	4.99
Performance-based restricted stock units unvested at March 31, 2008	1,078,440	5.06
Granted		
Vested	(439,529)	5.06
Forfeited	(5,500)	4.99
Performance-based restricted stock units unvested at June 30, 2008	633,411	5.05

Market based PSUs as of June 30, 2008 and changes during the three months ended June 30, 2008 were as follows:

	Number of shares	Weighted average grant date fair value
Market-based restricted stock units unvested at January 1, 2008	549,930	\$ 2.42
Granted		
Vested	(146,180)	3.03
Forfeited	(10,450)	2.42
Market-based restricted stock units unvested at March 31, 2008	393,300	2.19
Granted		
Vested	(1,500)	8.96
Forfeited	(2,000)	2.19
Market-based restricted stock units unvested at June 30, 2008	389,800	2.17

Total intrinsic value of PSUs exercised for the three months ended June 30, 2008 and 2007 was \$5,218 and \$1,959, respectively.

As of June 30, 2008, there was \$1,231 unrecognized share-based compensation cost related to PSUs. This deferred cost is expected to be recognized over a weighted-average vesting period of 0.77 years. To the extent the actual forfeiture rate is different from original estimate,



actual share-based compensation related to these awards may be different from the expectation.

***2008 Stock Incentive Plan***

Under the Company's 2008 Stock Incentive Plan (the "2008 Plan"), the Company may grant participants restricted stock awards, stock options, or other types of equity incentives. The number of shares authorized for issuance is (a) 2,000,000 shares plus (b) any authorized shares of Common Stock that, as of February 25, 2008, were available for issuance under the Company's 2008 Plan, or that thereafter become available for issuance under the 2005 Plan in accordance with its terms.

***Accounting for share-based compensation***

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123(R), using the modified prospective transition method and therefore has not restated the results from prior periods. Under this transition method, stock-based compensation expense recognized beginning January 1, 2006 includes: (a) compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006 based on the fair market value as of the grant date, measured in accordance with SFAS 123, and (b) compensation expense for all stock-based compensation awards granted on or subsequent to January 1, 2006, based on grant-date fair value estimated in accordance with the provisions of SFAS 123(R).

Fair values of RSUs and PSUs with performance conditions generally equal their intrinsic value on the date of grant. Fair values of PSUs with market conditions are calculated by an independent third-party appraiser who has adopted a Monte-Carlo simulation model using assumptions underlying the Black-Scholes methodology.

**Table of Contents**

The Company recognizes the compensation costs net of a forfeiture rate and recognizes the compensation costs for those shares expected to vest on a straight-line basis over the requisite service period of the award, which is generally the vesting period. The estimate of forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized through a cumulative catch-up adjustment in the period of change and will also impact the amount of stock compensation expense to be recognized in future periods.

The amount of stock-based compensation attributable to cost of revenues, sales and marketing, general and administrative expenses, and research and development is included in those line items on the face of the statement of operations. For the three-month and six-month periods ended June 30, 2008 and 2007, stock-based compensation expense related to the stock options, RSUs and PSUs under SFAS 123(R) was allocated as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Cost of revenues	\$ 123	\$ 175	\$ 277	\$ 367
Sales and marketing	240	335	482	665
General and administrative	180	251	352	504
Research and development	107	151	229	315
Total stock-based compensation expense	\$ 650	\$ 912	\$ 1,340	\$ 1,851

**15. NET INCOME PER SHARE**

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

	Three Months Ended June 30,		Six months Ended June 30,	
	2008	2007	2008	2007
<b>Net income (numerator) basic and diluted</b>				
Income from continuing operations	\$ 5,221	\$ 2,498	\$ 9,500	\$ 7,449
Income from discontinued operations, net of taxes			980	1,445
Net income	\$ 5,221	\$ 2,498	\$ 10,480	\$ 8,894
<b>Shares (denominator)</b>				
Weighted average common stock outstanding				
Basic	45,094,860	43,231,164	44,944,271	43,191,216
Dilutive effect of stock-based compensation	1,949,552	1,819,756	1,771,033	1,678,525
Diluted	47,044,412	45,050,920	46,715,304	44,869,741
<b>Net income from continuing operations per share</b>				
Basic	\$ 0.12	\$ 0.06	\$ 0.21	\$ 0.17
Diluted	\$ 0.11	\$ 0.06	\$ 0.20	\$ 0.17
<b>Net income from discontinued operations, net of tax, per share</b>				
Basic	\$	\$	\$ 0.02	\$ 0.04
Diluted	\$	\$	\$ 0.02	\$ 0.03

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

### Net income per share

Basic	\$	0.12	\$	0.06	\$	0.23	\$	0.21
Diluted	\$	0.11	\$	0.06	\$	0.22	\$	0.20

As of June 30, 2008 and 2007, the Company had 670,215 and 1,257,251 common stock options outstanding, respectively, that were excluded from the computation of diluted earnings per share (EPS), as their exercise prices exceeded the average market values in those periods. These options could potentially have a dilutive effect on EPS in the future.

### 16. SEGMENT INFORMATION

Since the acquisition of the non-telecommunications IT services business of Lenovo in October 2004, the Company has been organized as two business units, AsiaInfo Technologies, encompassing the Company's traditional telecommunications business, and Lenovo-AsiaInfo, providing IT services, including security products and services, IT consulting, software customization, and business process outsourcing services, to the enterprise market in China. After disposing of certain non-core business lines during 2005 and 2006, Lenovo-AsiaInfo now focuses on IT security solutions for the small and medium-sized enterprise market in China. Each business unit is further organized into three operating segments by product type: (1) software products and solutions, (2) service, and (3) third-party hardware. The Company follows the provisions of SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, which establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise about which discrete financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance.

**Table of Contents**

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

The following is a condensed statement of operations and total assets for the Company's reportable segments:

	Three Months Ended June 30,					
	2008			2007		
	AsiaInfo Technologies	Lenovo- AsiaInfo	Total	AsiaInfo Technologies	Lenovo- AsiaInfo	Total
<b>Revenue:</b>						
Software products and solutions	\$ 25,875	\$ 4,138	\$ 30,013	\$ 19,000	\$ 3,406	\$ 22,406
Service	4,042	167	4,209	3,950	61	4,011
Third-party hardware	6,834	1,002	7,836	2,306	847	3,153
<b>Total revenue:</b>	<b>36,751</b>	<b>5,307</b>	<b>42,058</b>	<b>25,256</b>	<b>4,314</b>	<b>29,570</b>
<b>Cost of revenues:</b>						
Software products and solutions	12,230	1,430	13,660	8,861	1,255	10,116
Service	1,636	68	1,704	1,842	138	1,980
Third-party hardware	6,492	1,152	7,644	2,190	805	2,995
<b>Total cost of revenues</b>	<b>20,358</b>	<b>2,650</b>	<b>23,008</b>	<b>12,893</b>	<b>2,198</b>	<b>15,091</b>
<b>Gross Profit</b>	<b>16,393</b>	<b>2,657</b>	<b>19,050</b>	<b>12,363</b>	<b>2,116</b>	<b>14,479</b>
<b>Business unit expenses:</b>						
Sales and marketing	5,956	2,256	8,212	4,857	1,796	6,653
General and administrative <sup>(1)</sup>	101	34	135	343	4	347
Research and development	4,465	564	5,029	3,809	352	4,161
<b>Total business unit expenses</b>	<b>10,522</b>	<b>2,854</b>	<b>13,376</b>	<b>9,009</b>	<b>2,152</b>	<b>11,161</b>
<b>Other operating income</b>						
<b>Contribution profit (loss)</b>	<b>\$ 5,871</b>	<b>\$ (197)</b>	<b>\$ 5,674</b>	<b>\$ 3,354</b>	<b>\$ (36)</b>	<b>\$ 3,318</b>

	Six Months Ended June 30,					
	2008			2007		
	AsiaInfo Technologies	Lenovo- AsiaInfo	Total	AsiaInfo Technologies	Lenovo- AsiaInfo	Total
<b>Revenue:</b>						
Software products and solutions	\$ 50,327	\$ 6,825	\$ 57,152	\$ 36,513	\$ 5,493	\$ 42,006
Service	7,346	204	7,550	7,415	165	7,580
Third-party hardware	11,157	1,205	12,362	9,190	849	10,039
<b>Total revenue:</b>	<b>68,830</b>	<b>8,234</b>	<b>77,064</b>	<b>53,118</b>	<b>6,507</b>	<b>59,625</b>
<b>Cost of revenues:</b>						

Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Software products and solutions	22,511	2,305	24,816	17,117	1,972	19,089
Service	3,310	108	3,418	3,404	272	3,676
Third-party hardware	10,599	1,341	11,940	8,730	807	9,537
Total cost of revenues	36,420	3,754	40,174	29,251	3,051	32,302
Gross Profit	32,410	4,480	36,890	23,867	3,456	27,323
Business unit expenses:						
Sales and marketing	11,841	4,266	16,107	9,243	3,480	12,723
General and administrative <sup>(1)</sup>	678	47	725	252	14	266
Research and development	8,575	1,112	9,687	7,482	765	8,247
Total business unit expenses	21,094	5,425	26,519	16,977	4,259	21,236
Other operating income					2,734	2,734
Contribution profit (loss)	\$ 11,316	\$ (945)	\$ 10,371	\$ 6,890	\$ 1,931	\$ 8,821

**Table of Contents**

	As of June 30, 2008			As of December 31, 2007		
	AsiaInfo Technologies	Lenovo-AsiaInfo	Total	AsiaInfo Technologies	Lenovo-AsiaInfo	Total
Total assets <sup>(2)</sup>	\$ 261,999	\$ 56,986	\$ 318,985	\$ 251,663	\$ 56,806	\$ 308,469

(1) General and administrative expenses reported reflect only the direct controllable expenses of each business unit and do not include allocation of corporate general and administrative expenses. The 2008 balances in AsiaInfo-Technologies segment primarily reflect the results of certain bad debt provision reversals recorded in the three months ended June 30, 2008.

(2) Included in total assets are net accounts receivable of \$41,320 and \$4,899 for AsiaInfo Technologies and Lenovo-AsiaInfo at June 30, 2008, respectively, and \$41,454 and \$3,779 for AsiaInfo Technologies and Lenovo-AsiaInfo at December 31, 2007, respectively.

The following is a reconciliation of operating segment contribution profit to income before provision for income taxes:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Total contribution profit for reportable segments	\$ 5,674	\$ 3,318	\$ 10,371	\$ 8,821
Corporate general and administrative expenses	(2,113)	(2,123)	(4,132)	(4,152)
Interest income	1,067	1,156	2,282	2,278
Gain from sales of short term investments	2,409	556	3,583	581
Impairment losses on short term investments	(50)		(50)	
Dividend	84	93	303	528
Other income (expense), net	(256)	52	(530)	(20)
Income before provision for income taxes and discontinued operations	\$ 6,815	\$ 3,052	\$ 11,827	\$ 8,036

**17. RELATED PARTIES TRANSACTIONS**

The Company entered into a series of contractual agreements with Lenovo in connection with the acquisition of Lenovo's non-telecommunications IT services business in October 2004. In conjunction with that acquisition, the Company delivered 5,472,414 shares of its common stock to Lenovo. Among them, 648,769 shares were returned to the Company from an escrow account in February 2007. As of June 30, 2008, Lenovo owned approximately 9 percent of the Company's outstanding common stock.

Edward Tian, a Director and major stockholder of the Company, was, until May 2006, the Vice President of China Network Communications Group Corporation (together with its affiliates, referred to as China Netcom Group), and an executive officer of both China Netcom Group Corporation (Hong Kong) Limited (China Netcom Hong Kong) and China Netcom (Group) Company Limited (China Netcom Limited), each of which is a subsidiary of the China Netcome Group. Effective May 17, 2006, Mr. Tian resigned as the Vice President of China Netcome Group, as well as from his position as an executive officer of China Netcom Hong Kong and China Netcom Limited, but will serve as a non-executive Director as well as the Vice Chairman of the Board of Directors of China Netcom Hong Kong. In the three months ended March 31, 2006, the Company entered into network solutions and software revenue contracts with China Netcom Group with an aggregate contract value of approximately \$3,555.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	Lenovo		Lenovo	
Purchases:				
Software products and solutions	\$	\$	\$	\$ 1
Service				

Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Third-party hardware			583		583
<b>Total purchases</b>			<b>583</b>		<b>584</b>
Operating expenses:					
Sales and marketing	16	18	35		43
General and administrative					
Research and development	1	1	2		2
<b>Total operating expenses</b>	<b>\$ 17</b>	<b>\$ 19</b>	<b>\$ 37</b>	<b>\$</b>	<b>45</b>

**Table of Contents**

	As of June 30, 2008 Lenovo	As of December 31, 2007 Lenovo
Balances with related parties:		
Other receivables	\$ 232	\$ 214
Deferred revenue	386	437
Other payables	779	732

James Ding, a major stockholder of the Company and Chairman of its Board, is also the Chairman of the Board of Directors of Beijing UITV Culture Development Ltd. ( Beijing UITV ). As of June 30, 2008, the Company had no account receivable from Beijing UITV.

**18. COMMITMENTS AND CONTINGENCIES**

*Product warranty* The Company's product warranty accrual reflected management's best estimate of probable liability under its product warranties. Management determines the warranty accrual based on historical experience and other currently available evidence. Product warranty accrual was recorded as a component of accrued expenses in the accompanying balance sheets.

Changes in the product warranty accrual for the periods ended June 30, 2008 and December 31, 2007:

	As of June 30, 2008	As of December 31, 2007
Balance at beginning of the period	\$ 595	\$ 681
Current period provision	25	131
Payments	(9)	(32)
Expired warranty	(118)	(220)
Foreign exchange difference	30	35
Balance at end of the period	\$ 523	\$ 595

*Litigation* On December 4, 2001, a securities class action case was filed in New York City against the Company, certain of its officers and directors and the underwriters of the Company's initial public offering ( IPO ). The lawsuit alleged violations of the U.S. federal securities laws and was docketed in the United States District Court for the Southern District of New York as Hassan v. AsiaInfo Holdings, Inc., et al. The lawsuit alleged, among other things, that the underwriters of the Company's IPO improperly required their customers to pay the underwriters excessive commissions and to agree to buy additional shares of the Company's common stock in the aftermarket as conditions of their purchasing shares in the Company's IPO. The lawsuit further claimed that the alleged practices of the underwriters should have been disclosed in the Company's IPO prospectus and registration statement. The suit seeks rescission of the plaintiffs' alleged purchases of the Company's common stock as well as unspecified damages. In addition to the case against the Company, various other plaintiffs had filed approximately 1,000 other, substantially similar class action cases against approximately 300 other publicly traded companies and their IPO underwriters in New York City, which along with the case against the Company, have all been transferred to a single federal district judge for purposes of case management.

In June 2003, based on a decision made by a special independent committee of its Board, the Company elected to participate in a proposed settlement agreement with the plaintiffs in this litigation. The proposed settlement contemplated that any amounts necessary to fund the settlement or settlement-related expenses would come from participating issuers' directors and officers' liability insurance policy proceeds as opposed to funds of the participating issuer defendants themselves. The proposed settlement also contemplated that the Company would assign any claims it may have against the underwriters of its IPO for excess commissions to the plaintiffs.

On October 13, 2004, the District Court certified six representative cases (out of hundreds of IPO cases that have been filed) as class actions. These cases were designated "focus cases" and the Court's rulings in those cases going forward were intended to be templates for the remaining hundreds of cases. After objection from the underwriter defendants to the appropriateness of treating these cases as class actions, the Second Circuit Court of Appeals heard the underwriter defendants' appeal of the District Court's class certification decision and on April 6, 2007 ruled that none of the six focus cases could be certified as a class action.

Based on the rulings from the Second Circuit Court of Appeals regarding class certification, the District Court entered an order formally removing the proposed settlement from the Court's docket. The plaintiffs asked the Court to certify new proposed classes of IPO investors and the Court set dates by when the parties must file briefs addressing the viability of the plaintiffs' new proposed classes, with the plaintiffs' opening briefs due on September 27, 2007, the defendants' opposition briefs due on December 21, 2007, and plaintiffs' briefs responding to the defendants' arguments due on February 15, 2008. If the litigation proceeds, the Company intends to continue to defend the litigation vigorously. Moreover,



## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

if the litigation proceeds, it believes that the underwriters may have an obligation to indemnify the Company for the legal fees and other costs of defending this suit and that the Company's directors and officers' liability insurance policies would also cover the defense and potential exposure in the suit.

**Table of Contents**

In addition to the above case, the Company received a letter dated July 30, 2007 from a putative stockholder demanding that the Company investigate and prosecute a claim for alleged short-swing trading in violation of Section 16(b) of the Securities Exchange Act of 1934, as amended (the Exchange Act) by the underwriters of the Company's IPO in March 2000 and certain of the Company's unidentified directors, officers and stockholders. On October 9, 2007, the putative stockholder commenced a civil lawsuit in the U.S. District Court for the Western District of Washington against Morgan Stanley and Deutsche Bank, two of the Company's lead underwriters during the IPO, alleging violations of Section 16(b) of the Exchange Act. The complaint alleges that the combined number of shares of the Company's common stock beneficially owned by the lead underwriters and certain unnamed officers, directors, and principal stockholders exceeded ten percent of the Company's outstanding common stock from the date of the IPO on March 3, 2000 through no earlier than March 2, 2001. It further alleges that those entities and individuals were subject to the reporting requirements of Section 16(a) and the short-swing trading prohibition of Section 16(b), and failed to comply with those provisions. The complaint seeks to recover from the lead underwriters any short-swing profits obtained by them in violation of Section 16(b). None of the Company's directors, officers or stockholders was named as defendants in this action, although the Company was named as a nominal defendant. On July 25, 2008, the Company filed a joint motion to dismiss, with some other issuers who are also named as nominal defendants in the action.

While the Company cannot guarantee the outcome of these proceedings, it believes that the final result of these actions will not have material effects on the Company's consolidated financial condition, results of operations or cash flows.

**19. STOCK REPURCHASE PROGRAM**

From the commencement of the Company's first stock repurchase program, which was approved by the Company's Board in the fourth quarter of 2004, through December 31, 2005, the Company had repurchased a total of 5,274,231 shares at a total cost of \$27,282 under this program.

On January 11, 2006, the Company announced the authorization of another stock repurchase program pursuant to which the Company was entitled, from time to time during a ninety-day period (expired on April 11, 2006), to purchase up to 4,000,000 shares of its common stock. As of April 11, 2006, the Company had repurchased 2,095,208 shares of its common stock at a total cost of \$9,563.

On April 25, 2006, the Company's Board authorized an extension to this share repurchase program for an additional 90 days, from April 25, 2006 to July 24, 2006, but did not change the aggregate number of shares subject to repurchase under the plan. As of July 18, 2006, the Company had repurchased 1,904,792 shares of its common stock at a total cost of \$8,223 pursuant to the extension of this repurchase program. The stock repurchase plan, as extended, was completed on July 18, 2006.

All common stock repurchased by the Company under the 2005 and 2006 repurchase programs were reported as the Company's treasury stock. Of the total shares repurchased, 4,498,130 shares were transferred to Lenovo in 2005 as part of the consideration for acquiring Lenovo-AsiaInfo. On June 27, 2006 and September 29, 2006, the Company's Board authorized the retirement of 3,799,109 shares and 976,992 shares of treasury stock, respectively. The retired shares resumed the status of authorized and unissued shares of the Company. As of December 31, 2006, the Company had 43,076,034 shares of common stock issued and outstanding, after taking into account the retirement of 4,776,101 shares of treasury stock. As of December 31, 2006, the Company had no remaining treasury stock.

On September 11, 2007, the Company announced the authorization of another stock repurchase program under which the Company was entitled to repurchase up to 3,000,000 shares of its outstanding common stock. Pursuant to this program, the Company may, from time to time for a period of four months, depending on market conditions, share price and other factors, make one or more purchases, on the open market, or in privately negotiated transactions, subject to availability, of up to 3,000,000 shares of common stock. As of December 31, 2007, the Company had repurchased 244,300 shares of its common stock at a total cost of \$1,953 pursuant to this repurchase program.

On February 27, 2008, the Company's Board authorized an extension to this share repurchase program, which expired on July 10, 2008. Under the extended program, the Company may repurchase up to 2,755,700 shares of its outstanding common stock. As of June 30, 2008, the Company had repurchased an additional 166,400 shares of its common stock at a total cost of \$1,664 pursuant to the extension of this repurchase program. All common stock repurchased by the Company became part of its treasury stock and may be retired or used by the Company to finance or execute acquisitions or other arrangements.

**Table of Contents**

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

Except for historical information, the statements contained in this quarterly report on Form 10-Q are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, the Exchange Act. The Private Securities Litigation Reform Act of 1995, or the Reform Act, contains certain safe harbors regarding forward-looking statements. Certain of the forward-looking statements include management's expectations, intentions and beliefs with respect to our growth, our operating results, the nature of the industry in which we are engaged, our business strategies and plans for future operations, our needs for capital expenditures, capital resources and liquidity, and similar expressions concerning matters that are not historical facts. Such forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed in the statements. All forward-looking statements included in this report are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. These cautionary statements are being made pursuant to the provisions of the Reform Act with the intention of obtaining the benefits of the safe harbor provisions of the Reform Act. The factors that could cause actual results to differ materially include, but are not limited to, the factors discussed below under Item 1A. Risk Factors in Part II Other Information.

In this report, AsiaInfo, the Company, we, us and our refer to AsiaInfo Holdings Inc., its subsidiaries and consolidated variable interest entities.

**Overview**

We are a leading provider of high-quality telecommunications software solutions and information technology (IT) security products and services in China. As an established leader in the Chinese telecommunications industry, we became a leading provider of IT security products and services in China with the acquisition of the non-telecommunications related IT services business of Lenovo Group Limited and its affiliates (collectively, Lenovo) in 2004. In the telecommunications market, our software products and services enable our customers to build, maintain, operate, manage and continuously improve their communications infrastructure and services. Our largest customers are the major telecommunications carriers in China and their provincial subsidiaries, such as China Mobile Communications Corporation (China Mobile), China United Telecommunications Corporation (China Unicom), China Network Communications Group Corporation (China Netcom), and China Telecommunications Corporation (China Telecom). In addition to providing customized software solutions to China's telecommunications carriers, we also offer sophisticated IT security products and services to many small and medium-sized companies in China.

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

We have derived, and believe that we will continue to derive, a significant portion of our revenues from a limited number of large telecommunications customers, such as China Mobile, China Unicom, China Netcom and China Telecom. Sales to China Mobile and its subsidiaries amounted to approximately 58%, 61% and 51% of our total revenues in 2007, 2006 and 2005, respectively. Sales to China Unicom and its subsidiaries amounted to approximately 12%, 14% and 20% of our total revenues in 2007, 2006 and 2005, respectively. Sales to China Netcom and its subsidiaries amounted to approximately 10%, 12% and 12% of our total revenues in 2007, 2006 and 2005, respectively. Sales to China Telecom and its subsidiaries amounted to approximately 5%, 5% and 3% of our total revenues in 2007, 2006 and 2005, respectively. The sum of our top five receivable balances represented 89% and 95% of our total receivable balances as of December 31, 2007 and 2006, respectively.

Since our acquisition of the non-telecommunications related IT services business of Lenovo in October 2004, we have been organized as two business divisions, AsiaInfo Technologies (China) Inc., or AsiaInfo Technologies, encompassing our traditional telecommunications business, and Lenovo-AsiaInfo Technologies, Inc. or Lenovo-AsiaInfo, providing IT security products and services to China's enterprise market. For financial reporting purposes, each of the two business divisions is further organized into three operating segments by product types:

software products and solutions;

services; and

third-party hardware.

**Revenues**

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

We report our revenues on the basis of the three principal types of revenues derived from our business: software products and solutions revenue, service revenue and third-party hardware revenue. Please refer to Note 16 to the Condensed Consolidated Financial Statements included in this report for detailed financial information regarding segment reporting.

***Software products and solutions revenue.*** We typically sell our software as part of a total solutions package for our customers, which includes proprietary software licenses, professional services related to the design and implementation of the solutions (such as consulting, training, technical support and maintenance) and, in cases where the customer requests a turn-key solution, related hardware. Software products and solutions revenue includes two types of revenues: software license revenue and software services revenue. Software license revenue consists of fees received from customers for licenses or sublicenses to use our software products or third-party software products in perpetuity, typically up to a specified maximum number of users. In most cases where a customer is

**Table of Contents**

required to purchase additional licenses from us because the number of users exceeds the number of licensed users, we enter into an extension agreement with the customer to expand and upgrade the customer's system. These extension contracts will usually include a license for the additional users, updated versions of our software and, if required, additional services and hardware for the customer's network. Our software license revenue also includes the benefit of value-added tax rebates on software license sales, which reflect the Chinese government's policy of encouraging China's software industry. Software services revenue consists of revenue from software installation, customization, training and other services. We also record reductions from revenue for our estimates of expected software sales returns from distributors based on current sales and historical sales returns.

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

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

**Net revenue (Non-GAAP).** Although we report our revenue on a gross basis, inclusive of hardware acquisition costs, we manage our business internally based on revenues net of hardware costs, or net revenues (Non-GAAP), which is consistent with our strategy of providing our customers with high value IT professional services and, where efficient, outsourcing lower-end services such as hardware acquisition and installation. This strategy may result in lower growth rates for total revenue as against prior periods, but will not adversely impact revenue net of hardware costs. The following table shows our revenue breakdown on this basis and reconciles our net revenues (Non-GAAP) to total revenues:

	Reconciliation of Net Revenues (Non-GAAP) to Total Revenues Three Months Ended June 30,					
	2008			2007		
	AsiaInfo Technologies	Lenovo- AsiaInfo	Total	AsiaInfo Technologies	Lenovo- AsiaInfo	Total
Revenues net of hardware costs:						
Software products and solutions revenue	\$ 25,875	\$ 4,138	\$ 30,013	\$ 19,000	\$ 3,406	\$ 22,406
Service revenue	4,042	167	4,209	3,950	61	4,011
Third-party hardware revenue net of hardware costs	342	(150)	192	116	42	158
Total revenues net of hardware costs	30,259	4,155	34,414	23,066	3,509	26,575
Total hardware costs	6,492	1,152	7,644	2,190	805	2,995
Total revenues	\$ 36,751	\$ 5,307	\$ 42,058	\$ 25,256	\$ 4,314	\$ 29,570

	Six Months Ended June 30,					
	2008			2007		
	AsiaInfo Technologies	Lenovo- AsiaInfo	Total	AsiaInfo Technologies	Lenovo- AsiaInfo	Total
Revenues net of hardware costs:						
Software products and solutions revenue	\$ 50,327	\$ 6,825	\$ 57,152	\$ 36,513	\$ 5,493	\$ 42,006
Service revenue	7,346	204	7,550	7,415	165	7,580
Third-party hardware revenue net of hardware costs	558	(136)	422	460	42	502
Total revenues net of hardware costs	58,231	6,893	65,124	44,388	5,700	50,088
Total hardware costs	10,599	1,341	11,940	8,730	807	9,537
Total revenues	\$ 68,830	\$ 8,234	\$ 77,064	\$ 53,118	\$ 6,507	\$ 59,625



## **Table of Contents**

We believe total revenues net of hardware costs in each of the segments of our business more accurately reflect our core business, which is the provision of software solutions and services, and provides transparency to our investors. We believe this measure provides transparency to our investors because it is the measure used by our management to evaluate the competitiveness and performance of our business in each of the segments. In addition, third-party hardware revenue tends to fluctuate from period to period depending on the requirements of our customers. As a result, a presentation that excludes hardware costs allows investors to better evaluate the performance of our core business. We have provided a reconciliation of this measure to the most directly comparable financial measure under accounting principles generally accepted in the United States ( US GAAP ), total revenues.

We have evaluated the criteria outlined in Emerging Issue Task Force ( EITF ) No. 99-19, Reporting Revenue Gross as Principal Versus Net as an Agent, in determining whether it is appropriate under US GAAP to record the gross amount of revenues and related costs or the net amount earned after deducting hardware costs paid to the supplier. We record the gross amounts billed to our customers because we are the primary obligor in these transactions, bear the inventory risk, have latitude in establishing prices, are involved in the determination of the product specifications, bear credit risk and have the right to select suppliers.

### **Cost of Revenues**

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

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

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

software license fees paid to third-party software providers for the right to sublicense their products to our customers as part of our solutions offerings as well as the amortization expenses of acquired intangible assets.

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

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

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

Amortization of intangible assets, depreciation of properties and equipments, and rental expenses are also included in cost of revenue.

### **Operating Expenses**

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

Sales and marketing expenses include compensation expenses for employees in our sales and marketing departments, third party advertising expenses, sales commissions and sales consulting fees, as well as the depreciation and amortization expenses allocated to our sales and marketing departments.

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

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

### **Taxes**

Except for certain hardware procurement and resale transactions, we conduct substantially all of our business through our Chinese subsidiaries and VIEs. Prior to the new Chinese Enterprise Income Tax Law (the EIT Law ), which became effective on January 1, 2008, foreign-invested enterprises ( FIEs ) were generally subject to a 30% state enterprise income tax plus a 3% local income tax. However, most of our operating subsidiaries in China, as FIEs, were entitled to tax holidays or certain preferential tax treatments, which thus reduced their effective rate of income tax to 15% or lower in some cases. Since the EIT law became effective, all resident enterprises are subject to a flat 25% income tax rate, unless otherwise they are eligible for certain preferential tax treatments under the new rules.

Under the EIT law effective from January 1, 2008, the rules for determining whether an entity is a resident in the PRC for tax purposes have changed and the determination of residence depends amongst other things on the place of actual management . If we, or our non-PRC subsidiaries, were to be determined to be PRC residents for tax purposes, we would be subject to tax in the PRC on our worldwide income, including the income arising in jurisdictions outside the PRC. We are still evaluating our resident status under the new law and related guidance.



---

**Table of Contents**

If we were to be non-resident for PRC tax purposes, dividends paid to us out of profits earned by our PRC subsidiaries after January 1, 2008 would be subject to a withholding tax. In the case of dividends paid by our PRC subsidiaries, the withholding tax would be 10% and in the case of dividends paid by our subsidiary 25% or more directly owned by a resident of Hong Kong, the withholding tax would be 5%. Aggregate undistributed earnings of our PRC subsidiaries and VIEs that are available for distribution to us of approximately \$39.2 million as of June 30, 2008 are considered to be indefinitely reinvested under APB opinion No. 23, *Accounting for Income Taxes - Special Areas*. Accordingly, no provision has been made for the Chinese dividend withholding taxes that would be payable upon the distribution of those earnings to us. The Chinese tax authorities have also clarified that distributions made out of pre-January 1, 2008 retained earnings will not be subject to the withholding tax.

Pursuant to the implementation rules to the EIT law issued in December 2007 and several subsequent transition rules, certain of our subsidiaries and VIEs in China may continue to enjoy preferential tax rates, if they are qualified as High and New Technology Enterprises. On July 11, 2008, the Chinese government authorities just announced detailed regulations on the applicable requirements and procedures to apply for preferential tax treatment as a High and New Technology Enterprise ( HNTE ) such as those that have been enjoyed by certain of our PRC subsidiaries and VIEs through 2007. We are currently evaluating the implications of such regulations and may apply for the HNTE status based on such regulations. As a result, until confirmation is received from the Chinese tax authorities that such preferential tax treatments will be allowed to continue for the relevant terms, some of our Chinese subsidiaries will become subject to a normal 25% rate, with a few exceptions where certain of our PRC subsidiaries and VIEs are still eligible for lower rates under the transition rules. Our deferred tax asset will increase \$783 if all of our PRC subsidiaries and VIEs are subject to a 25% tax rate. The unified tax laws should not affect any preferential tax treatment granted to FIEs in previous years. Please refer to Note 13 to our Consolidated Financial Statements for details of the preferential tax treatment for these subsidiaries.

Sales of hardware procured in China are subject to a 17% value-added tax. Most of our sales of hardware procured outside of China are made through our U.S. parent company, AsiaInfo Holdings, Inc., and thus are not subject to the value-added tax. We effectively pass value-added tax on hardware sales through to our customers and do not include them in revenues reported in our financial statements. Companies that develop their own software and register the software with the relevant authorities in China are generally entitled to a value-added tax refund. If the net amount of the value added tax payable exceeds 3% of software sales and software-related services, the excess portion of the value-added tax is refundable immediately. This policy is effective until 2010. The benefit of the rebate of value-added tax is included in our software revenue. The rebate totaled \$2.9million and \$2.8 million for the six-month periods ended June 30, 2008 and 2007, respectively.

Our PRC subsidiaries and VIEs are subject to business tax at the rate of 3% and 5%, respectively, on certain types of service revenues and the revenues are presented net of business tax incurred. Business taxes deducted from revenues during the six month periods ended June 30, 2008 and 2007 were \$1.9 million and \$1.1 million, respectively.

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

**Foreign Exchange**

A majority of our revenues and expenses relating to the hardware, software and service components of our business are denominated in Renminbi ( RMB ). The value of our shares will be affected by the foreign exchange rate between U.S. dollars and RMB because the value of our business is effectively denominated in RMB, while our shares are traded in U.S. dollars. Furthermore, an increase in the value of the RMB may require us to exchange more U.S. dollars into RMB in order to meet the working capital requirements of our subsidiaries in China. Depreciation of the value of the U.S. dollar will also reduce the value of the cash we hold in U.S. dollars, which we may use for purposes of future acquisitions or other business expansion. We actively monitor our exposure to these risks and adjust our cash position in the RMB and the U.S. dollar when we believe such adjustments will reduce our foreign exchange risks. For example, in February 2004 we exchanged approximately \$28 million cash from U.S. dollars to RMB in order to address concerns regarding a possible increase in the relative value of the RMB. We did not engage in any significant foreign exchange transactions in the three-month period ended June 30, 2008.

Pursuant to the rate of exchange quoted by Federal Reserve Bank of New York as of June 30, 2008 the exchange rate between the U.S. dollar and the RMB was US\$1.00 = RMB6.8591.

**Critical Accounting Policies**

We prepare our consolidated financial statements in accordance with US GAAP. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amount of revenues and expenses during the reporting period. On an on-going basis,

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

we evaluate our estimates and judgments, including those related to revenues and cost of revenues under customer contracts, warranty obligations, bad debts, inventories, short-term investments, long-term investments, long-lived assets, income taxes, goodwill and other intangible assets, stock options, and litigation. We base our estimates and judgments on historical experience and on various other factors that we believe are reasonable. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies affect the more significant judgments and estimates used in the preparation of our consolidated financial statements.

## Table of Contents

**Revenue recognition.** Our revenue is derived from three primary sources: (i) software license and related services, including assistance in implementation, customization and integration, post-contract customer support ( PCS ), training and consulting; (ii) professional services for systems design, planning, consulting, and system integration, and (iii) the procurement of hardware on behalf of our customers.

Revenues from customer orders requiring significant production, modifications, or customization of the software are recognized over the installation and customization period based on the percentage of completion method as prescribed by Statement of Position No. 81-1,

Accounting for Performance of Construction-Type and Certain Product-Type Contracts ( SOP 81-1 ). Software arrangements with significant production, modifications, or customization are sold with bundled PCS services. Because PCS services have never been sold separately in these arrangements, they do not have stand-alone fair value or vendor specific objective evidence of fair value. The percentage of completion method of revenue recognition is therefore applied to the period from the start of the significant production, modifications, or customization through the last element delivered, which is typically the end of the bundled PCS service period. Revisions in estimated contract costs are made in the period in which the circumstances requiring the revision become known. Provisions, if any, are made currently for anticipated losses on uncompleted contracts.

For software contracts that do not involve significant implementation or customization, license fees are recorded when there is persuasive evidence of an arrangement, the fee is fixed or determinable, collection is probable, and the related products or services are delivered as prescribed by SOP No. 97-2, Software Revenue Recognition. ( SOP 97-2 ) .

Our Lenovo-AsiaInfo IT security products are accounted for under SOP 97-2 because the related software is considered to be more than incidental and is essential to the functionality of the related equipment. The Lenovo-AsiaInfo IT security products are sold bundled with PCS services over a term of one, two or three years. We recognized total arrangement fees for the IT security products as revenue upon delivery assuming all other revenue recognition criteria are met regardless of whether the PCS terms were one two or three years because (a) PCS primarily includes telephone and online support, (b) PCS services are substantially provided within the first year of the arrangement term, (c) the costs of providing PCS services have historically been insignificant and are expected to be insignificant in the future, and (d) PCS does not include upgrades or enhancements. PCS services provided beyond the first year of the service term have historically been negligible. We accrue the estimated costs of providing PCS services upon delivery of the Lenovo-AsiaInfo IT security software products.

Consulting and other professional services revenues are recognized when the services are performed. Sales of third party hardware, if not bundled with other arrangements, are recognized when delivered if all other revenue recognition criteria are met. Costs associated with revenues are recognized when incurred.

Revenue recognized in excess of billings is recorded as unbilled receivables and is included in trade accounts receivable. Amounts billed but not yet collected are recorded as billed receivables and are included in trade accounts receivable. All billed and unbilled amounts are expected to be collected within one year. Billings for installation and customization services are rendered based on agreed upon milestones specified in customer contracts. Billings in excess of revenues recognized are recorded as deferred revenue.

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

On January 1, 2007, we adopted Financial Accounting Standard Board ( FASB ) Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109. Interest and penalties on income taxes are classified as a component of the provisions for income taxes.

**Goodwill.** Goodwill is tested for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired. We use a two-step impairment test to identify potential goodwill impairment and recognize a goodwill impairment loss in the statement of operations when the carrying amount of goodwill exceeds its implied fair value. We perform all goodwill impairment tests for each reporting unit in the fourth quarter of each year. The latest goodwill impairment tests were performed in the fourth quarter of 2007 and no impairment losses were recognized.

## **Consolidated Results of Operations**

**Revenues.** Gross revenues were \$ 42.1 million for the three-month period ended June 30, 2008, 42.2% higher than the year ago period and a 20.1% increase sequentially. Gross revenues were \$77.1 million for the six-month period ended June 30, 2008, representing an increase of

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

29.2% over the comparable period in 2007. The overall year-over-year increases in gross revenue were mainly the result of increases in the software products and solutions revenues and services revenues described below.

Software products and solutions revenue was \$30.0 million and \$57.2 million, respectively, for the three-month and six-month periods ended June 30, 2008, representing an increase of 34.0% and 36.1% over the comparable period in 2007 and a 10.6% sequential increase. The overall year-over-year increases in software products and solutions revenue were mainly due to growth in both our telecommunications software business and our IT security business. Second quarter telecommunications software products and solutions revenue rose 36.2% year-over-year and 5.8% sequentially, which is due to strong market demand for our industry-leading telecommunications software solutions, as more Chinese telecommunications carriers are turning to these software solutions in order to differentiate their service offerings as a result of increasing market competition. Second quarter software products and solutions revenue from our IT security business accounted for \$4.1 million, representing a 21.5% year-over-year increase and a 54.0%

---

**Table of Contents**

sequential increase. The year-over-year growth is attributable to the continuous improvement of our IT security business division. The significant sequential improvement was mainly due to the seasonality of our IT security business, which has historically recorded lower revenue in the first quarter of the year, due to the long Chinese New Year holiday.

Service revenue was \$4.2 million in the three-month period ended June 30, 2008, representing an increase of 4.9% against the comparable period in 2007 and a 26.0% sequential increase. Service revenue was \$7.6 million in the six-month period ended June 30, 2008, which is flat, compared to the same periods in 2007. The sequential increase was primarily due to lower integration service revenue in the first quarter, which is a seasonally slow quarter.

Third-party hardware revenue for the three-month and six-month periods ended June 30, 2008 was \$7.8 million and \$12.4 million, a 148.5% and 23.1% increase over the comparable periods in 2007 and a 73.1% increase sequentially. The year-over-year and sequential increases were the result of a higher number of contracts that included bundled third-party hardware in response to customer requests.

Our Lenovo-AsiaInfo division contributed approximately 12.6% to our gross revenues in the three-month period ended June 30, 2008, including a 13.8% contribution to software products and solutions revenue and a 4.0% contribution to service revenue. Lenovo-AsiaInfo contributed 14.6% to our gross revenue in the year-ago period and 8.4% in the preceding quarter.

During the second quarter, sales to our top four customers (China Mobile, China Unicom, China Netcom and China Telecom) accounted for approximately 87.6% of our total revenue.

**Cost of revenues.** Our cost of revenues was \$23 million and \$40.2 million in the three-month and six-month periods ended June 30, 2008, representing increases of 52.5% and 24.4%, respectively, over the comparable periods in 2007. Cost of revenue in the second quarter increased 34.0% compared to the three-month period ended March 31, 2008. The year-over-year and sequential increases in cost of revenues were primarily due to the increase in revenue, especially the revenue from third-party hardware in response to customer requests during this quarter.

**Gross profit.** Our gross profit margin in the second quarter of 2008 was 45.2% compared to 49.0% in the same period in 2007 and 51.0% in the first quarter of 2008. The decrease in gross margin reflects an increase in the percentage of revenue generated from third-party hardware, which has a lower gross margin than the revenue from our core software and service business.

**Operating expenses.** Our operating expenses in the second quarter of 2008 were \$15.5 million, representing an increase of 16.6% over the comparable period in 2007 and a 2.2% sequential increase. The increases were due to increased sales and marketing as well as increased research and development expenses, as discussed below.

Sales and marketing expenses were \$8.2 million for the second quarter of 2008, representing an increase of 23.4% over the comparable period in 2007 and a 4.0% sequential increase. The increase was mainly due to increases in sales headcount and accrued sales commission expenses that resulted from a higher number of new contracts. General and administrative expenses were \$2.2 million for the second quarter of 2008, representing a decrease of 8.9% over the comparable period in 2007 and a 13.8% sequential decrease. The decreases in general and administrative expenses were primarily due to lower bad debt provisions as a result of improved accounts receivable management.

Research and development expenses were \$5.0 million for the second quarter of 2008, representing an increase of 20.9% over the comparable period in 2007 and a 8.0% sequential increase. The year-over-year increase was mainly the result of an increase in headcount in line with our strategy of continuing to invest in our research and development capabilities and to position our company for future market opportunities.

**Total other income.** Total other income, including interest income, dividend income, gain from sales of investments, and other expense in the second quarter of 2008 was \$3.3 million, representing an increase of 75.2% over the comparable period in 2007 and a 39.4% sequential increase. The increases reflect higher returns on short-term investments, including interest income, dividend income and gain from sales of short-term investments in the second quarter.

**Income from continuing operations.** Income from continuing operations was \$5.2 million for the second quarter of 2008, representing an increase of 109.0% compared to the comparable period in 2007 and 22.0% in the previous quarter. The significant year-over-year increase was mainly due to strong demand for our telecommunications software products and solutions and our overall operating efficiency, which increased our operating margins during the quarter.

**Net income.** Net income for the second quarter of 2008 was \$5.2 million, or \$0.12 per basic share, compared to \$2.5 million, or \$0.06 per basic share, for the year-ago period, and \$5.3 million, or \$0.12 per basic share, for the previous quarter.

**Liquidity and Capital Resources**

Our capital requirements are primarily working capital requirements related to hardware sales and costs associated with the expansion of our business, such as research and development and sales and marketing expenses. We recognize hardware costs in full upon delivery of the hardware to our customers. In order to minimize our working capital requirements, we generally obtain from our hardware vendors payment terms that are timed to permit us to receive payment from our customers for the hardware before our payments to hardware vendors are due. With respect to our billing cycle, we generally require our customers to pay 80% to 90% of the invoice value of the hardware upon delivery. We typically place orders for hardware against back-to-back orders from customers and seek favorable payment terms from hardware vendors. However, we sometimes obtain less favorable payment terms from our customers, thereby increasing our working capital requirements. In addition to this careful management of our billing cycle, we have also historically financed working capital and other financing requirements through private placements of equity securities, our initial public offering in 2000 and, to a limited extent, bank loans.

---

## **Table of Contents**

Our net cash generated from operating activities for the six-month period ended June 30, 2008 was \$4.4 million. This was primarily attributable to our net income of \$10.5 million, adjusted by a net non-cash related income of \$0.5 million, gain on sale of discontinued operations of \$1.5 and a net increase in the components of our working capital of \$4.1 million.

Our accounts receivable balance as of June 30, 2008 was \$46.2 million, consisting of \$20.3 million in billed receivables and \$25.9 million in unbilled receivables. Our billed receivables are recorded based on agreed milestones included in our customer contracts. Our unbilled receivables are based on the revenues that we have booked through the percentage completion method, but for which we have not yet billed the customer. Our days sales outstanding as of June 30, 2008 were 107 days, as compared to last quarter's 128 days.

Our inventory position at the end of the second quarter of 2008 was approximately \$11.8 million, as compared to \$8.0 million as of December 31, 2007.

Our net cash used in investing activities for the three-month period ended June 30, 2008 was \$0.24 million which was primarily due to an increase in restricted cash of \$3.7 million and our acquisition of several small businesses, which was partially offset by the proceeds from sales of available for sale securities. Our net cash provided by investing activities for the six-month period ended June 30, 2008 was \$4.1 million.

Our net cash provided by financing activities for the three-month and six-month periods ended June 30, 2008 was \$2.3 million and 1.5 million, respectively, which represented proceeds from the exercise of stock options.

As of June 30, 2008, we had total short-term credit facilities of \$34.6 million for working capital purposes, expiring in December 2009, which were secured by bank deposits of \$11.2 million. As of June 30, 2008, unused short-term credit facilities were \$24.8 million and used facilities totaled \$9.8 million. The used facilities were pledged as security for issuing standby letters of credit and trade notes payable to hardware suppliers and customers. Additional bank deposits of \$6.0 million were used for issuing standby letters of credit and bank acceptance drafts as of June 30, 2008. Bank deposits pledged as security for these credit facilities totaled \$17.2 million as of June 30, 2008 and are presented as restricted cash in our consolidated balance sheets.

We anticipate that our available funds and cash flows generated from operations will be sufficient to meet our anticipated needs for working capital, capital expenditures and business expansion through 2008. We may need to raise additional funds in the future, however, in order to fund acquisitions, develop new or enhanced services or products, respond to competitive pressures to compete successfully for larger projects involving higher levels of hardware purchases, or if our business otherwise grows more rapidly than we currently predict. We anticipate that we would raise additional funds, if necessary, through new issuances of shares of our equity securities in one or more public offerings or private placements, or through credit facilities extended by lending institutions.

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

### **Off-Balance Sheet Arrangements**

As of June 30, 2008, we had short-term credit facilities for working capital purposes totaling \$34.6 million, expiring in December 2009, of which \$24.8 million had been used for issuing standby letters of credit and trade notes payable to hardware suppliers and customers. Unused short-term credit facilities were \$9.8 million.

### **Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 157, Fair Value measurements ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value under accounting principles generally accepted in the United States ( US GAAP ), and expands disclosures about fair value measurement. SFAS 157 does not require any new fair value measurements. Instead, it offers guidance on how to measure fair value by providing a fair value hierarchy which may be used to classify the sources of information. In February 2008, the FASB issued FASB Staff Position ( FSP ) Financial Accounting Standard ( FAS ) 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements that Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13 and FSP FAS 157-2, Effective Date of FASB Statement No. 157 . These FSPs (1) defer the effective date of SFAS 157 for one year for certain non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), (2) exclude certain leasing transactions accounted for under SFAS No. 13, Accounting for Leases , from the scope of SFAS 157, and (3) include several specific examples of items eligible or not eligible for the one-year deferral. The provisions of SFAS 157 are effective for financial statements issued for fiscal years

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

beginning after November 15, 2007, and interim periods within those fiscal years. FSP FAS 157-1 is effective upon the initial adoption of SFAS 157. FSP FAS 157-2 defers the effective date of certain provisions of SFAS 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of the FSP. We are in the process of assessing the potential impact the adoption of SFAS 157 may have on our consolidated financial position or results of operations.

In February 2007, the FASB issued SFAS No.159 ( SFAS 159 ), The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115 . SFAS159 provides companies with an option to report selected financial assets and liabilities at fair value. The standard requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company s choice to use fair value on its earnings. It also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. This Statement is effective as of the beginning of an entity s first fiscal year beginning after November 15, 2007. We do not expect the adoption of SFAS 159 to have a material effect on our consolidated financial statements.



---

**Table of Contents**

In December 2007, the FASB issued SFAS No.141R ( SFAS 141R ), Business Combination , to improve reporting by creating greater consistency in the accounting and financial reporting of business combinations. The standard requires the acquiring entity in a business combination to recognize all (and only) the assets acquired and liabilities assumed in the transaction; establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all the information they need to evaluate and understand the nature and financial effect of the business combination. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Early adoption is prohibited. We are in the process of assessing the potential impact the adoption of SFAS 141R may have on our consolidated financial position or results of operations.

In December 2007, the FASB issued SFAS No.160 ( SFAS 160 ), Non-controlling Interests in Consolidated Financial Statements to improve the relevance, comparability, and transparency of financial information provided to investors by requiring all entities to report non-controlling (minority) interests in subsidiaries in the same way as required in the consolidated financial statements. Moreover, SFAS160 eliminates the diversity that currently exists in accounting for transactions between an entity and non-controlling interests by requiring they be treated as equity transactions. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. We are in the process of assessing the potential impact the adoption of SFAS160 may have on our consolidated financial position or results of operations.

In March 2008, the FASB issued SFAS No. 161 ( SFAS 161 ), Disclosures about Derivative Instruments and Hedging Activities to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity s financial position, financial performance, and cash flows. It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. We are in the process of assessing the potential impact the adoption of SFAS 161 may have on our consolidated financial position or results of operations.

For information concerning certain risks that may affect our operating results and the value of our Common Stock, please see Item 1A. Risk Factors in Part II Other Information.

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

We are exposed to interest rate risk primarily associated with our cash and short-term investments. To date, we have not entered into any types of derivatives to hedge against interest-rate changes. There have been no significant changes in our exposure to changes in interest rates for the quarter ended June 30, 2008. Our exposure to interest rate changes is limited as we do not have any material borrowings.

We are exposed to exchange rate risk in connection with the relative value of the U.S. dollar and the RMB. Substantially all of our revenues and expenses relating to the service and software components of our business are denominated in RMB. As of June 30, 2008, the rate of exchange quoted by the Federal Reserve Bank of New York was US\$1.00 = RMB6.8591. If the exchange rate were to increase by 10% to US\$1.00 = RMB7.5450, our net assets would potentially decrease by \$14.1 million. If the exchange rate were to decrease by 10% to US\$1.00 = RMB6.1732, our net assets would potentially increase by \$17.2 million.

The value of our shares may be affected by the foreign exchange rate between U.S. dollars and RMB because the value of our business is effectively denominated in RMB, while our shares are traded in U.S. dollars. Furthermore, an increase in the value of the RMB may require us to exchange more U.S. dollars into RMB to meet the working capital requirements of our subsidiaries and VIEs in China. Depreciation of the value of the U.S. dollar will also reduce the value of the cash we hold in U.S. dollars, which we may use for purposes of future acquisitions or business expansion. We actively monitor our exposure to these risks and adjust our cash position in the RMB and the U.S. dollar when we believe such adjustments will reduce our foreign exchange risk. For example, in February 2004 we exchanged approximately \$28 million cash in US dollars into RMB in anticipation of increases in the value of the RMB. We did not engage in any significant foreign exchange transactions during the three-month period ended June 30, 2008.

As in any other business, we are subject to the risk of macroeconomic changes such as recessions and inflation.

**ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15 under the Exchange Act of 1934, as amended (the Exchange Act ) as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective.

### **Changes in Internal Control over Financial Reporting**

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended June 30, 2008, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

---

**Table of Contents**

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

See discussions under Item 3, Part I of our annual report on Form 10-K filed with the SEC on March 14, 2008, as amended. During the fiscal quarter ended June 30, 2008, we did not have any other material legal proceedings brought against us. On July 25, 2008, we filed a joint motion to dismiss, with some other issuers who are also named as nominal defendants in the action. No further material developments occurred in connection with any previously reported legal proceedings against us during the last fiscal quarter.

**ITEM 1A. RISK FACTORS**

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

We have derived, and believe that we will continue to derive, a significant portion of our revenues from a limited number of large customers in the telecommunications industry, such as China Mobile, China Unicom, China Telecom and China Netcom Group. China Mobile accounted for 58% of our revenues in 2007. The loss, cancellation or deferral of any large contract by any of our large customers would have a material adverse effect on our revenues, and consequently our profits. Despite our business development in the security products and services market following the acquisition of Lenovo-AsiaInfo's IT service business unit in 2004, the revenue expected to be generated by our business outside the telecommunications industry is still limited compared to our overall revenues. Moreover, we cannot provide any assurance that a material proportion of our revenues will be derived from other industries in the future.

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

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

Historically, China's telecommunications sector has been subject to a number of state-mandated restructurings. For example, in 2002 China Telecom was split geographically into a northern division (comprising 10 provinces) and a southern division (comprising 21 provinces). Under the restructuring, the northern division of China Telecom merged with China Netcom and was renamed China Network Communications Group Corporation, or China Netcom Group, while the southern division continued to use the China Telecom name. As a result of the restructuring, new orders for telecommunications infrastructure expansion and improvement projects decreased, which adversely affected our revenue. Any similar restructurings of this nature could cause our operating results to vary unexpectedly from quarter to quarter in the future.

*Our acquisition of Lenovo's IT services business and any future acquisitions or investments may expose us to potential risks and have an adverse effect on our ability to manage our business.*

Selective acquisitions, such as our 2004 acquisition of Lenovo's non-telecommunications IT service division, form part of our strategy to further expand our business. If we are presented with appropriate opportunities that we feel will enhance our revenue growth, operations and profitability, we may acquire additional businesses, services or products that are complementary to our core business. Such acquisitions could result in the use of significant amounts of cash and/or dilutive issuances of our common stock. Such acquisitions involve other significant risks. For example, our integration of such acquired entities and/or operations into our business may not be successful and may not enable us to expand into new business platforms as well as we expect. This would significantly affect the expected benefits of these acquisitions. Moreover, the integration of new businesses into our operations has required significant attention from our management. Future acquisitions will also likely present similar challenges.

The IT security products and services business unit we acquired from Lenovo in 2004 faced strong challenges in the final months of 2005. It experienced significantly lower shipment volume than we anticipated and made only a nominal contribution to our revenue for the fourth quarter of 2005. As a result, full year earnings for Lenovo-AsiaInfo were significantly below our expectations. Following the disappointing quarter, Mr. Yu Bing, formerly Chief Executive Officer of the Lenovo-AsiaInfo division and member of our Board, submitted his resignation. We also

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

received resignations from approximately 45 other employees in our Lenovo-AsiaInfo division. Our management team, under the guidance of our Board, conducted an inquiry into the events surrounding the revenue shortfall in the fourth quarter of 2005 and the resignations from the Lenovo-AsiaInfo division. On January 24, 2007, we entered into a settlement and release agreement with Lenovo to resolve certain claims arising out of the acquisition of Lenovo-AsiaInfo. The agreement provides for the mutual release of certain claims that we or Lenovo may have had against each other relating to the acquisition.

The acquisition of Lenovo's non-telecommunications IT services division and possible future acquisitions may also expose us to other potential risks, including risks associated with unforeseen or hidden liabilities, the diversion of resources from our existing businesses and potential loss, or harm to, relationships with employees and clients as a result of our integration of new businesses. In addition, we cannot be sure that we will be able to realize the benefits we anticipate from acquiring any companies, or that we will not incur costs, including those relating to intangible assets or goodwill, in excess of our projected costs for these transactions. The occurrence of any of these events could have a material and adverse effect on our ability to manage our business, our financial condition and our results of operations.

**Table of Contents**

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

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

A large part of the contract amount of our projects sometimes relates to hardware procurement. Since we recognize most of the revenues relating to hardware plus a portion of services and software revenues at the time of hardware delivery, the timing of hardware delivery can cause our quarterly gross revenues to fluctuate significantly. Due to the foregoing factors, we believe that quarter to quarter comparisons of our operating results may not be a good indication of our future performance and should not be overly relied upon. It is likely that our operating results in some periods may be below the expectations of public market analysts and investors. In this event, the price of our common stock will probably decline, perhaps significantly more in percentage terms than any corresponding decline in our operating results.

***Our working capital requirements may increase significantly.***

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

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

Although we had net income in 2004, 2006 and 2007, we sustained net losses in 2003 and 2005. There are no assurances that we can sustain profitability or avoid net losses in the future. We continue to expect that certain of our operating expenses will increase as our business grows. The level of these expenses will be largely based on anticipated organizational growth and revenue trends and a high percentage of those expenses, particularly compensation expenses, will be fixed. As a result, any delays in expanding sales volume and generating revenue could result in substantial operating losses.

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

We maintain a relatively stable work force of software and network engineers engaged in all phases of planning and executing projects on behalf of our customers. As a result, our operating costs are relatively fixed from quarter to quarter, regardless of fluctuations in our revenues. Future fluctuations in our revenues could result in decreases in our operating margins. In addition, enhanced competition in the software market and other markets in which we operate could result in reduced prices, which, together with our relatively fixed operating costs, could also result in reduced operating margins.

***China's laws and regulations currently prohibit foreign-invested companies from engaging in systems integration businesses involving state secrets, which is part of the IT services business we acquired from Lenovo in 2004. China's laws and regulations also restrict certain foreign invested companies from participating in the value-added telecommunications, or VATS business. Substantial uncertainties exist with respect to our contractual arrangements with our affiliates engaged in these businesses, due to uncertainties regarding the interpretation and application of current and future China laws and regulations.***

In 2001, the State Secrecy Bureau of China promulgated the Administrative Measures for Qualification of Computer Information Systems Integration Involving State Secrets, which expressly prohibits foreign persons or foreign-invested enterprises from engaging in systems integration businesses involving state secrets, also referred to as restricted businesses.

We and our operating subsidiaries in China are considered foreign persons or foreign-invested enterprises under the laws of China. In addition to a number of other types of IT services, one of the businesses operated by the IT services division we acquired from Lenovo in 2004 was a restricted business. We operate the restricted businesses primarily through Lenovo Security Technologies (Beijing), Inc. or Lenovo Security, and Lenovo Computer System and Technology Services Limited or Lenovo Computer. When we acquired the restricted business, we intended to

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

operate the restricted business through Lenovo Security, upon Lenovo Security's receipt of all requisite business licenses and qualifications, such as the Computer Information System Integration Involving State Secrets Qualification Certificate issued by the State Secrecy Bureau of China for Protection of State Secrets. Lenovo Security has obtained most of these licenses. Since September, 2006, Lenovo Security has conducted most of our operations related to the restricted business and, consequently, generates most of our revenue derived from the restricted business.

---

**Table of Contents**

Lenovo Computer is owned by certain subsidiaries of Lenovo. Lenovo Security is owned by Legend Holdings Limited, the parent company and controlling shareholder of Lenovo, and two of our employees who are citizens of China. We do not currently have any equity interest in Lenovo Computer or in Lenovo Security, but instead enjoy economic benefits substantially similar to equity ownership in such companies through contractual arrangements among Lenovo-AsiaInfo, our wholly-owned subsidiary, and these affiliated entities and their respective shareholders.

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

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

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

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

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

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

***Regulations relating to acquisitions of Chinese companies by foreign entities may limit our ability to acquire Chinese companies and adversely affect the implementation of our acquisition strategy, and any failure by our stockholders who are China residents to make or obtain any required registrations pursuant to such regulations may subject us to legal sanctions.***

On October 21, 2005, the China State Administration of Foreign Exchange, or SAFE, issued a notice, known as Circular 75, which sets forth a new regulatory framework for acquisitions of Chinese businesses involving offshore companies. Under Circular 75, if an acquisition of a Chinese company by an offshore company controlled by Chinese residents occurred prior to the issuance of the SAFE notice, certain China residents were required to submit a registration form to the local SAFE branch to register their ownership interests in the offshore company prior

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

to March 31, 2006. Such China residents must also amend the registration form if there is a material event affecting the offshore company, such as, among other things, a change in share capital, a transfer of shares, or if such company is involved in a merger, acquisition or a spin-off transaction or uses its assets in China to guarantee offshore obligations. In the past, we have acquired a number of assets from, or equity interests in, Chinese companies through issuances of our shares of common stock to individuals who may be deemed to be China residents for the purpose of the SAFE notices. However, there is substantial uncertainty as to whether we would be considered an offshore company for purposes of Circular 75, and, at present, it is unclear whether Circular 75 requires a company such as ours to register.



---

## **Table of Contents**

As it is uncertain how the SAFE notice will be interpreted or implemented, we cannot predict how these regulations will affect our future acquisition strategies and business operations. For example, if we decide to acquire additional Chinese companies, we cannot assure you that we or the owners of such companies will be able to complete the filings and registrations, if any, required by the SAFE notice. This may restrict our ability to implement an acquisition strategy and could adversely affect our business and prospects.

In addition, six China regulatory authorities, including the China Ministry of Commerce and the Chinese Securities Regulatory Commission, or CSRC, jointly promulgated a new rule entitled Provisions regarding Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, or the New M&A Rules, effective September 8, 2006. The New M&A Rules established additional procedures and requirements that make merger and acquisition activities by foreign investors more time-consuming and complex, including, in some circumstances, advance notice to the Ministry of Commerce of any change-of-control transaction in which a foreign investor takes control of a Chinese domestic enterprise. Compliance with the New M&A Rules, and any related approval processes, including obtaining approval from the Ministry of Commerce, may delay or inhibit our ability to complete acquisitions of domestic Chinese companies, which could affect our ability to expand our business or maintain our market share.

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

Effective January 1, 2002, we adopted SFAS No. 142, which requires us, among other things, to conduct annual reviews of goodwill, and SFAS No. 144, which requires us to test intangible assets for impairment whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. In connection with our business acquisitions, we make assumptions regarding estimated future cash flows and other factors to determine the fair value of goodwill and intangible assets. In assessing the related useful lives of those assets, we have to make assumptions regarding their fair value, our recoverability of those assets and our ability to successfully develop and ultimately commercialize acquired technology. If those assumptions change in the future when we conduct our periodic reviews in accordance with applicable accounting standards, we may be required to record impairment charges.

We recorded a non-cash impairment charge of \$21.2 million as a result of an independent valuation during the fourth quarter of 2005 of the goodwill and acquired intangible assets mainly attributable to our acquisition of Lenovo's IT services business in 2004. No impairment charge was recorded in 2007. It is possible that future reviews will result in further write-downs of goodwill and other intangible assets.

### ***We are highly dependent on our executive officers.***

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

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

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

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

We customarily provide our customers with one to three year warranties, which cover both hardware and our proprietary and third-party software products. Although we seek to arrange back-to-back warranties with hardware and software vendors, we have the primary responsibility with respect to their warranties. Our contracts often lack disclaimers or limitations on liability for special, consequential and incidental damages, nor do we typically cap the amounts our customers can recover for damages. In addition, we do not currently purchase any insurance policy with respect to our exposure to warranty claims. The failure of our installed projects to operate properly could give rise to substantial liability for special, consequential or incidental damages, which in turn could materially and adversely affect us.

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

We sell most of our services on a fixed-price, fixed-time basis. In contracts with our customers, we typically agree to pay late completion fines of up to 5% of the total contract value. In large scale telecommunications infrastructure projects, there are many factors beyond our control

which could cause delays or cost overruns. In this event, we would be exposed to cost overruns and liability for late completion fines.

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

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

---

**Table of Contents**

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

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

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

A portion of our business involves the development and customization of software applications for customers. We generally retain significant ownership or rights to use and market such software for other customer projects, where possible. However, our customers sometimes retain co-ownership and rights to use the applications, processes, and intellectual property so developed. In some cases, we may have no right or only limited rights to reuse or provide these developments to projects involving other customers. To the extent that we are unable to negotiate contracts which permit us to reuse source-codes and methodologies, or to the extent that we have conflicts with our customers regarding our ability to do so, we may be unable to provide similar solutions to our other customers.

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

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

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

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

effect service of process upon those persons within the U.S.; or

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

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

Substantially all of our revenues, expenses and liabilities are denominated in either U.S. dollars or Renminbi (RMB). As a result, we are subject to the effects of exchange rate fluctuations between those currencies. On July 21, 2005, the China government changed its decade-old policy of pegging the value of the RMB to the U.S. dollar. Under the new policy, the RMB is permitted to fluctuate within a narrow and managed band against a basket of certain foreign currencies, including the U.S. dollar. This change in policy has resulted in approximately 15% appreciation of the RMB against the U.S. dollar. The China government may decide to adopt an even more flexible currency policy in the future, which could result in further and more significant appreciation of the RMB against the U.S. dollar.

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

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

We use U.S. dollars as our reporting and functional currency. The financial records of our China subsidiaries are maintained in RMB, their functional currency and the currency of China. Their balance sheets are translated into U. S. dollars based on the rates of exchange existing on the balance sheet date. Their statements of operations are translated using a weighted average rate for the period. Foreign currency translation adjustments are reflected as accumulated other comprehensive income (loss) in stockholders' equity. Fluctuation in exchange rate might result in significant foreign currency translation adjustments. We reported foreign currency translation adjustments of \$7.0 million, \$2.6 million and \$2.2 million in other comprehensive income (loss) in 2007, 2006 and 2005, respectively.

---

**Table of Contents**

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

We operate in a highly competitive environment, both in the telecommunications market and in the market for IT security services and solutions. In the telecommunications market, our competitors include both multinational and local companies such as Amdocs, Digital China, Huawei, Linkage and Neusoft. In the security products and services market, our competitors are mainly local players such as Topsec and international players such as Cisco.

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

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

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

***High technology and emerging market shares have historically experienced extreme volatility and may subject you to losses.***

The trading price of our shares may be subject to significant market volatility due to investor perceptions of investments relating to China and Asia, as well as developments in the telecommunications industry. In addition, the high technology sector of the stock market frequently experiences extreme price and volume fluctuations, which have particularly affected the market prices of many software companies and which have often been unrelated to the operating performance of those companies.

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

In the past, periods of volatility in the market price of a particular company's securities have often been followed by the institution of securities class action litigation against that company. Many companies in our industry have been subject to this type of litigation in the past, and we are currently involved in this type of litigation as a result of allegedly improper allocation procedures relating to the sale of our common stock in connection with our initial public offering in March of 2000. Litigation is often expensive and diverts management's attention and resources, which could materially and adversely affect our business.

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

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

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

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

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

issuance may make it more difficult for a third party to acquire a majority of our outstanding voting stock.

We currently have authorized the size of our board of directors to be not less than three or more than ten directors. The terms of the office of the nine-member board of directors have been divided into three classes: Class I, whose term will expire at the annual meeting of the stockholders to be held in 2009; Class II, whose term will expire at the annual meeting of stockholders to be held in 2010; and Class III, whose term will expire at the annual meeting of stockholders to be held in 2011. This classification of the board of directors may have the effect of delaying or preventing changes in our control or management.

---

## **Table of Contents**

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

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

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

### ***Failure to comply with the United States Foreign Corrupt Practices Act could subject us to penalties and other adverse consequences.***

Since we are a Delaware Corporation, we are subject to the United States Foreign Corrupt Practices Act, which generally prohibits U.S. companies from engaging in bribery or other prohibited payments to foreign officials for the purpose of obtaining or retaining business. Non-U.S. companies, including some that may compete with our company, are not subject to these prohibitions. Corruption, extortion, bribery, pay-offs, theft and other fraudulent practices may occur in China. We can make no assurance, however, that our employees or other agents will not engage in such conduct for which we might be held responsible.

If our employees or other agents are found to have engaged in such practices, we could suffer severe penalties and other consequences that may have a material adverse effect on our business, financial condition and results of operations.

### ***We are subject to potential liabilities and anticipate recurring costs in complying with the Sarbanes-Oxley Act.***

In July 2002, President George W. Bush signed the Sarbanes-Oxley Act of 2002, or the Act, into law. Among other things, the Act imposes corporate governance, reporting, and disclosure requirements; introduces stricter independence and financial expertise standards for audit committees; and sets stiff penalties for securities fraud.

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

Section 404 of the Act requires our management and our independent registered public accounting firm to assess our internal controls over financial reporting on an annual basis. During the course of this evaluation, documentation and attestation, we may identify deficiencies that we may not be able to remedy in time to meet the deadline imposed by the Act for compliance with the requirements of Section 404. If we fail to achieve and maintain the adequacy of our internal controls, we may not be able to conclude that we have effective internal controls, on an ongoing basis, over financial reporting in accordance with the Act. Moreover, effective internal controls, particularly those related to revenue recognition, are necessary for us to produce reliable financial reports and are important to help prevent fraud. As a result, our failure to achieve and maintain effective internal controls over financial reporting could result in the loss of investor confidence in the reliability of our financial statements, which in turn could harm our business and negatively impact the trading price of our common stock. Furthermore, we will incur recurring costs and expend management time and other resources necessary to comply with Section 404 and other requirements of the Act.

### ***We are exposed to certain tax risks with respect to tax benefits enjoyed by certain of our subsidiaries.***

Our subsidiaries and affiliated entities in China are subject to China taxation. Historically, as foreign invested enterprises, or FIEs, most of those subsidiaries enjoyed various tax holidays and other preferential tax treatments, which reduced their effective income tax rates to 15% or lower. On January 1, 2008, the new EIT Law, took effect and has applied a uniform 25% enterprise income tax rate to all resident enterprises in China, including FIEs. Moreover, the new tax law applies to enterprises established outside of China with management and control located in China. Although management and control is not clearly defined, because substantially all of our management are currently located in China, we may be considered a China resident enterprise and therefore may be subject to the China enterprise income tax at the rate of 25% on our worldwide

## Edgar Filing: ASIAINFO HOLDINGS INC - Form 10-Q

income. Certain of our subsidiaries in China will continue to enjoy preferential tax rates, if they are qualified as High and New Technology Enterprises under the EIT Law, but certain of our subsidiaries and affiliated entities will likely become subject to enterprise income tax at 25% as no preferential tax treatment would be applicable. This change in the China tax laws may increase our total tax expenses and adversely affect our results of operations.

### **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None.



**Table of Contents**

**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**

**(a) Exhibits**

Please see Exhibit Index.

**Table of Contents**

SIGNATURE

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

AsiaInfo Holdings, Inc.

Date: August 6, 2008

By: /s/ Eileen Chu  
Name: Eileen Chu  
Title: Chief Financial Officer

**Table of Contents**

## EXHIBIT INDEX

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

**Exhibit**

<b>Number</b>	<b>Description</b>
3.1 (1)	Certificate of Incorporation of AsiaInfo Holdings, Inc., dated September 8, 1998
3.2 (1)	Certificate of Amendment to Certificate of Incorporation of AsiaInfo Holdings, Inc., dated August 27, 1999
3.3 (2)	Certificate of Amendment to Certificate of Incorporation of AsiaInfo Holdings, Inc., dated November 15, 2000
3.4 (2)	Certificate of Correction to Certificate of Amendment to Certificate of Incorporation of AsiaInfo Holdings, Inc., dated January 18, 2001
3.5 (5)	Amended and Restated By-Laws of AsiaInfo Holdings, Inc., dated April 24, 2007
4.1 (1)	Specimen Share Certificate representing AsiaInfo Holdings, Inc. shares of common stock
10.1 (15)	Lease of AsiaInfo's headquarters at 6 Zhongguancun South Street, Beijing, China, dated October 20, 2006 (English Translation)
10.2 (4)	Master Executive Employment Agreement between AsiaInfo Holdings, Inc. and Steve Zhang dated April 1, 2004*
10.3 (4)	Change of Control Severance Agreement between AsiaInfo Holdings, Inc. and Steve Zhang dated April 1, 2004*
10.4 (7)	Acquisition Agreement between AsiaInfo Holdings, Inc. and Lenovo Group Limited dated July 27, 2004
10.5 (5)	Supplement and Amendment No.1 to Acquisition Agreement dated as of October 1, 2004
10.6 (8)	Trademark License Agreement between Bonson Information Technology Limited and Lenovo (Beijing) Limited dated October 19, 2004
10.7 (8)	Patent, Copyright and Technology License Agreement between Lenovo (Beijing) Limited, Legend Holdings Limited, Bing Yu and Zheng Wang dated October 19, 2004
10.8 (8)	Patent Assignment Agreement between Lenovo (Beijing) Limited, Legend Holdings Limited, Bing Yu and Zheng Wang dated October 19, 2004
10.9 (8)	Exclusive Business Cooperation Agreement between Lenovo-AsiaInfo Technologies, Inc. and Lenovo Computer System and Technology Services Co., Ltd. dated October 19, 2004
10.10 (8)	Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Lenovo (Beijing) Limited and Lenovo Computer System and Technology Services Co., Ltd. dated October 19, 2004
10.11 (8)	Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Lenovo Manufacturing Limited and Lenovo Computer System and Technology Services Co., Ltd. dated October 19, 2004
10.12 (8)	Equity Transfer Arrangement Agreement between Lenovo-AsiaInfo Technologies, Inc., Lenovo Group Limited, Lenovo (Beijing) Limited, Lenovo Manufacturing Limited, Lenovo Computer System and Technology Services Co., Ltd. and Bonson Information Technology Limited dated October 19, 2004
10.13 (8)	Power of Attorney executed by Lenovo (Beijing) Limited dated October 19, 2004
10.14 (8)	Power of Attorney executed by Lenovo Manufacturing Limited dated October 19, 2004
10.15 (8)	Loan Agreement between Lenovo-AsiaInfo Technologies, Inc. and Legend Holdings Limited dated October 19, 2004
10.16 (9)	AsiaInfo Holdings, Inc. 2005 Stock Incentive Plan, as amended through April 8, 2005*
10.17 (10)	Power of Attorney executed by Legend Holdings Limited dated December 2, 2004

**Table of Contents**

10.18 (10)	Exclusive Business Cooperation Agreement between Lenovo-AsiaInfo Technologies, Inc. and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004
10.19 (10)	Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Legend Holdings Limited and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004
10.20 (10)	Equity Transfer Arrangement Agreement between Lenovo-AsiaInfo Technologies, Inc., Legend Holdings Limited and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004
10.21 (10)	Loan Agreement executed by Lenovo-AsiaInfo Technologies, Inc. and Zheng Wang dated October 19, 2004
10.22 (10)	Power of Attorney executed by Zheng Wang dated December 2, 2004
10.23 (10)	Share Pledge Agreement between Lenovo-AsiaInfo Technologies, Inc., Zheng Wang and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004
10.24 (10)	Exclusive Option Agreement between Lenovo-AsiaInfo Technologies, Inc., Zheng Wang and Lenovo Security Technologies (Beijing), Inc. dated December 2, 2004*
10.25 (12)	Frame Contract by and among James Ding, Lenovo-AsiaInfo Technologies, Inc., Lenovo Security Technologies (Beijing), Inc. and Jian Qi, dated June 2, 2006
10.26 (12)	Equity Interest Transfer Agreement between James Ding and Jian Qi, dated June 2, 2006
10.27 (12)	Exclusive Option Agreement by and among Lenovo-AsiaInfo Technologies, Inc., Jian Qi and Lenovo Security Technologies (Beijing), Inc., dated June 2, 2006
10.28 (12)	Share Pledge Agreement by and among Lenovo-AsiaInfo Technologies, Inc., Jian Qi and Lenovo Security Technologies (Beijing), Inc., dated June 2, 2006
10.29 (12)	Loan Agreement between Lenovo-AsiaInfo Technologies, Inc. and Jian Qi, dated June 2, 2006
10.30 (12)	Power of Attorney executed by Jian Qi, dated June 2, 2006
10.31 (15)	Employment Contract between AsiaInfo Technologies (China), Inc. and Steve Zhang, dated December 8, 2007 (English Translation) *
10.32 (15)	Confidentiality and Non-Competition Agreement between AsiaInfo Technologies (China), Inc. and Steve Zhang, dated December 8, 2007 (English Translation) *
10.33 (13)	Master Executive Employment Agreement between AsiaInfo Holdings, Inc. and Eileen Chu dated January 1, 2007*
10.34 (13)	Change of Control Severance Agreement between AsiaInfo Holdings, Inc. and Eileen Chu dated January 1, 2007 *
10.35 (13)	Employment Contract between AsiaInfo Technologies (China), Inc. and Eileen Chu, dated January 1, 2007 (English Translation) *
10.36 (13)	Confidentiality and Non-Competition Agreement between AsiaInfo Technologies (China), Inc. and Eileen Chu, dated January 1, 2007 (English Translation) *
10.37 (13)	Employment Contract between AsiaInfo Technologies (China), Inc. and Yinhu Zhang, dated August 18, 2006 (English Translation) *
10.38 (13)	Confidentiality and Non-Competition Agreement between AsiaInfo Technologies (China), Inc. and Yinhu Zhang, dated August 18, 2006 (English Translation) *
10.39 (16)	Employment Contract between Lenovo Security Technologies (Beijing), Inc. and Jian Qi, dated February 1, 2008 (English Translation) *
10.40 (16)	Confidentiality and Non-Competition Agreement between Lenovo Security Technologies (Beijing), Inc. and Jian Qi, dated February 1, 2008 (English Translation) *

**Table of Contents**

10.41 (15)	Employment Contract between AsiaInfo Technologies (China), Inc. and Feng Liu, dated January 16, 2008 (English Translation) *
10.42 (15)	Confidentiality and Non-Competition Agreement between AsiaInfo Technologies (China), Inc. and Feng Liu, dated January 16, 2008 (English Translation) *
10.43 (6)	Master Executive Employment Agreement between AsiaInfo Holdings, Inc. and Jian Qi dated April 1, 2004*
10.44 (6)	Change of Control Severance Agreement between AsiaInfo Holdings, Inc. and Jian Qi dated April 1, 2004*
10.45 (14)	Strategic Investors Agreement dated November 29, 2006, by and among AsiaInfo Holdings, Inc., CITIC Capital MB Investment Limited and PacificInfo Limited.
24.1	Power of Attorney (included on signature page to this report)
31.1	Certification of Principal Executive Officer required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer required by Rules 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* Management contract, or compensatory plan or arrangement.

- (1) Incorporated by reference to our Registration Statement on Form S-1 (No.333-93199).
- (2) Incorporated by reference to our Annual Report on Form 10-K for the fiscal year ended December 31, 2000.
- (3) Incorporated by reference to our Quarterly Report on Form 10-Q filed on August 14, 2003.
- (4) Incorporated by reference to our Annual Report on Form 10-K for the fiscal year ended December 31, 2004.
- (5) Incorporated by reference to our Current Report on Form 8-K filed on April 25, 2007.
- (6) Incorporated by reference to our Quarterly Report on Form 10-Q filed on May 10, 2004.
- (7) Incorporated by reference to our Quarterly Report on Form 10-Q filed on August 9, 2004.
- (8) Incorporated by reference to our Quarterly Report on Form 10-Q filed on November 9, 2004.
- (9) Incorporated by reference to our Revised Proxy Statement for the 2004 Annual Meeting of Stockholders filed on April 14, 2004.
- (10) Incorporated by reference to our Quarterly Report on Form 10-Q filed on May 10, 2005.
- (11) Incorporated by reference to our Annual Report on Form 10-K filed on March 15, 2006.
- (12) Incorporated by reference to our Quarterly Report on Form 10-Q filed on August 9, 2006.
- (13) Incorporated by reference to our Annual Report on Form 10-K filed on March 14, 2007.
- (14) Incorporated by reference to our Current Report on Form 8-K filed on November 30, 2006.
- (15) Incorporated by reference to our Annual Report on Form 10-K filed on March 14, 2008, as amended.
- (16) Incorporated by reference to our Quarterly Report on Form 10-Q filed on May 8, 2008.