PACIFICNET INC
Form 10QSB
November 17, 2005

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

FORM 10-QSB

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2005

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

FOR THE TRANSITION PERIOD FROM ______ TO______
COMMISSION FILE NUMBER: 000-24985

PACIFICNET INC.

(Exact name of small business issuer in its charter)

DELAWARE (State or other jurisdiction of incorporation or organization)	91-2118007 (I.R.S. Employer Identification No.)
601 New Bright Building, 11 Sheung Yuet Road, Kowloon Bay, Kowloon, Hong Kong (address of principal Executive offices)	N/A (Zip Code)

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

UNIT 2710, HONG KONG PLAZA, 188 CONNAUGHT ROAD WEST, HONG KONG
(Former Name and Address)

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

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

There were 10,826,983 shares of the Company's common stock outstanding on September 30, 2005.

Transitional Small Business Disclosure Format (check one): YES / / NO /X/

TABLE OF CONTENTS

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

PACIFICNET INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(Unaudited. In thousands of United States dollars except par values and share numbers)

	SEPTEMBER 30, 2005 (UNAUDITED)
ASSETS	
Current Assets:	
Cash and cash equivalents	$ 4,778
Restricted cash - pledged bank deposit	369
Accounts Receivables (net of allowance for doubtful accounts of $0)	8,501
Inventories	1,749
Loans receivable from related parties	1,349
Loans receivable from third parties	1,597
Other Current Assets	4,301
TOTAL CURRENT ASSETS	22,644
Property and Equipment, net	2,422
Investments in affiliated companies and subsidiaries	1,279
Marketable equity securities - available for sale	438
Goodwill	13,449
TOTAL ASSETS	$ 40,232

LIABILITIES AND STOCKHOLDERS' EQUITY	
Current Liabilities:	
Bank Line of Credit	$ 645
Bank Loans-current portion	1,385
Capital Lease Obligations - current portion	137
Accounts Payable	2,327
Accrued Expenses and other payables	1,233
Provision for taxation	66
Due to related party	513
TOTAL CURRENT LIABILITIES	6,306
Long-term liabilities:	
Bank Loans - non current portion	16
Capital Lease Obligations - non current portion	101
TOTAL LONG-TERM LIABILITIES	117
TOTAL LIABILITIES	6,423
Minority Interests in Consolidated Subsidiaries	3,718
Commitments and Contingencies	
Stockholders' Equity:	
Preferred stock, par value $0.0001, Authorized - 5,000,000 shares Issued and outstanding - none	--
Common Stock, par value $0.0001, Authorized - 125,000,000 shares Issued and outstanding: Sep 30, 2005 - 11,961,687 issued; 10,826,983 outstanding December 31, 2004 - 10,627,737 shares issued, 9,791,583 outstanding	1
Treasury Stock, at cost - 836,154 shares	(104)
Additional Paid-In Capital	57,653
Cumulative Other Comprehensive Loss	(2)
Accumulated Deficit	(27,457)
TOTAL STOCKHOLDERS' EQUITY	30,091
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 40,232

See condensed notes to consolidated financial statements.

Page 3

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

	THREE MONTHS ENDED SEPTEMBER 30, 2005	2004	NINE 20
Revenues			
Product sales	6,040	5,477	18
Services and others	4,682	2,577	12
TOTAL REVENUES:	$ 10,722	$ 8,054	$ 30
Cost of revenues			

Product sales	(5,655)	(5,027)	(16
Services and others	(3,078)	(1,655)	(8
TOTAL COST OF REVENUES	(8,733)	(6,682)	(24
Gross profit	1,989	1,372	5
Selling, general and administrative expenses	(775)	(782)	(2
Depreciation and amortization	(133)	(74)	
Interest expenses	(54)	(53)	
EARNINGS FROM OPERATIONS	1,027	463	2
Interest income	70	6	
Other income (expense), net	256	78	
EARNINGS BEFORE INCOME TAXES AND MINORITY INTEREST	1,353	547	3
Benefit (Provision) for income taxes	14	--	
Share of income of associated companies	8	--	
Minority Interests	(764)	(411)	(1
NET EARNINGS AVAILABLE TO COMMON STOCKHOLDERS	$ 611	$ 136	$ 1
BASIC EARNINGS PER COMMON SHARE:	$ 0.06	$ 0.02	$
DILUTED EARNINGS PER COMMON SHARE:	$ 0.05	$ 0.02	$

See condensed notes to consolidated financial statements.

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

	N ENDED 2005
CASH FLOWS FROM OPERATING ACTIVITIES	
Net earnings	1,619
Adjustment to reconcile net earnings to net cash used in operating activities:	
Equity earnings (loss) of associated company	(12)
Provision for income taxes	43
Minority Interest	1,322
Depreciation and amortization	274
Accounts receivable and other current assets	(2,832)
Inventories	(452)
Accounts payable and accrued expenses	338
Net cash provided by (used in) operating activities	300

CASH FLOWS FROM INVESTMENT ACTIVITIES	
Decrease in restricted cash	3,132
Increase in purchase of marketable securities	(409)
Acquisition of property and equipment	(1,346)
Acquisition of subsidiaries	(2,022)
Acquisition of investee company	(216)
Net cash used in investing activities	(861)
CASH FLOWS PROVIDED BY FINANCING ACTIVITIES:	
Increase in loan receivables	(1,597)
Loans from related parties	(1,349)
Increase in loan from a related party	513
Advances (repayments) under bank line of credit	(7)
Increase (repayment) of amount borrowed under capital lease obligations	29
Proceeds from sale of common stock	--
Increase in share consideration post acquisition of subsidiaries	--
Repurchase of treasury shares	--
Proceeds from exercise of stock options and warrants	981
Advances under bank loans	5
Net cash provided by (used in) financing activities	(1,425)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(1,986)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	6,764
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 4,778
CASH PAID FOR:	
Interest	182
Income taxes	34
NONCASH INVESTING AND FINANCING ACTIVITIES:	
Investment in subsidiaries acquired through issuance of common stock	$ 2,762
Common stock issued as a result of exercise of stock options	--

See condensed notes to consolidated financial statements.

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-QSB. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. For further information, refer to the financial statements and footnotes thereto included in the Company's annual report on Form 10-KSB for the year ended December 31, 2004, as filed with the

SEC.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows for all periods presented have been made. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. Examples include provisions for returns and impairment losses, accounting for income taxes, bad debts, and property, plant and equipment lives for depreciation purposes. Actual results may differ from these estimates. The results of operations for the three and nine month period ended September 30, 2005 are not necessarily indicative of the operating results that may be expected for the entire year ending December 31, 2005. These financial statements should be read in conjunction with the notes to the financial statements and the Management's Discussion and Analysis included elsewhere in this report.

STOCK-BASED COMPENSATION

During the quarter ended September 30, 2005, the Company did not grant any stock options and no options were canceled, forfeited, or exercised. As of September 30, 2005, there were 1,207,100 stock options outstanding and 376,100 options exercisable. The weighted average exercise price of the options outstanding and exercisable is $3.82 and $2.12, respectively, and the weighted average remaining contractual life is 3.25 and 1.25 years, respectively.

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

	Three months ended September 30, 2005	Three months ended September 30, 2004	Nine Sep 2005
Net earnings			
As reported	$ 611	$ 136	$ 1,
Less, stock-based employee compensation cost, net of tax	--	--	(2,
Pro forma	$ 611	$ 51	$ (1,
Earnings (loss) per share			
Basic			
As reported	$ 0.06	$ 0.02	$ 0
Pro forma	$ 0.06	$ 0.01	$ (0
Diluted			
As reported	$ 0.05	$ 0.02	$ 0
Pro forma	$ 0.05	$ 0.01	$ (0

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued SFAS No. 123 (Revised 2004) "Share-Based Payment" ("SFAS No. 123R"). SFAS No. 123R addresses all forms of share-based payment ("SBP") awards, including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. SFAS No. 123R will require the Company to expense SBP awards with compensation cost for SBP transactions measured at fair value. On March 29, 2005, the SEC issued Staff Accounting Bulletin (SAB) 107 which expresses the views of the SEC regarding the interaction between SFAS No. 123R and certain SEC rules and regulations and provides the SEC's views regarding the valuation of share-based payment arrangements for public companies. In April 2005, the SEC issued a release which amends the compliance dates for SFAS No. 123R. We expect the adoption of SFAS No. 123R and SAB 107 to have a material impact on the Company's financial statements.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections". SFAS No. 154 replaces APB Opinion No. 20 "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements". SFAS No. 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. We do not expect the adoption of SFAS No. 154 to have any impact on the Company's financial statements.

2. EARNINGS PER SHARE

Basic earnings per share ("EPS") is based on the weighted average number of shares of common stock outstanding during the period. Diluted EPS is based on the weighted average number of shares of common stock outstanding plus dilutive common stock equivalents such as additional shares issued as if in-the-money options and warrants were exercised (utilizing the treasury stock method) during the period. Diluted EPS for 2005 excludes the potential dilutive effect of 500,000 warrants because their impact would be antidilutive based on current market prices. All per share and per share information are adjusted retroactively to reflect stock splits and changes in par value, when applicable.

	THREE MONTHS ENDED SEPTEMBER 30,		NI
	2005	2004	2005
Numerator-net earnings	$ 611	$ 136	$ 1,
Denominator-weighted average shares to compute basic EPS	10,826,983	7,284,615	10,171,
Basic EPS shares	10,826,983	7,284,615	10,171,
Potential dilutive from assumed exercise of stock options and warrants	918,760	517,892	859,
Denominator - weighted average number of shares	11,745,743	7,802,507	11,030,
Basic earnings per share	$ 0.06	$ 0.02	$ 0
Diluted earnings per share	$ 0.05	$ 0.02	$ 0

3. BUSINESS ACQUISITIONS

In April, 2005, the Company completed the acquisition of a controlling interest in Guangzhou 3G Information Technology Co. Ltd. ("Guangzhou3G-WOFE"), through the purchase of a 51% interest of Guangzhou3G-WOFE's parent company, Pacific 3G Information & Technology Co. Limited (Guangzhou3G-BVI), a British Virgin Islands company.

PacificNet Holdings agreed to purchase 23,050 shares (the "Sale Shares") of 3G-BVI from Asiafame International Limited, Stargain International Limited and Trilogic Investments Limited, with principle place of business located in the People's Republic of China (the "Sellers"), and directly subscribed to 3G-BVI to purchase 5,000 shares (the "Subscribed Shares").

The total consideration paid for the Sale Shares was payable as follows:

(i) USD$1,183,000 payable to the Sellers in cash within 30 days after the closing of the transaction;

(ii) USD$4,182,000, by delivery of 522,750 shares of common stock, par value $0.0001 per share (the "Common Stock") of PacificNet (the "PacificNet Shares") to the Sellers. The PacificNet Shares are to be held in an escrow account with an Escrow Agent designated by PacificNet Holdings. The first installment of the PacificNet Shares in the amount of 130,050 will be released 45 days after the closing of the transaction. The remaining installments will be released in equal installments of 98,175 shares within 30 days after the end of each quarter, including the quarter ended March 31, 2005, provided that Guangzhou 3G attains certain net income milestones by the end of each quarter. The Sellers will be entitled to receive all of the PacificNet Shares if Guangzhou 3G has achieved cumulative net income for the year ended December 31, 2005 of not less than USD$2,000,000. The Sellers appointed Tony Tong and Victor Tong, PacificNet's current CEO and President, respectively, as proxy for the Sellers for a period of 10 years with full power to vote the PacificNet Shares at all meetings of stockholders of the Registrant; and

(iii) issuance of warrants to purchase up to 100,000 shares of the PacificNet's Common Stock. The exercise price of the warrants is the 5-Day Volume Weighted Average Price of the PacificNet's Common Stock prior to March 30, 2005. The warrant is exercisable for a period of 3 years.

PacificNet Holdings subscribed to 3G-BVI to purchase an additional 5,000 shares. The total purchase price for the Subscribed Shares is USD$500,000, payable within 45 days after the delivery of (i) stock powers transferring the Sale Shares to PacificNet Holdings; (ii) stock certificates for the Sale Shares and the Subscribed Shares; (iii) an executed Subscription Agreement for the Subscribed Shares; and (iv) minutes of the Board of Directors and shareholders of Guangzhou 3G and 3G-BVI approving the transaction. Net assets acquired totaled $253,000 representing total assets acquired of $495,000 less liabilities assumed of $242,000.

PACT included the financial results of the subsidiary in its consolidated 2005 financial results from the date of the purchase April 2005 through September 30, 2005. Guangzhou3G-WOFE was set up as a wholly-owned foreign enterprise ("WOFE") in the PRC immediately prior to the acquisition and therefore no unaudited pro forma results are required.

4. STOCKHOLDERS' EQUITY

COMMON STOCK ISSUED.

For the three months ended September 30, 2005, the Company issued (i) 98,175 shares of restricted common stock in connection with acquisitions of certain subsidiaries.

For the nine months period ended September 30, 2005, the Company issued (i) 378,400 shares of restricted common stock in connection with acquisitions of certain subsidiaries and (ii) 57,000 shares of common stock as a result of exercise of options and 600,000 shares of common stock from the exercise of warrants for cash consideration totaling $981,400.

WARRANTS EXERCISED.

For the nine months ended September 30, 2005, the Company received $870,000 from Sino Mart Management Limited ("Sino Mart") as a result of Sino Mart's exercise of a warrant to purchase 600,000 shares of common stock at a price of $1.45 per share. Background of the warrant: On March 28 2002, the Company completed a $3,480,000 private placement by issuing 2,400,000 shares of common stock at a price of $1.45 per share to Sino Mart Management Limited ("Sino Mart"), whose executive director Mr. TONG Cho-Sam is the father of the chairman and CEO of the Company. In addition, the Company issued Sino Mart a warrant to purchase up to an additional 600,000 shares of common stock at $1.45 per share. The warrant is fully exercisable beginning on April 1, 2002. The $3,480,000 private placement transaction (including the 600,000 warrants) was approved at a special stockholder meeting held on March 25, 2002. (See Note 6)

Total warrants outstanding as of September 30, 2005 are 1,121,138. The weighted average remaining life is 2.72 years and the weighted average price per share is $6.99 per share.

COMMON STOCK REPURCHASE PROGRAM.

The Company's Board of Directors has approved a Corporate Stock Repurchase Program to purchase up to US$800,000 worth of outstanding shares of its common stock in open market transactions, from time to time, in compliance with Rule 10b-18 of the Securities Exchange Act of 1934 and all other applicable securities regulations. The purpose of the repurchase program is to enhance shareholder value. During the three months ended September 30, 2005, the Company did not repurchase any shares.

5. SEGMENT INFORMATION

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 separate 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. As segment reporting only occurred after the acquisition of Clickcom and GZ3G value added services (VAS) businesses, prior period's comparative information cannot be reclassified into these three business units, but have been reclassified into the operating segments by subsidiary types.

The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies. 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 income statement and total assets. Accordingly, other items such as external sales, inter-segment sales, interest revenue (expense), income tax expense (benefit), depreciation and amortization are not disclosed by segment, since this information is not used by the Company's chief operating decision making group to assess the operating performance of individual segments.

The Company's reportable segments are operating units, which represent the operations of the Company's significant business operations.

Our operations include the following three groups:

(1) Outsourcing Services: including Business Process Outsourcing (BPO), call center, IT Outsourcing (ITO) and software development services.

(2) Value-Added Telecom Services (VAS): including Interactive Voice Response (IVR), SMS and related VAS.

(3) Communication Distribution Services: including calling cards, GSM/CDMA/XiaoLingTong products, multimedia self-service Kiosks.

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

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2005 (US $000)	1. OUTSOURCING BUSINESS ($)	2.VAS BUSINESS ($)	3. COMMUNICATI DISTRIBUTION BUSINESS ($)
Revenues	3,362	2,546	4,678
Earnings (loss) before income taxes and minority interest	323	1,171	102
Total Assets	6,541	8,383	10,047

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2004 (US $000)	1. OUTSOURCING BUSINESS ($)	2. VAS BUSINESS ($)	3. COMMUNICATIO DISTRIBUTIO BUSINESS ($)
Revenues	2,545	1,489	3,988
Earnings (loss) before income taxes and minority interest	292	380	48
Total Assets	4,745	3,252	273

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2005 (US $000)	1. OUTSOURCING BUSINESS ($)	2.VAS BUSINESS ($)	3. COMMUNICATIO DISTRIBUTIO BUSINESS ($)

Revenues	9,828	7,092	13,408
Earnings (loss) before income taxes and minority interest	911	2,716	425
Total Assets	6,644	8,383	10,047

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2004 (US $000)	1. OUTSOURCING BUSINESS ($)	2.VAS BUSINESS ($)	3. COMMUNICATIO DISTRIBUTIO BUSINESS ($)
Revenues	6,847	4,270	7,793
Earnings (loss) before income taxes and minority interest	743	1,133	100
Total Assets	4,745	3,252	273

6. RELATED PARTY TRANSACTIONS

Loan receivable from related parties

As at September 30, 2005, there was a total loan receivable of US$1,349,000 due from related parties including US$795,000 due from Cheer Era (30% owned by PACT), US$192,000 due from a director of PACT's subsidiary, Soluteck, and US$362,000 due from the shareholder of Yueshen, a subsidiary of PACT. The terms of these three related parties loan receivables are below:

LOAN TO CHEER ERA

As at September 30, 2005, there was a total loan receivable of US$795,000 outstanding from Cheer Era, a 30% owned investee of PACT. The purpose of the loan was a working capital loan to finance the expansion of Cheer Era's business in Europe and North America. The repayment of this loan will be due around end of 2005 with 8% interest per annum or be due on September 30, 2006 with 7.5% interest per annum, plus 8% penalty interest in case of overdue. The loan is collateralized with 149,459 PACT shares owned by the two equity owners of Cheer Era having 70% majority stake in Cheer Era, and the remaining assets and equity ownership of Cheer Era.

LOAN TO SOLUTEK'S DIRECTOR

As at September 30, 2005, there was a loan outstanding of US$192,000 receivable from a director of Soluteck, payable in three equal installments of US$72,314 each, being principal plus interest, due on 14th of December for three consecutive years ending 2007. The interest rate for the loan is 8% per annum plus 5% penalty interest in case of overdue. The loan is collateralized with 100,000 PACT shares owned by the borrowing director and Ms Iris Lo, and the remaining assets of Smartime Holding Ltd.

LOAN TO YUESHEN'S SHAREHOLDER

As at September 30, 2005, a US$362,000 loan receivable was outstanding from the shareholder of a PACT's subsidiary, Yueshen for the purpose of repaying the working capital loan by the predecessor of Yueshen advanced prior to PACT's acquisition. This loan is collateralized with PACT shares owned by the shareholder of Yueshen.

DUE TO RELATED PARTY

As at September 30, 2005, a US$513,000 loan was outstanding from Epro to a shareholder of Epro. On August 5, 2005, US$513,000 was advanced to Epro for a period of 5 years at 6.5% interest per annum for working capital purposes.

7. GOODWILL

The Company has one class of goodwill arising from business combination resulting from the acquisitions of our subsidiaries. We currently have six (6) reporting units: Linkhead, EPRO, YueShen, Smartime/Soluteck, Clickcom-WOFE, and Guangzhou 3G-WOFE for the purpose of goodwill assessment. We determine our reporting units if the entity constituted a business, financial information was available, and segment management can regularly review the operating results of that component. We allocated goodwill amongst the reporting units based on the consideration paid in shares and cash minus the proportional share of the fair value of net assets and liabilities at the time of acquisition specific to each reporting unit. The fair value of each reporting unit represents the amount at which the unit as a whole could be bought or sold in a current transaction between willing parties in an open marketplace.

The total carrying amount of goodwill recorded on the balance sheet at September 30, 2005 is US$13,449,000 and the changes in the carrying amount of goodwill for the following reporting periods are summarized below:

(US$000s)	VAS	Outsourcing	Dist Com
Balance as of December 31, 2003	$ (147)	$ 567	
Goodwill acquired during the year	4,416	2,976	
Impairment losses	--	--	
Goodwill written off related to sale of business unit	--	--	
Balance as of December 31, 2004	4,269	3,543	
Goodwill acquired during the 3 months	220	--	
Impairment losses	--	--	
Goodwill written off related to sale of business unit	--	--	
Balance as of March 31, 2005	4,489	3,543	
Goodwill acquired during the3 months	3,516	--	
Impairment losses	--	--	
Goodwill written off related to sale of business unit	--	--	
Balance as of June 30, 2005	$ 8,005	$ 3,543	
Increase in goodwill due to contingent consideration earned by subsidiary	801		
Balance as of September 30, 2005	$ 8,806	$ 3,543	

We have assessed the need to record impairment losses on our goodwill assets at least annually or when an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Our assessment includes using a combination of qualitative/quantitative analyses such as DCF/PE multiples based on 5 year profit forecasts, and published comparables, where applicable. Management concluded that there have been no material adverse changes on the operating environments during the reporting periods that would have otherwise affected the carrying value of the goodwill. In addition, there has been no disposal of any reporting subsidiaries and, as a result, no gain or loss is recognized during those reporting periods.

8. MARKETABLE SECURITIES

The total carrying amount of marketable securities recorded on the balance sheet at September 30, 2005 is US$438,000 and the changes in the carrying amount of marketable securities for the following reporting periods are summarized below:

	Amount in (US$000s)
Balance as of December 31, 2004	$ 29
Marketable securities purchased during 2Q05	409
Cost as at September 30, 2005	438
Unrealised gains or (losses)	--
Balance as of September 30, 2005	438

9. INCOME TAXES

The Company is subject to US federal income taxes, Hong Kong profits tax, and the People's Republic of China income taxes.

- The Company has a loss position generated by the parent company and is not subject to U.S. income tax.
- The Company's subsidiaries which are based in the People's Republic of China ("PRC") are governed by the Income Tax Law of the PRC concerning Foreign Investment Enterprises ("FIEs") and Foreign Enterprises and various local income tax laws (the "Income Tax Laws"). Under the Income Tax Laws, FIEs generally are subject to an income tax at an effective rate of 33% (30% state income taxes plus 3% local income taxes) on incomes reported in the statutory financial statements after appropriate tax adjustments, unless the enterprise is located in a specially designated region for which more favorable effective tax rates are applicable at a reduced rate of 15%. The subsidiaries operating in the PRC are exempted from income taxes in the first and second years and allowed a fifty percent reduction in the standard tax rates in the third to fifth years. The Company is not subject to any local income tax of 3% until the exemption and reduction periods expire. Ultimately, for Chinese income tax purposes, the tax position of the Company must be approved by the appropriate Chinese taxing authority. The first year the Company's PRC entities will be subject to income tax is 2006,assuming taxable profits are achieved.
- For the Company's entities that are based in Hong Kong the subsidiaries are subject to Hong Kong profits tax at a rate of 17.5%. The Company has net operating loss carryforwards of approximately $2.2M that are available as at the year ended December 31, 2004 to offset future taxable income in Hong Kong.

No tax benefits have been recorded related to the loss carryforwards generated by the Company or any or it subsidiaries as management is uncertain as to the likelihood of their realization.

Based on management best estimates, a tax provision estimate of approximately $43,000 was made for the nine months ended September 30, 2005, as a result of increasing profit before taxes for certain subsidiaries located in the PRC. Interim estimates are subject to change as the year progresses and more information becomes available.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

PRELIMINARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

In addition to historical information, the matters discussed in this Form 10-QSB contain forward-looking statements that involve risks or uncertainties. Generally, the words "believes," "anticipates," "may," "will," "should," "expect," "intend," "estimate," "continue," and similar expressions or the negative thereof or comparable terminology are intended to identify forward-looking statements. Such statements are subject to certain risks and uncertainties, including the matters set forth in this report or other reports or documents we filed with the Securities and Exchange Commission from time to time, which could cause actual results or outcomes to differ materially from those projected. Undue reliance should not be placed on these forward-looking statements, which speak only as of the date hereof. We undertake no obligation to update these forward-looking statements. Readers should carefully review the risks described in other documents we filed from time to time with the Securities and Exchange Commission, including the Annual Report on Form 10-KSB for the fiscal year ended December 31, 2004, the Quarterly Reports on Form 10-QSB filed by the Company and Current Reports on Form 8-K (including any amendments to such reports). References in this filing to the "Company", "Group", "we", "us", and "our" refer to PacificNet Inc. and its subsidiaries.

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued SFAS No. 123 (Revised 2004) "Share-Based Payment" ("SFAS No. 123R"). SFAS No. 123R addresses all forms of share-based payment ("SBP") awards, including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. SFAS No. 123R will require the Company to expense SBP awards with compensation cost for SBP transactions measured at fair value. On March 29, 2005, the SEC issued Staff Accounting Bulletin (SAB) 107 which expresses the views of the SEC regarding the interaction between SFAS No. 123R and certain SEC rules and regulations and provides the SEC's views regarding the valuation of share-based payment arrangements for public companies. In April 2005, the SEC issued a release which amends the compliance dates for SFAS No. 123R. We expect the adoption of SFAS No. 123R and SAB 107 to have a material impact on the Company's financial statements.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections". SFAS No. 154 replaces APB Opinion No. 20 "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements". SFAS No. 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. We do not expect the adoption of SFAS No. 154 to have any impact on the

Company's financial statements.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

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

ALLOWANCE FOR DOUBTFUL ACCOUNTS

We evaluate the collectibility of our trade receivables based on a combination of factors. We regularly analyze our significant customer accounts, and, when we become aware of a specific customer's inability to meet its financial obligations to us, such as in the case of bankruptcy filings or deterioration in the customer's operating results or financial position, we record a specific reserve for bad debt to reduce the related receivable to the amount we reasonably believe is collectible. We also record reserves for bad debt for all other customers based on a variety of factors including the length of time the receivables are past due, the financial health of the customer, macroeconomic considerations and historical experience. If circumstances related to specific customers change, our estimates of the recoverability of receivables could be further adjusted. In the event that our trade receivables become uncollectible, we would be forced to record additional adjustments to receivables to reflect the amounts at net realizable value. The accounting effect of this entry would be a charge to income, thereby reducing our net profit. Although we consider the likelihood of this occurrence to be remote based on past history and the current status of our accounts, there is a possibility of this occurrence.

INCOME TAXES

We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. We have considered future market growth, forecasted earnings, future taxable income, and prudent and feasible tax planning strategies in determining the need for a valuation allowance. We currently have recorded a full valuation allowance against net deferred tax assets as we currently believe it is more likely than not that the deferred tax assets will not be realized.

CONTINGENCIES

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

VALUATION OF LONG-LIVED ASSETS INCLUDING GOODWILL AND PURCHASED INTANGIBLE ASSETS

We review property, plant and equipment, goodwill and purchased intangible assets for impairment at least annually or whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. Our asset impairment review assesses the fair value of the assets based on the future cash flows the assets are expected to generate. An impairment loss is recognized when estimated undiscounted future cash flows expected to result from the use of the asset plus net proceeds expected from disposition of the asset (if any) are less than the carrying value of the asset. This approach uses our estimates of future market growth, forecasted revenue and costs, expected periods the assets will be utilized and appropriate discount rates. Such evaluations of impairment of long-lived assets including goodwill arising on a business combination and purchased intangible assets are an integral part of, but not limited to, our strategic reviews of our business and operations performed in conjunction with restructuring actions. When an impairment is identified, the carrying amount of the asset is reduced to its estimated fair value. Deterioration of our business in a geographic region or within a business segment in the future could also lead to impairment adjustments as such issues are identified. The accounting effect of an impairment loss would be a charge to income, thereby reducing our net profit.

NATURE OF THE OPERATIONS OF THE COMPANY

NATURE OF BUSINESS

We were incorporated in the state of Delaware in 1987. Our business consists of three groups, all of which operate within the outsourcing and telecommunications industries in China, which includes the People's Republic of China (PRC), or mainland China, Hong Kong Special Administrative Region (HKSAR), and Macau Special Administrative Region. We intend to continue to grow our business by acquiring and managing growing technology and network communications businesses with established products and customers in China. Our current subsidiaries are grouped into the following three divisions providing various voice focused telecom services:

(1) Outsourcing Services [Human Voice Service]: including Business Process Outsourcing (BPO), CRM, call center, IT Outsourcing (ITO) and software development services. PacificNet's Outsourcing Services Group includes the following subsidiaries: PacificNet Epro, Smartime (aka Soluteck Shenzhen), and PacificNet Solutions. Our business process outsourcing services generate revenues from call center services, call center management software sales, and training and consulting. We invoice our call center clients monthly at per seat monthly rates, a base price plus commission per call, or a per hour charge rate, depending on the customer's preference. Our call center software clients pay per license, for which there is usually a one-time charge on sale of the software and annual maintenance fees for service. We charge per project for our consulting and training services and for our telecom VAS, which are invoiced throughout the project.

(2) Value-Added Telecom Services (VAS) [Machine Voice Service]: including Interactive Voice Response (IVR), SMS and related VAS. PacificNet's VAS Group includes the following subsidiaries: Linkhead, Clickcom, and Guangzhou 3G (aka

Sunroom). Our telecom VAS often includes a post-sale service contract for systems integration and consulting services for which we bill separately.

(3) Communication Products Distribution Services Group [Voice Product Distribution Service]: including calling cards, GSM/CDMA/XiaoLingTong products, and multimedia self-service entertainment kiosks. This group includes the following subsidiaries: PacificNet Communications, Yueshen, and Cheer Era. Our calling card and related mobile telecom products are mostly sold cash-on-delivery.

Our clients include the leading telecom operators, banks, insurance, travel, marketing, and service companies, as well as telecom consumers, in Greater China. Clients include China Telecom, China Netcom, China Mobile, China Unicom, PCCW, Hutchison Telecom, CSL, SmarTone, Sunday, Swire Travel, Coca-Cola, SONY, Samsung, TNT Express, Huawei, TCL, Dun & Bradstreet, American Express, Bank of China, DBS, Hong Kong Government, and Hongkong Post. Headquartered in Hong Kong and Minneapolis USA, PacificNet employs over 1,400 staff in its various subsidiaries in China with offices in Beijing, Shenzhen, Guangzhou, Shandong, and 27 provinces in China.

During the third fiscal quarter ended September 30, 2005, we have continued to win business from high-profile Chinese and multinational companies conducting business in China such as China Mobile, China Unicom, China Telecom, Bank of China, Ping An Insurance, TCL, TNT Express, Watsons, Hutchison, etc. All of our business units remain productive, and we continue to focus on penetrating the CRM and VAS/IVR markets through organic growth and via acquisition. With the launch of the 'iPACT' IVR-Alliance program, we hope to sign up new local IVR service providers to join our unified brand and IVR content and service offerings, under a chain of unified service standard under the iPACT brand. We believe this segment will contribute to revenue growth, market share improvement, and stronger partnerships with all the major telecom operators and local IVR service providers in China. We believe that our fundamentals are good and that market opportunities for growth and profitability in China's CRM and VAS sector are vast.

THE FOLLOWING ARE SOME OF THE HIGHLIGHTS IN THE THIRD QUARTER AND EVENTS SUBSEQUENT TO THE END OF THE THIRD QUARTER:

* "iPACT" VAS Alliance Program

In July, PacificNet announced the launch of a new IVR-Alliance program called "iPACT" at the 2005 Voice Value-added Service (VAS) Conference. Under this iPACT program, PacificNet plans to sign up qualified Voice-VAS and IVR service providers as profit sharing partners in China under a unified brand "iPACT". PacificNet will provide to qualified VAS-Alliance partners, on a profit sharing basis, all of the hardware, software, application, and content for VAS, including a variety of IVR and other wireless and fixed-line VAS content, including color ring back tone services, background music services, VICQ mobile instant messaging services, sports news, weather forecasts, stock market, humor, songs and mobile karaoke, mobile TV, games, entertainment, as well as community-oriented services, such as chatline and dating services. Mobile and fixed-line phone users can access PacificNet's VAS-Alliance services through Guangzhou 3G presence in 26 provinces in China. PacificNet and its subsidiary Guangzhou 3G are working together in rolling out the pilot test for iPACT, and have signed up five iPACT partners as early pilot sites covering the following regions: Shenzhen, Yantai, Zhenzhou, Guizhou and Shangdong.

* Hitching International Acquisition Status

On October 3, PacificNet announced that it had entered into an agreement to acquire a majority and controlling interest in Hitching International Corporation ("HIC"). Through its subsidiary in Shenzhen China, HIC operates one of the leading Direct Response Television (DRTV) infomercial marketing companies for financial advisory services in China. HIC is headquartered in Shenzhen China with more than 600 employees in its DRTV infomercial telemarketing call center. The DRTV call center, with about 400 phone lines, occupies about 35,000 sq. feet. PacificNet is currently in the process of due diligence of legal, regulatory and financial information to be reviewed.

* Nasdaq National Market Listing

On October 6, PacificNet's common stock listing was transferred from the NASDAQ SmallCap to the NASDAQ National Market. Management believes that this move may increase liquidity and visibility of PacificNet's common stock within the investment community.

* Call Center Expansion in Guangzhou China

Due to the recent increase in the demand for telemarketing and call center services, PacificNet Epro announced in October the purchase of a new 250-seat call center facility in China, to support the rapidly growing business of the company. The new contact center is located in a Grade-A office building in Guangzhou, occupying one floor with over 18,000 sq. ft. This new site will supplement the existing 400-seat, 800-agents call center facility in Hong Kong, which has been operating at or above full capacity for the past year. The combined Hong Kong-China operation will expand Epro's total call center capacity to 650 seats and over 1,200 agents, serving existing and new clients in both Hong Kong and mainland China.

PacificNet Epro believes that the contact center expansion in Guangzhou may lead to annual revenue growth in the coming years. Furthermore, the new facility in China should lead to growth in profit margin because the labor cost and office facility is less than half of the cost in Hong Kong. To date, PacificNet Epro has invested RMB 10 million for the initial set up of the new Guangzhou contact center site and plans to invest another RMB 10 million for a second stage expansion.

On October 19, PacificNet announced that its PacificNet Epro ("Epro") subsidiary has acquired a 70% ownership interest in Guangzhou JunFeng Network Technology Co. Ltd. (JunFeng). The purchase price will be paid for via PacificNet Epro's existing cash. The acquisition is expected to be reflected in PacificNet Epro's 2006 earnings. JunFeng is a call center and value-added telecom service provider based in Guangzhou that owns various Value-Added Services (VAS) and call center licenses. These licenses are instrumental for PacificNet to develop contact center business in China. A wide array of supporting services are provided, including professional inbound services, outbound services, facilities management and IVRS support services, to meet clients' diversified needs.

SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

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

We prepare our consolidated financial statements in accordance with U.S. 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, we evaluate our estimates and assumptions, including those related to revenues and cost of revenues under customer contracts, warranty obligations, bad debts, income taxes, goodwill and other intangible assets, and litigation. We base our estimates and assumptions 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 assumptions and estimates used in the preparation of our consolidated financial statements.

FOREIGN EXCHANGE

A majority of our call center services revenues and expenses relating to hardware sales are denominated in Hong Kong dollars, and substantially all of our revenues and expenses relating to the value added services (VAS) components of our business are denominated in Renminbi. The value of our shares will be affected by the foreign exchange rate between U.S. dollars and Renminbi because the value of our business is effectively denominated in Renminbi, while our shares are traded in U.S. dollars. Furthermore, an increase in the value of the Renminbi may require us to exchange more U.S. dollars into Renminbi 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 Renminbi and the U.S. dollar when we believe such adjustments will reduce our foreign exchange risks.

REVENUE RECOGNITION

We generate revenues from four primary sources: call center software, business services, mobile services and applications, and call center and telemarketing services. We recognize revenue in accordance with US GAAP. The specific literature that we follow in connection with revenue recognition is the Securities and Exchange Commission's Staff Accounting Bulletin No. 104 Revenue Recognition, the American Institute of Certified Public Accountants Statement of Position ("SOP") 97-2, Software Revenue Recognition, as amended by SOP 98-9 Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions, FASB Emerging Issues Task Force ("EITF") 00-21, Revenue Arrangements with Multiple Deliverables, and in certain instances EITF No. 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent and SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts.

We recognize revenue when there is persuasive evidence of an arrangement, the product has been shipped and title has passed or the services have been delivered, the price is fixed or determinable and collectibility is probable. If an acceptance period is required, we recognize revenues upon the earlier of customer acceptance or the expiration of the acceptance period. Our agreements with customers, resellers and distributors do not contain product return rights. If the fee is not fixed or determinable due to the existence of extended payment terms, revenue is recognized periodically as payments become due, provided all other conditions for revenue recognition are met.

RESULTS OF OPERATIONS

The following table sets forth selected statement of operations data as a percentage of revenues for the periods indicated.

	QUARTER ENDED SEPTEMBER 30, 2005	QUARTER ENDED SEPTEMBER 30, 2004	NINE SEPT
Revenues	100%	100.0%	
Cost of Revenues	(81.4%)	(83.0%)	
Gross Margin	18.6%	17.0%	
Selling, general and administrative expense	(7.2%)	(9.7%)	
Depreciation and amortization	(1.3%)	(0.9%)	
Interest expenses	(0.5%)	(0.7%)	
Earnings from operation	9.6%	5.7%	
Interest income	0.7%	0.1%	
Other income net	2.3%	1.0%	
Earnings before income taxes and minority interests	12.6%	6.8%	
Provision for income taxes	0.1%	0.0%	
Share of income of associated companies	0.1%	0.0%	
Minority interest	(7.1%)	(5.1%)	
Net earning	5.7%	1.7%	

THREE MONTHS ENDED SEPTEMBER 30, 2005 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2004

REVENUES. Revenues for the three months ended September 30, 2005 were

$10,722,000, an increase of $2,668,000 from $8,054,000 for the three months ended September 30, 2004. The increase in revenues is primarily due to the increased business as a result of the acquisition of Guangzhou 3G completed in April 2005. Several of our businesses experience fluctuations in quarterly performance. Traditionally, the first quarter from January to March is a low season for our call center business due to the long Lunar New Year holidays in China. Revenues from the VAS and IVR segment can vary from quarter to quarter due to new product launches and the seasonality of certain product lines. For the three months ended September 30, 2005, revenues of $3,362,000 (2004: $1,489,000), $2,546,000 (2004: $2,545,000), and $4,677,000 (2004: $3,988,000) were derived from the services rendered by the Company's three operating units, which include the following three groups:

(1) Outsourcing Services: including Business Process Outsourcing (BPO), call center, IT Outsourcing (ITO) and software development services.

(2) Value-Added Telecom Services (VAS): including Interactive Voice Response (IVR), SMS and related VAS.

(3) Communication Distribution Services: including calling cards, GSM/ CDMA/ XiaoLingTong products, multimedia self-service Kiosks.

Summarized financial information concerning each of our main operating units is set forth in the following table. The "Admin & Other" column included our other insignificant subsidiaries and corporate related items.

FOR THE PERIOD ENDED SEPTEMBER 30, 2005	1.Outsourcing Business ($)	2.VAS Business Distribution ($)	3.Communications Distribution Business ($)	Admin
Revenues	3,362,000	2,546,00	4,678,000	
Earings (loss) before income taxes and minority interests	323,000	1,171,000	102,000	

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2004	1.Outsourcing Business ($)	2.VAS Business ($)	3.Communications Distribution Business ($)	Admin &
Revenues	2,545,000	1,489,000	3,988,000	
Earings (loss) before income taxes and minority interests	292,000	397,000	48,000	

COST OF REVENUES. Cost of revenues for the three months ended September 30 was $8,733,000, an increase of $2,051,000 from $6,682,000 for the three months ended September 30, 2004. The increase is directly associated with the corresponding increase in costs related to the increased business due to the acquisition of

Guangzhou 3G.

GROSS PROFIT. Gross profit for the three months ended September 30 was $1,989,000, an increase of $617,000 from $1,372,000 for the three months ended September 30, 2004. Gross margin for the three months ended September 30, 2005 was 19% of total revenues compared to 17% for the same period in 2004. We believe that our gross margin overall approximates the industry standards. The improvement on gross margins for both from the prior periods was primarily due to higher margin acquisitions added to PACT in the first and second quarters of 2005, such as PACT 3G and Clickcom, both WOFEs are set up with revenues net of operating costs from the PRC operating entities. In addition, the proportionate increase of high-margin investees in Groups (1) outsourcing services and Group (2) VAS services have outgrown the 2-5% of low-margin investees under Group (3) Communication Distribution Services for both quarters.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Selling, general and administrative expenses, including depreciation and amortization, totaled $962,000 for the three months ended September 30, 2005, an increase of $53,000, from $909,000 for the three months ended September 30, 2004. This increase resulted from increasing the size of our operations, which included increased premises costs and staff costs.

INCOME TAXES. Interim income tax provisions are based upon management's estimate of taxable income and the resulting consolidated effective income tax rate for the full year. As a result, such interim estimates are subject to change as the year progresses and more information becomes available.

MINORITY INTERESTS. Minority interests for the three months ended September 30, 2005 totaled $(764,000), compared with $(411,000) for the same period in the prior year. The increase is due to an increase in the number of our subsidiaries which resulted in a greater number of outside ownership interests consolidated with the parent for financial reporting purposes.

NINE MONTHS ENDED SEPTEMBER 30, 2005 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2004

REVENUES. Revenues for the nine months ended September 30, 2005 were $30,607,000, an increase of $10,967,000 from $19,640,000 for the nine months ended September 30, 2004. As a contrast to prior period revenue, contributions by Epro, Linkhead, and Yueshen, in the aggregate, were 95% of total revenues. Revenues for the nine months ended September 30, 2005 were mainly derived from the following 3 sources:

s(a) Newly acquired subsidiaries in Group (1) Outsourcing Services such as Smartime has added approximately $2.8 million to nine months ended September 30, 2005 as compared to the same period in the prior year;

(b) Newly acquired subsidiary in Group (2) Value-added Telecom Services, such as PACT 3G and Clickcom, have together added approximately $2.3 million revenues in the nine months ended September 30, 2005 as compared to the same period in the prior year; and

(c) The remaining incremental revenues for nine months ended September 30, 2005 as compared to prior period were derived from growth from existing subsidiaries such as Yue Shen (Group 3), Linkhead (Group 2), EPRO (Group 1) and PACT Communications for $3.3m, $0.5m , $0.1m and $1.5m respectively.

COST OF REVENUES. Cost of revenues for the nine months ended September 30, 2005 was $24,753,000, an increase of $9,029,000 from $15,724,000 for the nine months ended September 30, 2004. This increase is directly associated with the costs related to the increased business due to the acquisition of the newly acquired subsidiaries.

GROSS MARGIN AND GROSS MARGIN RATIO. Gross margin for the nine months ended September 30, 2005 was $5,854,000, an increase of $1,938,000 from $3,916,000 for the nine months ended September 30, 2004. As explained above, the improvement on gross margins for both three months and nine months periods from the prior periods was primarily due to higher margin acquisitions added to PACT during the first and second quarters of 2005, such as PACT 3G and Clickcom; both WOFEs are set up with revenues net of operating costs from the PRC operating entities. In addition, the proportionate increase of high-margin investees in groups (1) outsourcing services and group (2) VAS services have outgrown the 2-5% of low-margin investees under group (3) Communication Distribution Services for both quarters. Group (3) as contributor to the overall gross margin contributor has been decreasing for the nine months ended September 30, 2005 as compared to the prior period.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Selling, general and administrative expenses, including depreciation and amortization, totaled $2,987,000 for the nine months ended September 30, 2005, an increase of $286,000, from $2,701,000 for the nine months ended September 30, 2004. This increase resulted from increasing the size of our operations, which included increased premises costs and staff costs, mainly attributable to the operations of Epro, Linkhead, Yueshen and Smartime.

OTHER INCOME. Other income was $732,000 for the nine months ended September 30, 2005, as compared to $152,000 for the nine months ended September 30, 2004, primarily due to non-operating gains from sale of properties and interest income during the first nine months of 2005.

OTHER INCOME (EXPENSE) For the nine months ended September 30, 2005, non-operating income or sundry income included in the Statement of Operations was mainly derived from gains from sales of real estate properties of approximately$120,000, gains from investment of securities $113,000, other income from system integration services of approximately $287,000, and other miscellaneous income.

EQUITY EARNINGS IN UNDISTRIBUTED EARNINGS OF INVESTEE COMPANY. The Company recorded $12,000 in equity earnings in its investee company for the nine month ended September 30, 2005 compared with $nil for the same period in the prior year, derived primarily from 30%-owned investee, Cheer Era Limited, which was acquired in April 2004.

INCOME TAXES. A tax provision estimate of approximately $43,000 was made for the nine months ended September 30, 2005, as a result of increasing profit before taxes for some of the subsidiaries based on management best estimates. Interim estimates are subject to change as the year progresses and more information becomes available.

MINORITY INTEREST. Share of earnings by minority interest for the nine months ended September 30, 2005 was $1,949,000, as compared with $1,062,000 for the same period in the prior year representing increased sharing of earnings by newly acquired subsidiaries such as PACT 3G, Clickcom, Smartime since September 30, 2004.

LIQUIDITY AND CAPITAL RESOURCES

CASH AND CASH EQUIVALENTS. As of September 30, 2005, the Company had cash and cash equivalents of $4,778,000 as compared to $6,764,000 at December 31, 2004.

WORKING CAPITAL. The Company's working capital increased to $16,338,000 at September 30, 2005, as compared to $16,185,000 at December 31, 2004. When compared to balances at December 31, 2004, the increase in working capital at September 30, 2005 was due to cash proceeds received for the exercise of options and warrants of approximately $981,000 offset by consideration paid for the acquisition of Clickcom and Guangzhou 3G.

NET CASH FROM OPERATING ACTIVITIES. Net cash raised in operating activities was $300,000 for the nine months ended September 30, 2005 as compared to net cash used in operating activities of $871,000 for the nine months ended September 30, 2004. The decrease in net cash used in operating activities in the nine months ended September 30, 2005 was primarily due to increase in earnings for the period ended September 30, 2005. Net cash used in operating activities of $871,000 for the nine months ended September 30, 2004, resulted primarily from net earnings of $328,000, increased by non-cash items totaling $1,813,000 and decreased by changes in operating assets of $3,012,000.

NET CASH FROM INVESTING ACTIVITIES. Net cash used in investing activities was $861,000 for the nine months ended September 30, 2005 compared to $3,584,000 for the comparative prior period. Net cash used in investing activities in the nine months ended September 30, 2005 was primarily due to the acquisition of Guangzhou 3G and Clickcom for $2,022,000 and the acquisition of property and equipment for $1,346,000 offset by a decrease in restricted cash of $3,132,000 and purchases of marketable securities of $409,000. Net cash used in investing activities for the nine months ended September 30, 2004 was $3,854,000 representing the acquisition of subsidiary companies, interest in investee company, and property and equipment of $1,302,000, $385,000 and $1,039,000, respectively. The additions to property and equipment were a result of the expansion of the CRM and call center business in Hong Kong.

NET CASH FROM FINANCING ACTIVITIES. Net cash used in financing activities for the nine months ended September 30, 2005 was $1,425,000 representing funds advanced from related parties and other loan receivables of $2,433,000 offset by funds raised from the exercise of stock options and warrants totaling $981,000. Net cash provided by financing activities for the nine months ended September 30, 2004 was $2,877,000 representing net proceeds from issuance of common stock of $2,813,000, net proceeds from shares issued to certain sellers in the post-acquisition of subsidiaries for payments made to sellers to finance the acquisitions of $564,000, net cash proceeds received from the exercise of stock options of $74,000 and advances under bank loans of $1,990,000, offset by repayments on debt of $2,465,000 and repurchase of treasury shares of $99,000.

RELATED PARTY TRANSACTIONS:

LOAN RECEIVABLE FROM RELATED PARTIES

As at September 30, 2005, there was a total loan receivable of US$1,349,000 due from related parties including US$795,000 due from Cheer Era (30% owned by PACT), US$192,000 due from a director of PACT's subsidiary, Soluteck, and US$362,000 due from the shareholder of Yueshen, a subsidiary of PACT. The terms of these three related parties loan receivables are below:

LOAN TO CHEER ERA

As at September 30, 2005, there was a total loan receivable of US$795,000 outstanding from Cheer Era, a 30% owned investee of PACT. The purpose of the loan was a working capital loan to finance the expansion of Cheer Era's business in Europe and North America. The repayment of this loan will be due at the end of 2005 with 8% interest per annum or be due on September 30, 2006 with 7.5% interest per annum, plus 8% penalty interest in case it has not been timely paid. The loan is collateralized with 149,459 PACT shares owned by the two equity owners of Cheer Era having 70% majority stake in Cheer Era, and the remaining assets and equity ownership of Cheer Era.

LOAN TO SOLUTEK'S DIRECTOR

As at September 30, 2005, there was a loan outstanding of US$192,000 receivable from a director of Solutek, payable in three equal installments of US$72,314 each, being principal plus interest, due on December 14 for three consecutive years ending 2007. The interest rate for the loan is 8% per annum plus 5% penalty interest in case it has not been timely paid. The loan is collateralized with 100,000 PACT shares owned by the borrowing director and Ms Iris Lo, and the remaining assets of Smartime Holding Ltd.

LOAN TO YUESHEN'S SHAREHOLDER

As at September 30, 2005, a US$362,000 loan receivable was outstanding from the shareholder of a PACT's subsidiary, Yueshen for the purpose of repaying the working capital loan by the predecessor of Yueshen advanced prior to PACT's acquisition. This loan is collateralized with PACT shares owned by the shareholder of Yueshen.

LOAN PAYABLE TO RELATED PARTY

As at September 30, 2005, a US$513,000 loan was outstanding from Epro to a shareholder of Epro. In August 2005, US$513,000 was advanced to Epro for a period of 5 years at 6.5% interest per annum for working capital purposes.

COMMON STOCK - EXERCISE OF WARRANTS

On March 28 2002, we completed a $3,480,000 private placement by issuing 2,400,000 shares of common stock at a price of $1.45 per share to Sino Mart Management Limited ("Sino Mart"), whose executive director Mr. TONG Cho-Sam is the father of the chairman and CEO of the Company. In addition, the Company issued Sino Mart a warrant to purchase up to an additional 600,000 shares of common stock at $1.45 per share. The warrant is fully exercisable beginning on April 1, 2002. The $3,480,000 private placement transaction (including the 600,000 warrant) was approved at a special stockholder meeting held on March 25, 2002. For the nine months ended September 30, 2005, we received $870,000 from Sino Mart Management Limited ("Sino Mart") as a result of Sino Mart's exercise of a warrant to purchase 600,000 shares of common stock at a price of $1.45 per share.

INFLATION. Inflation has not had a material impact on the Company's business in recent years.

CURRENCY EXCHANGE FLUCTUATIONS. All of the Company's revenues are denominated either in U.S. dollars or Hong Kong dollars, while its expenses are denominated primarily in Hong Kong dollars and Renminbi ("RMB"), the currency of the People's Republic of China. The value of the RMB-to-U.S. dollar or Hong Kong dollar-to-United States dollar and other currencies may fluctuate and is affected by, among other things, changes in political and economic conditions. Since 1994, the conversion of Renminbi into foreign currencies, including U.S. dollars, has been based on rates set by the People's Bank of China, which are set daily based on the previous day's interbank foreign exchange market rates and current exchange rates on the world financial markets. Since 1994, the official exchange rate generally has been stable. Recently there has been increased political pressure on the Chinese government to decouple the RMB from the United States dollar. Although a devaluation of the Hong Kong dollar or RMB relative to the United States dollar would likely reduce the Company's expenses (as expressed in United States dollars), any material increase in the value of the Hong Kong dollar or RMB relative to the United States dollar would increase the Company's expenses, and could have a material adverse effect on the Company's business, financial condition and results of operations. The Company has never engaged in currency hedging operations and has no present intention to do so.

On July 21, 2005, the Chinese government changed its policy of pegging the value of the Renminbi to the U.S. dollar. This revaluation of the Renminbi is based on a conversion of Renminbi (RMB) into United States dollars (USD) at an exchange rate of USD1.00 = RMB8.11. Under the new policy, the Renminbi will be permitted to fluctuate within a band against a basket of certain foreign currencies. This change in policy resulted initially in an approximately 2.0% appreciation in the value of the Renminbi against the U.S. dollar and could result in further and more significant appreciations. Although the Company generates substantially all of its revenues in Renminbi which has become more valuable in U.S. dollar terms, the Company's U.S. dollar cash deposits are subject to foreign currency translations which will impact net income.

For the financial figures stated in this Form 10-QSB, the conversion of Renminbi (RMB) into U.S. dollar (USD) is based on USD1.00=RMB8.268. Therefore, the conversion rate is based on the rate prior to the Renminbi revaluation on July 21, 2005. As management believes that the net effect for the difference between the interim exchange rate and the conversion rate stated in this Form 10-QSB is not material, the foreign currency translation will be revisited as at the year ending December 31.

There is a risk that fluctuations in the value of the Renminbi with respect to other currencies could adversely affect our business and financial results.

OFF-BALANCE SHEET ARRANGEMENTS. We had no outstanding derivative financial instruments, off-balance sheet guarantees, interest rate swap transactions or foreign currency forward contracts. We did not engage in trading activities involving non-exchange traded contracts during 2005.

CONTRACTUAL OBLIGATIONS.

We have significant cash resources to meet our contractual obligations as of September 30, 2005, as detailed below:

Contractual Obligations	Total	1 year	1-3 years	4-5 year
Line of credit	$ 645,000	$ 645,000	--	
Bank Loans	$1,401,000	$1,385,000	$ 16,000	
Capital leases	$ 238,000	$ 137,000	$ 101,000	
Total cash contractual obligations	$2,284,000	$2,167,000	$ 117,000	

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

SEASONALITY AND QUARTERLY FLUCTUATIONS. Several of our businesses experience fluctuations in quarterly performance. Traditionally, the first quarter from January to March is a low season for our call center business due to the long Lunar New Year holidays in China. Revenue and income from operations for the call center and VAS tend to be higher in the fourth quarter due to special holiday promotions. Internet/Direct Commerce revenues also tend to be higher in the fourth quarter due to increased consumer spending during that period. Revenues from the VAS and IVR segment can vary from quarter to quarter due to new product launches and the seasonality of certain product lines.

ITEM 3. CONTROLS AND PROCEDURES

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

There were no changes in the Company's internal controls over financial reporting or in other factors that could materially affect, or are reasonably likely to materially affect, our internal control over financial reporting as well as these controls subsequent to the Evaluation Date.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

None.

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

None.

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.

The following exhibits are filed as part of this report:

Exhibit Number	Description
31.1	Certification of Chief Executive Officer pursuant to Rule 13A-14(A)/15D-15(E) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.
31.2	Certification of the Chief Financial Officer pursuant to Rule 13A-14(A)/15D-15(E) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.
32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. 1350 (Section 906 of the Sarbanes-Oxley Act of 2002), filed herewith.

SIGNATURES

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

PACIFICNET INC.

DATE: NOVEMBER 14, 2005 BY: /S/ TONY TONG

TONY TONG
CHIEF EXECUTIVE OFFICER
(PRINCIPAL EXECUTIVE OFFICER)

DATE: NOVEMBER 14, 2005 BY: /S/ WANG SHAO JIAN

WANG SHAO JIAN
CHIEF FINANCIAL OFFICER
(PRINCIPAL FINANCIAL OFFICER)