

BRASIL TELECOM SA
Form 20-F
June 30, 2006

SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 20-F

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005**
Commission file number: 1-15256

BRASIL TELECOM S.A.
(F/K/A TELECOMUNICAÇÕES DO PARANÁ S.A. - TELEPAR)
(Exact Name of Registrant as Specified in Its Charter)

Brazil Telecom Company
(Translation of Registrant's Name into English)

The Federative Republic of Brazil
(Jurisdiction of Incorporation or Organization)

SIA/Sul, ASP, Lote D, Bloco B
71215-000 Setor de Indústria, Brasília, DF, Brazil
(Address of Principal Executive Offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange On Which Registered
Preferred Shares, without par value, represented by American Depositary Shares*	New York Stock Exchange

* American Depositary Shares issuable upon deposit of Preferred Shares were registered under a separate registration statement on Form F-6.

Securities registered or to be registered pursuant to Section 12(g) of the Act: None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: None

**Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of
the close of the period covered by this Annual Report:**

At December 31, 2005 there were outstanding:
249,597,049,542 Common Shares, without par value
305,701,231,289 Preferred Shares, without par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

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, an accelerated filer, or a non-accelerated filer.

See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

Indicate by check mark which financial statement item the Registrant has elected to follow.

Item 17 Item 18

TABLE OF CONTENTS

	Page
<u>PRESENTATION OF FINANCIAL INFORMATION</u>	<u>4</u>
<u>FORWARD-LOOKING INFORMATION CONTAINED IN THIS ANNUAL REPORT</u>	<u>5</u>
 PART I	
<u>ITEM 3. Key Information</u>	<u>7</u>
<u>Selected Financial Information</u>	<u>8</u>
<u>Exchange Rates</u>	<u>11</u>
<u>Risk Factors</u>	<u>12</u>
<u>ITEM 4. Information on the Company</u>	<u>28</u>
<u>History and Development of the Company</u>	<u>28</u>
<u>Capital Expenditures</u>	<u>36</u>
<u>Business Overview</u>	<u>37</u>
<u>Regulation of the Brazilian Telecommunications Industry</u>	<u>70</u>
<u>Property, Plant and Equipment</u>	<u>77</u>
<u>Environmental and Other Regulatory Matters</u>	<u>77</u>
<u>ITEM 5. Operating and Financial Review and Prospects</u>	<u>78</u>
<u>Overview of Results of Operations</u>	<u>78</u>
<u>US GAAP Reconciliation</u>	<u>83</u>
<u>Critical Accounting Policies</u>	<u>84</u>
<u>New Accounting Pronouncements</u>	<u>87</u>
<u>Results of Operations for the Years Ended December 31, 2003, 2004 and 2005</u>	<u>88</u>
<u>Liquidity and Capital Resources</u>	<u>102</u>
<u>ITEM 6. Directors, Senior Management and Employees</u>	<u>109</u>
<u>Board of Directors and Senior Management</u>	<u>109</u>
<u>Board Practices</u>	<u>112</u>
<u>Corporate Governance Practices</u>	<u>115</u>
<u>Employees</u>	<u>115</u>
<u>Performance Bonus Plan</u>	<u>116</u>
<u>Share Ownership</u>	<u>116</u>
<u>ITEM 7. Major Shareholders and Related Party Transactions</u>	<u>117</u>
<u>Major Shareholders</u>	<u>117</u>
<u>Related Party Transactions</u>	<u>122</u>
<u>ITEM 8. Financial Information</u>	<u>125</u>
<u>Consolidated Statements and Other Financial Information</u>	<u>125</u>
<u>Legal Proceedings</u>	<u>125</u>
<u>Dividend Policy</u>	<u>133</u>

<u>ITEM 9. The Offer and Listing</u>	<u>135</u>
<u>Offer and Listing Details</u>	<u>135</u>
<u>Markets</u>	<u>138</u>
<u>ITEM 10. Additional Information</u>	<u>140</u>
<u>Memorandum and Articles of Association</u>	<u>140</u>
<u>Material Contracts</u>	<u>140</u>
<u>Exchange Controls</u>	<u>143</u>
<u>Taxation</u>	<u>145</u>
<u>Independent Auditors</u>	<u>152</u>
<u>Documents on Display</u>	<u>152</u>
<u>ITEM 11. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>153</u>
<u>Quantitative Information About Market Risk</u>	<u>153</u>

PART II

<u>ITEM 14. Material Modifications to the Rights of Security Holders and Use of Proceeds</u>	<u>156</u>
<u>ITEM 15. Controls and Procedures</u>	<u>156</u>
<u>ITEM</u>	
<u>16A. Audit Committee Financial Expert</u>	<u>156</u>
<u>ITEM</u>	
<u>16B. Code of Ethics</u>	<u>156</u>
<u>ITEM</u>	
<u>16C. Principal Accountant Fees and Services</u>	<u>156</u>
<u>ITEM</u>	
<u>16D. Exemptions from the Listing Standards for Audit Committees</u>	<u>157</u>
<u>ITEM</u>	
<u>16E. Purchases of Equity Securities by the Issuer and Affiliated Purchasers</u>	<u>158</u>

PART III

<u>ITEM 17. Financial Statements</u>	<u>159</u>
<u>ITEM 18. Financial Statements</u>	<u>159</u>
<u>ITEM 19. Exhibits</u>	<u>159</u>
<u>INDEX OF DEFINED TERMS</u>	<u>161</u>
<u>TECHNICAL GLOSSARY</u>	<u>163</u>

SIGNATURES

EXHIBIT 8.1 SUBSIDIARIES OF BRASIL TELECOM S.A.

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

INDEX TO EXHIBITS

PRESENTATION OF FINANCIAL INFORMATION

In this Annual Report, Brasil Telecom S.A., a corporation organized under the laws of the Federative Republic of Brazil and its subsidiaries are referred to collectively as "Brasil Telecom," "our company," "we," "us" or the "Registrant." References to our company's businesses and operations are references to the businesses and operations of our company on a consolidated basis for the years 2003, 2004 and 2005.

References to (i) the "*real*," "*reais*" or "R\$" are to Brazilian *reais* (plural) and the Brazilian *real* (singular) and (ii) "dollars" or "US\$" are to United States dollars. All amounts in Brazilian currencies that existed prior to the adoption of the *real* as the Brazilian currency on July 1, 1994 have been restated in *reais*. On May 31, 2006, the Commercial Market selling rate (as defined in Item 3 "Key Information Selected Financial Data Exchange Rates") was R\$2.3005 to US\$1.00 as published by the Brazilian Central Bank. The exchange rate information in this Annual Report should not be construed as a representation that any such amounts have been, would have been or could be converted at this or any other exchange rate.

Our audited consolidated financial statements were prepared in conformity with generally accepted accounting principles in Brazil ("Brazilian GAAP") which are similar to the Brazilian Corporation Law (Law 6.404/76, as amended by Law 10.303/01), except for the effects of the recognition of inflationary effects from January 1, 1996 to December 31, 2000, and are consistent with the rules and regulations of the Brazilian Securities and Exchange Commission (CVM *Comissão de Valores Mobiliários*), and the accounting standards issued by the Brazilian Institute of Independent Auditors (*Instituto dos Auditores Independentes do Brasil* or "IBRACON"). Investors should note that financial statements prepared in accordance with Brazilian GAAP differ from financial statements prepared in accordance with Brazilian Corporation Law in the methodology used for the recognition of inflation, among other things. See Notes 2a and 2b to our audited consolidated financial statements for (i) a summary of the principal differences between Brazilian GAAP and Brazilian Corporation Law as they relate to us and (ii) a reconciliation from Brazilian Corporation Law to Brazilian GAAP of shareholders' equity as of December 31, 2003, 2004 and 2005 and net income (loss) for each of the years ended December 31, 2003, 2004 and 2005. Brazilian GAAP when applied to us differs in certain important respects from generally accepted accounting principles in the United States ("US GAAP"). See Note 33 to our audited consolidated financial statements for (i) a summary of the principal differences between Brazilian GAAP and US GAAP as they relate to us and (ii) a reconciliation to US GAAP of shareholders' equity as of December 31, 2004 and 2005 and net income (loss) for each of the years ended December 31, 2003, 2004 and 2005. These audited consolidated financial statements are referred to herein as the "Financial Statements."

Our audited annual consolidated financial statements as of December 31, 2003, 2004 and 2005, and for each of the three years ended December 31, 2003, 2004 and 2005 prepared in accordance with Brazilian GAAP with reconciliation of shareholders' equity and income statements to US GAAP, included in this Annual Report, have been audited by KPMG Auditores Independentes, in accordance with the standards of the Public Company Accounting Oversight Board as stated in their report appearing in this Annual Report.

The "Index of Defined Terms" that begins on page 161 lists the page where each defined term is defined within this document. Technical terms are defined in the Technical Glossary on page 163.

Certain figures included in this Annual Report have been subject to rounding adjustments. Accordingly, figures shown as totals in certain tables may not be an arithmetic aggregation of the figures that precede them.

FORWARD-LOOKING INFORMATION CONTAINED IN THIS ANNUAL REPORT

This Annual Report contains forward-looking statements. We may also make forward-looking statements in press releases and oral statements. Forward-looking statements are not statements of historical fact and involve known and unknown risks and uncertainties. The words "anticipates," "believes," "estimates," "expects," "forecasts," "intends," "plans," "predicts," "projects," "targets" and similar words are intended to identify these forward-looking statements.

In this Annual Report, we have made forward-looking statements with respect to, but not limited to:

- our marketing strategy;
- our ability to meet our network expansion, service quality and modernization obligations;
- our market share in general and the growth in our internet service offerings in particular;
- our compliance with radiation standards;
- the reduction of our labor force;
- the payment of our debt;
- the material adverse financial effect of any labor, civil or tax claims arising out of acts committed by Telebrás prior to the effective date of the breakup of Telebrás;
- the retroactive application of state value-added taxes to certain services, including installation services, rendered during the five years preceding June 30, 1998;
- the growth in the customer base and products offered by cable television services providers in our region;
- our projected capital expenditures; and
- our liquidity.

Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions because they relate to future events and therefore depend on circumstances that may or may not occur in the future. Our future results and shareholder values may differ materially from those expressed in or suggested by these forward-looking statements. Many of the factors that will determine these results and values are beyond our ability to control or predict.

Because these forward-looking statements involve risks and uncertainties, there are important factors that could cause actual results to differ materially from those expressed or implied by these forward-looking statements. These factors include:

- the performance of the Brazilian economy generally;
- the levels of exchange rates between Brazilian and foreign currencies;
- the telecommunications policy of Brazil's federal government;

- the growth of the Brazilian telecommunications industry as a whole;
- the introduction of competition to the Brazilian telecommunications industry in general and in our region in particular;

- the receipt of additional, and/or the revocation of our existing, governmental approvals and licenses;
- the availability of financing;
- the resolution of disputes among certain of our controlling shareholders;
- changes in the rates that we may charge under government regulations;
- the emergence of new technologies and the response of our customer base to those technologies;
- our ability to grow our business, in particular our mobile telephone business;
- acquisitions by us of other companies; and
- other factors discussed under Item 3. Key Information Risk Factors."

The reader should not place undue reliance on any forward-looking statement. Forward-looking statements speak only as of the date they are made, and we do not undertake any obligation to update them in light of new information or future developments. Neither our independent auditors, nor any other independent accountants, have compiled, examined, or performed any procedures, with respect to the prospective financial information contained herein, nor have they expressed any opinion or any other form of assurance on such information or its achievability, and assume no responsibility for, and disclaim any association with the prospective financial information.

Information included in this Annual Report concerning Brazil, Telecom Italia International N.V. ("TII"), Techold Participações S.A. ("Techold") and Timepart Participações Ltda. ("Timepart") and other direct and indirect shareholders has been included herein based on public filings or other sources we assume to be correct but we have not independently verified such information.

PART I

ITEM 3. KEY INFORMATION

Selected Financial Data

Background

The selected financial information presented herein should be read in conjunction with our Financial Statements and notes, which appear elsewhere in this Annual Report. Our selected financial information is presented on a consolidated basis for all years presented.

The following paragraphs discuss some important features of the presentation of the selected financial information and our Financial Statements. These features should be considered when evaluating the selected financial information and our Financial Statements and Notes.

Brazilian GAAP and US GAAP

The consolidated financial statements have been prepared in accordance with Brazilian GAAP, which differ in certain significant respects from US GAAP.

See Note 33 to our Financial Statements for (i) a summary of the principal differences between Brazilian GAAP and US GAAP as they relate to us, and (ii) a reconciliation to US GAAP of shareholders' equity as of December 31, 2004 and 2005 and net income (loss) for each of the years ended December 31, 2003, 2004 and 2005.

Change in Accounting Methodology

For a discussion of recent changes in accounting methodology regarding depreciation, see Item 4. Information on the Company "Property, Plant and Equipment" and Item 5. Operating and Financial Review and Prospects "Operating Results Results of Operations for the Years Ended December 31, 2003, 2004 and 2005 Cost of Services Depreciation and Amortization."

Difference from Financial Statements Published in Brazil

Our statutory financial statements prepared in accordance with the Brazilian Corporation Law (the "Statutory Financial Statements") are the basis for dividend and tax determinations. See Notes 2a and 2b to our Financial Statements for (i) a summary of the principal differences between Brazilian GAAP and Brazilian Corporation Law as they relate to us and (ii) a reconciliation from Brazilian Corporation Law to Brazilian GAAP of shareholders' equity as of December 31, 2004 and 2005 and net income (loss) for each of the years ended December 31, 2003, 2004 and 2005. Our Statutory Financial Statements also differ from our Financial Statements in respect of certain reclassifications, and presentation of comparative information.

Selected Financial Information

Income Statement Data:	2001	2002	2003	2004	2005
<i>Brazilian GAAP:</i>					
Net operating revenue	6,158,408	7,071,368	7,915,194	9,064,855	10,138,684
Cost of services	4,798,434	5,163,861	5,472,142	6,142,645	6,525,898
Gross profit	1,359,974	1,907,507	2,443,052	2,922,210	3,612,786
Operating expenses:					
Selling expenses	724,570	763,375	821,656	1,086,946	1,656,242
General and administrative expenses	604,890	661,060	847,074	998,592	1,264,741
Other net operating expenses (income)	56,769	(118,496)	214,953	61,198	626,306
Operating income (loss) before net financial expenses	(26,255)	601,568	559,369	775,474	65,497
Net financial expenses	236,357	618,899	844,802	579,514	596,239
Operating income (loss)	(262,612)	17,331	(285,433)	195,960	(530,742)
Net non-operating expenses (income)	93,071	64,497	541,691	112,073	(149,024)
Employee's profit share	50,834	41,387	1,076	53,783	0
Income (loss) before taxes and minority interests	(406,517)	(123,215)	(828,200)	30,104	(679,766)
Income and social contribution tax benefits	199,039	111,596	320,751	75,012	389,066
Income (loss) before minority interests	(207,478)	(11,619)	(507,449)	105,116	(290,700)
Minority interests	---	---	14	(6,276)	(12,971)
Net income (loss)	(207,478)	(11,619)	(507,435)	98,840	(303,671)
Number of Common Shares (millions) ⁽¹⁾	237,165	243,564	249,597	249,597	249,597
Number of Preferred Shares millions) ⁽¹⁾	293,218	292,020	289,850	292,011	305,701
Net income (loss) per thousand Common Shares (<i>reais</i>) ⁽¹⁾	(0.87)	(0.05)	(2.03)	0.40	(1.22)
Dividends per thousand Common Shares (<i>reais</i>) ⁽¹⁾	0.37	0.51	0.39	0.70	0.98
Dividends per thousand Common Shares (dollars) ⁽¹⁾⁽²⁾	0.16	0.14	0.14	0.26	0.42
Dividends per thousand Preferred Shares (<i>reais</i>) ⁽¹⁾	0.37	0.51	0.39	0.70	0.98
Dividends per thousand Preferred					

Edgar Filing: BRASIL TELECOM SA - Form 20-F

Shares (dollars) ⁽¹⁾⁽²⁾	0.16	0.14	0.14	0.26	0.42
------------------------------------	------	------	------	------	------

(1) See Note 3s to our Financial Statements.

(2) Dividends per thousand shares were converted into dollars at the Commercial Market selling rate of R\$2.3200 per dollar on December 31, 2001, of R\$3.5333 per dollar on December 31, 2002, of R\$2.8892 per dollar on December 31, 2003, of R\$2.6544 per dollar on December 31, 2004, and of R\$2.3407 per dollar on December 31, 2005, respectively.

Selected Financial Information (continued)

Income Statement Data (continued)	2001	2002	2003	2004	2005
U.S. GAAP:					
Net income (loss)	(169,716)	317,280	(287,739)	284,907	168,790
Net income (loss) per thousand shares (<i>reais</i>) ⁽³⁾ :					
Common Shares Basic	(0.32)	0.59	(0.54)	0.53	0.30
Common Shares Diluted	(0.32)	0.59	(0.54)	0.53	0.30
Preferred Shares Basic	(0.32)	0.59	(0.54)	0.53	0.30
Preferred Shares Diluted	(0.32)	0.59	(0.54)	0.53	0.30

(3) In accordance with Statement of Financial Accounting Standards No. 128, "Earnings Per Share," or SFAS 128, basic and diluted earnings per share have been calculated, for US GAAP purposes, using the "two class method." See Note 33e to our Consolidated Financial Statements.

	At December 31				
	2001	2002	2003	2004	2005
	(Thousands of <i>reais</i>)				
Balance Sheet Data:					
Brazilian GAAP:					
Intangibles ⁽¹⁾	372,537	470,544	531,556	863,929	649,949
Property, plant and equipment, net	12,240,270	11,260,625	9,567,243	9,370,091	8,687,607
Total assets	15,772,551	16,432,198	15,622,803	17,402,504	16,728,089
Loans and financing current portion	530,661	683,276	1,990,274	1,103,133	1,489,384
Loans and financing non-current portion	3,504,489	4,398,532	2,645,563	4,178,365	3,418,841
Total liabilities (including funds for capitalization and minority interests)	7,796,249	8,808,409	8,781,841	10,921,139	11,231,482
Shareholders' equity	7,976,302	7,623,789	6,840,962	6,481,365	5,496,607
US GAAP:					
Intangibles ⁽²⁾	873,559	830,328	978,414	1,419,363	1,410,004

Edgar Filing: BRASIL TELECOM SA - Form 20-F

Property, plant and equipment, net	12,139,658	11,670,826	10,035,667	9,795,888	9,224,017
Total assets	16,546,508	17,202,182	16,538,085	18,383,735	18,100,528
Loans and financing current portion	525,137	480,666	1,737,494	834,321	1,198,051
Loans and financing non-current portion	3,504,489	4,252,221	2,455,897	3,990,371	3,254,622
Total liabilities (including funds for capitalization and minority interests)	8,711,767	9,390,158	9,281,644	11,311,615	11,542,343
Shareholders' equity	7,834,741	7,812,024	7,256,440	7,072,120	6,558,186

- (1) Includes the goodwill from our acquisition of a controlling stake in CRT, which was calculated based on book value.
- (2) Intangibles under US GAAP include the goodwill from our merger with Telesc, Telegoiás, Telebrasília, Telemat, Telems, Teleron, Teleacre and CTMR and our merger with CRT at December 31, 2001, 2002, 2003, 2004 and 2005, and amounts relating to our personal communication system (PCS) licenses at December 31, 2002, 2003, 2004 and 2005. See Note 33o to our Consolidated Financial Statements.

Exchange Rates

Until March 14, 2005, there were two principal foreign exchange markets in Brazil: the commercial rate exchange market (the "Commercial Market") and the floating rate exchange market (the "Floating Market"). Most foreign trade and financial foreign currency exchange transactions were carried out on the Commercial Market. Purchases of foreign exchange in the Commercial Market could be carried out only through a financial institution authorized to buy and sell currency in that market. The Floating Market rate generally applied to specific transactions for which the approval of the Brazilian Central Bank (or the Central Bank) was not required.

On March 4, 2005, the National Monetary Council (CMN) enacted new rules with respect to the foreign exchange market in Brazil. Resolution 3.265 unified the Commercial Market and the Floating Market in a single market (the Foreign Exchange Market). The new rules also eliminated previous restrictions thereby allowing more flexibility for the purchase and sale of foreign currency. The unified Foreign Exchange Market is intended to simplify both inbound and out bound exchange transactions by permitting exchange contracts to be executed by the local institutions authorized to deal in foreign exchange. Foreign currencies may only be purchased through a Brazilian financial institution authorized to operate in the market. Furthermore, under the Foreign Exchange Market, Brazilian entities and individuals may purchase and sell foreign currency in transactions of any nature and without any limitations on the amounts involved, subject to the legality of the transaction and in accordance with the economic basis of the transactions and obligations set forth in the respective documentation. Rates are freely negotiated but the Central Bank may, in limited circumstances, intervene in the Foreign Exchange Market to curb excessive volatility.

Under the *Real Plan* ("Real Plan"), adopted on July 1, 1994, the *real* was introduced as the official unit of Brazilian currency, with each *real* having an exchange rate of R\$1.00 to US\$1.00. The issuance of *reais* was initially subject to quantitative limits backed by a corresponding amount of dollars in reserves, but the government subsequently expanded those quantitative limits and allowed the *real* to float, with parity between the *real*/dollar (R\$1.00 to US\$1.00) as a ceiling.

Since January 15, 1999 the *real* has been allowed to float freely. In 2000, the *real* devalued by 9.3% against the dollar to R\$1.9554. Further deterioration in the political and economic environment in 2001, in addition to the Brazilian energy crisis, resulted in the *real* devaluing by 18.7% against the dollar in that year. In 2002, as a reaction to political and economic uncertainties, the global economic downturn, the crisis in Argentina and the Brazilian presidential elections, the dollar appreciated by 52.3% against the *real* to R\$3.5333 per US\$1.00 at December 31, 2002. The *real* recovered in 2003, appreciating by 18.2% to R\$2.8892 per US\$1.00, at December 31, 2003. In 2004, the *real* appreciated by 8.1% against the dollar, quoted at R\$2.6544 per US\$1.00 on December 31, 2004. In 2005, the *real* appreciated by 13.4% against the dollar, quoted at R\$2.3407 per US\$1.00 on December 31, 2005. We cannot guarantee that the *real* will not substantially devalue again in the future. See " Risk Factors Risks Relating to Brazil."

Selling Rate for Dollars

As of May 31, 2006, the selling rate published by the Brazilian Central Bank was R\$2.3005 per US\$1.00. The following table sets forth the reported high and low selling rates for dollars for the months indicated.

	High	Low
December 2005	2.3735	2.1800
January 2006	2.3460	2.2116
February 2006	2.2217	2.1177
March 2006	2.2238	2.1067
April 2006	2.1534	2.0884
May 2006	2.3235	2.0586

Source: Brazilian Central Bank

The following table sets forth the reported high and low, average and period-end selling rates for dollars for the annual periods indicated. The average selling rates represent the average of the month-end commercial market selling rates (R\$/US\$) during the relevant period.

For the Year Ended December 31,	High	Low	Average	Period End
2001	2.801	1.936	2.352	2.320
2002	3.955	2.271	2.915	3.533
2003	3.662	2.822	3.060	2.889
2004	3.205	2.654	2.926	2.654
2005	2.762	2.163	2.434	2.340

Source: Brazilian Central Bank

Brazilian law provides that whenever there is a serious imbalance in Brazil's balance of payments or reliable information to foresee such an imbalance temporary restrictions may be imposed on remittances of foreign capital abroad. We cannot guarantee that these restrictive measures will not be taken by the Brazilian government in the future. See " Risk Factors Risks Related to Operations In Brazil."

RISK FACTORS

The following are risk factors that relate materially to our company and to an investment in our Preferred Shares or ADSs. Our business, results of operations or financial condition could be harmed if any of these risks materialize and, as a result, the trading price of our Preferred Shares or ADSs could decline and a holder of those securities could lose a substantial portion or all of his investment.

Risks Related to Our Business

Regulatory developments could affect our services, including placing restrictions on the rates we charge for our services, which could adversely impact our business.

Our main activities, as well as the main activities of our competitors, are subject to regulation and inspection by the Agência Nacional de Telecomunicações ("Anatel"). The regulations enacted by Anatel and applicable to our activities include provisions regarding charges, fees, universalization, quality of services, net expansion, licenses, competition, changes in our corporate control (including participation by foreign investors), interconnection and other operational issues related to the functioning of our telecommunications net.

Any changes in the laws, regulations or governmental policies applicable to the telecommunications sector or in the interpretation of such laws and regulations may have material adverse effects on our financial condition and results of operations.

Moreover, it is not possible to predict which policies for the telecommunications sector will be adopted by the government in the future or the consequences of such policies to our business and the business of our competitors.

The new concession contracts contain sections regarding the new Plano Geral de Metas de Qualidade (*General Plan for Quality Targets*; the PGMQ) and the new Plano Geral de Metas de Universalização (*General Plan for Universalization Targets*; the PGMU) related to (i) new targets for the universalization of services; (ii) change in the criteria for the charging of local calls, substituting pulses for minutes in the calculation of charges; (iii) new parameters for the adjustment of rates (the Telecommunications Industry Index (IST) became the official index to measure the sector inflation and adjust rates, although private-regime companies that compete with us do not require Anatel approval when setting their rates and may unilaterally determine the prices they charge for their services) and interconnection rates; and (iv) portability of fixed line telephone numbers.

These changes may affect the financial balance of our concession contract and adversely affect our business and financial conditions. We are currently discussing certain terms of the new concession contract with Anatel to reconcile the fact that such terms do not contemplate investments made by us to reach the previous targets determined by our old concession contract, the fact that we are to bear the costs associated with the new universalization targets and the fact that the IST may not accurately reflect inflation in a given period. We can not assure that we will be able to successfully challenge such provisions.

Termination of Concession Contracts

According to the General Telecommunications Law, as well as according to the Concession Contracts, the concessions are revocable in the following situations:

- non-renewal upon the expiration of the concessions;

- an extraordinary situation in which the public interest is in jeopardy, during which time the Brazilian government may operate our company. In such cases, the Brazilian government must be legislatively authorized to terminate the concession and our company must be indemnified;
- contractual, legal or free-will termination by us when an act or omission of the Brazilian government makes rendering services excessively burdensome to us, or:

- the occurrence of:

- (a) a split-up, spin-off, amalgamation, merger, capital reduction or transfer of our corporate power without Anatel's authorization;
- (b) the transfer of the concessions without Anatel's authorization;
- (c) our dissolution or bankruptcy; or
- (d) an extraordinary situation where Brazilian government intervention, although legally possible, is not undertaken since such intervention would prove to be inconvenient, unnecessary or would result in unfair benefits for us.

A proposed bill of law terminating monthly subscription fees may adversely affect our business and financial conditions.

On May 12, 2004, the Consumer Defense Committee of the House of Representatives approved a bill of law proposing the termination of the monthly subscription fees charged for fixed-line services by Brazilian telephone concessionaires, including our company. The bill is still under consideration before the House of Representatives, where a special committee was created on June 3, 2005 to discuss and to make a report regarding the bill. The bill will be subject to the approval of the House of Representatives, the Senate and the President. In 2005 the revenue of monthly subscription fees charged for fixed-line was R\$3.5 billion. Should this bill be approved, it may have an impact on our current rate structure and, as a result, our operations and competitive position could be adversely affected.

We are subject to financial covenants and other contractual provisions under our existing indebtedness. Failure to comply with these provisions could adversely affect our business and financial condition.

The agreements that govern our debt, including our credit facilities with National Bank for Social and Economic Development (*Banco Nacional de Desenvolvimento Econômico e Social* – BNDES), contain a number of significant covenants, the failure to comply with which could adversely impact our business. In particular, the terms of these agreements restrict our ability, and the ability of our subsidiaries, to incur additional debt, make capital expenditures, grant liens, pledge assets, sell or dispose of assets and make certain acquisitions, mergers and consolidations. Furthermore, in accordance with a number of our debt agreements, including our credit facilities with BNDES, we are required to comply with these covenants and maintain certain specified financial ratios in order to maintain the current maturity dates for these debt agreements. As a general rule, the occurrence of an event of default under a credit facility with BNDES may trigger the acceleration of other agreements representing our indebtedness.

During December 2004, we initiated a process of adjusting the covenants related to certain agreements with BNDES, in order to fit them to the new reality of the telecommunications sector and our company. As part of this adjustment process, we and BNDES introduced a new mechanism in the credit facility agreements. In the event of a failure by us to comply with semi-annual financial covenants, instead of the right to accelerate the entire amount of the debt, which may trigger cross-defaults in our debt instruments, BNDES may request the retention of funds in a blocked account in an amount equivalent to three times the highest installment of principal plus interest due under such agreement. If we, after the creation of such a blocked account, we again fail to comply with the financial covenants, then BNDES will have the right, but not the obligation, to declare the acceleration of the debt. The adjustment process extended these remedies to all BNDES agreements to which we are a party, effective as of December 31, 2004. Any failure by us to comply with the financial covenants of our debt instruments, and subsequent acceleration of our debt by BNDES, would have a material adverse effect on our ability to conduct our operations.

On January 5, 2006, we announced that we intended to book provisions in our financial statements for the year ended December 31, 2005, in the amount of R\$622 million (see description in PART II of this report in our Financial Statements). Such provisions, if booked, could affect our results and, accordingly, jeopardize the compliance in the fiscal year ended on December 31, 2005 until and including the third quarter of 2006 of financial covenants set forth in certain debt agreements, including the credit facilities with BNDES, and the *Escritura de Emissão*,

relating to the Debentures of the 4th issuance, being the 3rd public, the loan agreements entered into with Japan Bank of International Cooperation (JBIC) and with Sumitomo Mitsui Banking Corporation. Therefore, prior to making the decision to book the provisions, we initiated negotiations with our creditors to adjust the affected financial covenants, in particular the ratio between EBTIDA and the financial expenses.

On January 6, 2006, we entered into negotiations with BNDES and the financial institutions acting as its agents under the credit facilities. In view of our failure to comply with certain financial covenants, BNDES decided to retain funds in a blocked account equivalent to the highest installment plus interest due under agreement in an amount of approximately R\$250 million. In February 2005, the agreements were amended to determine that the funds to be retained shall be equivalent to the highest installment plus interest, instead of three times such figure, as provided for in the initial amendment to the credit facilities.

On January 30, 2006, the holders of our outstanding debentures of the 4th issuance approved an adjustment to the financial covenant relating to the ratio between Consolidated EBITDA and Consolidated Financial Expenses, contained in Section 4.19.1(e)(i) *Escritura de Emissão* from equal or higher than 2.25, to equal or higher than 1.5, as of the fourth quarter of 2005, until and including the third quarter of 2006. If we had not obtained this amendment, we would not have been in compliance with this financial covenant for the fourth quarter of 2005, when we reached a ratio of 2.17. See Item 10. Additional Information Material Contracts Debentures *Escritura de Emissão*.

On February 17, 2006, we signed the First Amendment to the Loan Agreement entered into with JBIC, dated March 18, 2004, and the First Amendment to the Loan Agreement entered into with Sumitomo Mitsui Banking Corporation, dated March 24, 2004. These amendments adjusted the financial covenants in each respective loan agreement relating to EBTIDA and the financial expenses from equal or higher than 2.25, to equal or higher than 1.5, as of the fourth quarter until and including the third quarter of 2006. For the fourth quarter of 2005 we achieved a Consolidated EBITDA over Consolidated Financial Expenses ratio of 2.17. See Item 10. Additional Information Material Contracts JBIC Guaranteed Loan.

Regarding the loan agreements with BNDES we failed to comply with the financial covenant of Brasil Telecom Participações consolidated results. The Consolidated EBITDA over Consolidated Financial Expenses ratio was supposed to remain above or equal to 2.50, but we reached 2.17 in the fourth quarter of 2006. Following the provisions established in the agreements, BNDES is running retention up to R\$250 million of our cash investments, without penalties concerning interest or fees, which will be valid until we achieve the 2.50 ratio.

On February 3, 2006, we obtained a waiver from BNDES in order to avoid the acceleration of the agreements in view of a potential failure to comply with the financial covenants in the first semester of 2006. See Item 10. Additional Information Material Contracts JBIC BNDES Loan Agreements.

Compliance with these covenants in future periods will depend upon our financial and operating performance, which may be affected by adverse business, market and economic conditions. If we are unable to comply with these covenants, or to obtain waivers from our lenders, our debt agreements may be accelerated and the terms of our debt agreements may be otherwise amended adversely. If we are unable to meet our debt service obligations or comply with our debt covenants, we could be forced to restructure or refinance our indebtedness, seek additional equity capital or sell assets. See Item 5. Operating and Financial Review and Prospects Liquidity and Capital Resources Indebtedness."

Certain beneficial owners directly or indirectly control a large percentage of our voting shares, and their interests may conflict with the interests of our other shareholders, including minority shareholders. Disputes among our controlling shareholders and entities that manage our controlling shareholders have had and could in the future have a material adverse effect on our management and operations.

We are controlled by Brasil Telecom Participações S.A., which is in turn controlled by Solpart Participações S.A. ("Solpart"), whose stockholders are Timepart, Techold and TII. As the controlling shareholder of Brasil Telecom Participações S.A., Solpart has the power to modify our business plan, modify our dividend plan and sell our material assets. As of the date of this annual report, control of Solpart, as well as certain actions taken by Solpart's shareholders and their affiliates are the subject of a number of judicial and arbitration proceedings.

On March 9, 2005, International Equity Investments, Inc. as the sole shareholder of CVC/Opportunity Equity Partners LP (since renamed Citigroup Venture Capital International Brazil, LP) ("CVC LP") which holds a direct stake in Brasil Telecom Participações S.A. and a substantial indirect stake in Zain Participações S.A. (Zain), a company that indirectly owns a majority of the voting interests in Solpart, and therefore indirectly owns a majority of the voting shares of Brasil Telecom Participações S.A. and our company, publicly announced the ouster of CVC/Opportunity Equity Partners, Ltd ("CVC Ltd"), currently named Opportunity Equity Partners, Ltd., (Opportunity Ltd.) from the management of CVC LP. Opportunity Ltd. was replaced by a new company incorporated abroad, Citigroup Venture Capital International Brazil LLC ("CVC International Brazil").

On March 9, 2005, CVC LP, in compliance with CVM/SEP/GEA-2 Written Notice 225/05 and the terms of CVM Instruction 358, announced that International Equity Investments, Inc. and CVC International Brazil had entered into certain agreements with Investidores Institucionais Fundo de Investimento em Ações (Investidores Institucionais FIA), Caixa de Previdência dos Funcionários do Banco do Brasil Previ (Previ), Fundação dos Economistas Federais Funcef (Funcef) and Fundação Petrobras de Seguridade Social Petros (Petros), including a voting agreement with respect to their shares of Zain (collectively, the Agreements).

Under the Agreements, CVC LP and Investidores Institucionais FIA, with combined holdings of approximately 90% of the voting shares of Zain, will jointly exercise the corporate control of Zain and Invitel S.A. (Invitel), a company controlled by Zain with approximately 68% of its voting shares, and in which Previ, Funcef, Petros and other Brazilian pension entities hold nearly all of the remaining shares. The Agreements also establish that the parties are to attempt to disinvest, under identical terms, jointly and in an organized manner, their shareholdings in Zain and Invitel, companies which control, among other companies, us, our Parent, and our subsidiary, 14 Brasil Telecom Celular S.A. (BrT Celular).

In connection with the execution of the Agreements, Previ, Funcef and Petros signed the Put Option on Shares Issued by Zain granting CVC LP a put option on its Zain shares, which may be exercised under certain circumstances during a limited period of time, but not before November 2007. CVC LP's right to exercise the put option is conditioned on the occurrence of certain future events, some of which are beyond the control of CVC LP, Investidores Institucionais FIA, Previ, Funcef and Petros. If CVC LP exercises its put option, the exercise price is set at R\$1,045,941,692.43, adjusted by the variation of the IGP-DI Index + 5% p.a. The fulfillment of the conditions to the exercise of such put option granted by Previ, Funcef and Petros does not depend and is not tied to the occurrence of any operation or business involving, directly or indirectly, property or other assets owned by Zain, Invitel or any of their controlled companies, including us, our Parent and BrT Celular.

On April 12, 2005, Anatel issued a decision approving among other things: (i) the replacement of Opportunity Ltd. by CVC International Brazil as the general partner of CVC LP; (ii) the replacement of CVC/Opportunity Equity Partners Administradora de Recursos Ltda. by Angra Partners Consultoria Empresarial e Participações Ltda. as the new manager of Investidores Institucionais FIA, an indirect shareholder of Brasil Telecom Participações S.A. and Brasil Telecom S.A.; and (iii) certain changes resulting from the Agreements entered into by CVC LP and Investidores Institucionais. This decision was published in the Federal Gazette (*Diário Oficial*) on April 14, 2005. After reviewing our appeal filed by prior management related to Opportunity Ltd., Anatel upheld its April 12, 2005 decision.

On October 6, 2003, Fundação 14 de Previdência Privada (Fundação 14), successor to Fundação Sistel de Seguridade Social, was prevented by the other shareholders of Investidores Institucionais FIA from exercising its voting rights at the Investidores Institucionais FIA's Unitholders Meeting. At such meeting, Banco Opportunity S.A. was ousted from the administration of Investidores Institucionais FIA. Consequently, Fundação 14 brought an ordinary action before the 5th Federal Court of Rio de Janeiro against Previ and several investors in Investidores Institucionais FIA, seeking a declaration that the resolutions adopted at the Investidores Institucionais FIA's

Unitholders Meeting held on October 6, 2003 were invalid. On May 18, 2005, an injunction granted on May 17, 2005 in favor of Fundação 14 by a federal tribunal in Rio de Janeiro, which would have allowed Banco Opportunity S.A. to return to the management of Investidores Institucionais FIA's was revoked by a decision granted by Superior Tribunal de Justiça (STJ), the highest Brazilian court for non-constitutional matters; in the proceeding SLS 128. On July 12, 2005, Fundação 14 filed before the 5th Federal Court of Rio de Janeiro a motion to abandon this lawsuit. To the best of our knowledge, this STJ decision is being challenged by Banco Opportunity S.A.

On July 27, 2005, at an Extraordinary General Shareholders Meeting of our Parent, the shareholders removed and replaced the members of the board. The new board members assumed their board positions on August 25, 2005, and at their first formal meeting replaced the officers of our Parent.

At an Extraordinary General Shareholders Meeting held on September 30, 2005, our shareholders removed and replaced the prior members of our Board of Directors (except for Mr. Antonio Cardoso dos Santos, who was elected by the holders of our preferred stock and remains a director). Also on September 30, 2005, our newly constituted Board of Directors replaced all of the senior officers with a new management team, including Mr. Ricardo Knoepfelmacher, as Chief Executive Officer, Charles Lagana Putz, as Chief Financial Officer and Investor Relations Officer, Luiz Francisco Tenorio Perrone as Human Resources Officer, and Francisco Aurelio Sampaio Santiago as Network Officer. Subsequently, at an Extraordinary General Shareholders Meetings held on November 17, 2005 and January 12, 2006, our shareholders removed and replaced the members of our fiscal council (which functions as our audit committee for purposes of SEC and NYSE rules and regulations).

The process of replacing the directors and officers of Brasil Telecom Participações S.A. and Brasil Telecom S.A. was litigious, as evidenced by various lawsuits filed by our former managers and their affiliates in an attempt to resume their former management roles. While we cannot predict the cumulative effect of this ongoing litigation on our business and results of operations, extensive litigation regarding ownership of our company creates uncertainty with respect to the identity of our current and future management, which may impair our ability to carry out our business plan.

ASSESSMENT OF THE ACTIONS OF OUR FORMER MANAGERS UNDER THE MANAGEMENT OF OPPORTUNITY LTD.

In observance of their fiduciary duties, under the terms of the applicable legislation, the current management of Brasil Telecom Participações S.A. and the current management of Brasil Telecom S.A. have performed and continue to perform internal investigations of the businesses and operations conducted by the former managers appointed by Opportunity, Ltd. In the course of such investigations, the current managers identified management acts indicating abuse of controlling power, breach of fiduciary duties, and conflict of interest, as well as various violations of Brazilian law and Companies Bylaws.

Therefore, in accordance with a notice to shareholders released on December 12, 2005, we filed a formal complaint with the CVM - the Brazilian Securities and Exchange Commission, against our former management, Opportunity Fund and other individuals and companies, both domestic and foreign, linked to our former management, who have been involved with, or participated in any way, or benefited from the actions which are the object of the formal complaint. On March 21, 2006, a second formal complaint, as an amendment to the first complaint, was submitted to CVM, in light of new management actions identified.

We intend to pursue all appropriate legal measures to recover potential losses and damages suffered, consistent with our best interests and fiduciary obligations. On April 28, 2006, at Ordinary and Extraordinary Meetings of Shareholders of Brasil Telecom S.A. and Brasil Telecom Participações S.A., the shareholders of each company approved the filing of damages lawsuits against prior management.

Despite the potentially misleading actions of our prior management as described above, to the knowledge of our management, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report.

ISSUES ARISING OUT OF OVERLAPPING OF LICENSES WITH A TELECOM ITALIA AFFILIATE

When we received the certification of achievement of universalization targets for 2003, established by Anatel, we were already providing fixed telephone services (PSTN) at domestic local and long distance modalities (DLD) intra-regional in Region II of the General Concession Plan (PGO).

After the achievement of such targets, Anatel, in January 2004, issued authorizations enlarging our potential areas of operations: PSTN local and LDN in Regions I and III of PGO (and in a few sectors of Region II); International Long Distance Call (ILD) in Regions I, II and III of PGO; mobile telephone, by means of our subsidiary BrT Celular, in Region II of Personal Mobile Service (SMP). Our existing concession agreements were also expanded, allowing LDN calls to any Brazilian territory. If TII acquires an indirect controlling interest in our Parent, TII and TIM could be viewed as affiliated companies under the Brazilian telecommunications law. As a result, our ability to render domestic (NLD) and international (ILD) fixed telephone services, as well as mobile telephone services, in the same regions as TIM, would be at risk of partial restriction or revocation by Anatel.

On January 16, 2004, Anatel issued Act 41,780, establishing a period of 18 months during which TII could reacquire an indirect controlling interest in our company, as long as TII neither participated nor voted on any issues related to the overlapping services offered by us and TIM, including domestic and international long distance calls and mobile telephone services. On June 30, 2004, the Administrative Council for Economic Defense CADE, in the records of Writ of Prevention 08700.000018/2004 -68, set forth restrictions on the exercise of control rights by TII and its representatives over the Boards of Directors of Solpart, our Parent and our company.

On April 28, 2005, certain TII affiliates and BrT Celular purported to enter into various corporate agreements, including an instrument called Merger Agreement and a Protocol related thereto. The April 28, 2005 agreements alleged that the proposed merger was justified as a possible solution to the overlapping regulatory licenses and authorizations with TIM, and to avoid sanctions and penalties which could be imposed by Anatel. Certain actions contemplated by these agreements have since been forbidden by injunctions issued by the US and Brazilian courts. The agreements are also subject to legal challenges by our indirect shareholders. Regardless of whether the validity of the April 28, 2005 agreements is confirmed, there is the possibility that assets related to our fixed and mobile segments (see Note 43) will eventually lose their value as a result of overlapping operations or sanctions issued by Anatel. It is possible that these agreements will be declared null and void by courts or in arbitration proceedings, which would remove TII from the control block of that group, eliminating the overlapping concessions and consequently, the regulatory risks. Nevertheless, it is not possible at this time to anticipate such legal developments and their future effects on our operations or financial statements.

On July 7, 2005, Anatel declared, by means of Act 51,450, that the counting of an 18 month term to solve the overlapping of licenses would start on the date of the effective return of TII to our control group. On July 26, 2005, Anatel, by means of Order 576/2005, declared that the counting of term would start on April 28, 2005. Therefore, according to Anatel, the interested companies shall adopt the measures necessary to eliminate the overlapping of licenses until the end of the 18 month term, October 2006, under the penalty of legal sanctions, which may affect either companies or both of them.

Depending on the final decision of Anatel, the threatened sanctions could have a material adverse effect on the business and operations of us and our subsidiary, BrT Celular.

On March 15, 2006, we and our subsidiary, BrT Celular, began an arbitration against TIM International N.V. (TIMINT) and TIM Brasil Serviços e Participações S.A. (TIMB), seeking to annul the Merger Agreement. We disclosed such arbitration in a material fact on March 16, 2006.

On May 2, 2006, TIMINT and TIMB announced their decision to terminate the Merger Agreement. In the same letter, TIMINT and TIMB reserved their alleged rights under sections 10.3 and 11.1 of the Merger Agreement. The arbitration that we brought against the Merger Agreement continues.

LAWSUITS AND INJUNCTIONS AFFECTING OUR OPERATIONS

Disputes among controlling shareholders

We are unable to predict the outcome of the disputes related to the overlap of licenses and whether such disputes will be resolved without the issuance by Anatel of any sanctions or penalties. In addition, the disputes among the shareholders of Solpart, including the dispute over the ownership structure of Solpart, and management

of entities which hold a stake in Brasil Telecom Participações S.A. and Zain may result in changes to our board and/or senior management.

Delays in payment or defaults of our clients for long periods may adversely affect our business.

On March 31, 2006, we accounted losses related to accrued receivables in the amount of R\$112.8 million, as a result of the default of subscribers, which correspond to 3.1% of our consolidated net earnings during the period ended on that date.

Subscribers in default are those who fail to pay their bills within 30 days of their maturity date. Anatel requires us to render our services to all consumers, notwithstanding their credit history. Therefore, we may not select our subscribers or refuse to provide our services to certain subscribers, except if such subscriber has failed to pay past debts with us. High levels of default for long periods may adversely affect our business, our financial health and operational results.

Problems with billing, invoicing and collection services may adversely affect our earnings.

On July 2003, users were given the option to use our code to complete calls from mobile handsets. By Resolution No. 343, dated as of July 17, 2003, Anatel established that carriers shall render invoicing and collection services to other carriers with which they had entered into traffic agreements. Upon the certification that we had achieved the then established universalization targets, we were authorized to complete long distance national and international calls. We have entered into agreements with several carriers to include on our telephone bills the long distance services rendered by such carriers, as well as the long distance services rendered by other collective interest carriers. Any problems with the execution of invoicing and collection services by other carriers may adversely affect our levels of bad debts.

Any reduction in the offer of products by suppliers may adversely affect us.

We rely on several technology, equipment and services suppliers. Any difficulty in obtaining these products, due to, for example, a decrease in supply, excessive demand by global telecommunication players (causing product price pressure), discontinuity in the operations of one or more relevant suppliers (including bankruptcy or production problems), problems with the transfer or any other factor which affects the supplying of goods, may jeopardize either our expansion plans or the continuity of our services.

We sponsor employee social security plans and any changes in the regulations regarding mortality rates may require us to book additional provisions on our financial statements.

The amount, frequency and duration of our contributions to employee social security employees plans is directly related to the mortality rate, which represents the average life span of employees, among other factors.

Any change in these criteria may result in the need to contribute for longer periods in comparison to those initially provided. Consequently, we may be compelled to book additional provisions on our financial statements, which may adversely affect our results.

We may need to enter financing agreements with third parties in order to conclude potential strategic acquisitions carry on new transactions, effect regulatory investments, and maintain wireless and fixed telephone line plants.

We may not be able to bear financing demands through funds arising out of ordinary cash flow and may need to enter into financing agreements with third parties in the future. Such financing may not be available to us in

acceptable and competitive conditions or indeed in market conditions. If we are unable to obtain financings on terms favorable to us or at all, our transactions and operations may be materially and adversely affected.

Problems with sophisticated information and processing systems may cause significant adverse effects on our financial status and operational results.

Our sophisticated information ecember 31, 2002 and for the fiscal 2001 quarters ended December 31, 2001. The operating results for any given quarter are not necessarily indicative of results for any future periods (in thousands). Fiscal 2002 Quarter Ended Fiscal 2001 Quarter Ended ----- 31-Mar 30-Jun 30-Sep 31-Dec 31-Mar 30-Jun 30-Sep 31-Dec ----- Revenue \$ 1,396 \$ 723 \$ 187 \$ 13 \$ 195 \$ 115 \$ 415 \$ 238 Gross margin 298 256 99 (121) (10) (43) 259 (46) Loss from operations (303) (340) (483) (1,518) (1,158) (923) (977) (1,156) Other items, net 22 21 5 (15) 77 76 84 65 Provision for impairment of affiliated companies (7) (7) (8) (75) -- (1,093) -- Loss from discontinued Operations -- -- -- (107) 14 64 10 91 ----- Net loss \$ (365) \$ (376) \$(1,251) \$ (929) \$(1,081) \$(1,582) \$(1,251) \$(1,091) ----- BASIC AND DILUTED LOSS PER SHARE: Loss from continuing operations \$ (0.11) \$ (0.09) \$ (0.12) \$ (0.36) \$ (0.73) \$ (0.58) \$ (0.61) \$ (0.72) Other items, net 0.01 0.01 -- -- 0.05 0.05 0.05 0.04 Provision for impairment losses of affiliated companies -- -- -- (0.02) -- -- (0.68) -- Net losses from discontinued operations -- -- -- (0.03) 0.01 0.04 0.01 0.06 Net losses \$ (0.14) \$ (0.10) \$ (0.32) \$ (0.22) \$ (0.68) \$ (0.99) \$ (0.78) \$ (0.68) =====

===== 29 13. EVENTS SUBSEQUENT TO DECEMBER 31, 2002 a. REVERSE STOCK SPLIT Effective at the open of business on January 6, 2003 (the "Effective Date"), every five (5) shares of the Company's issued and outstanding common stock shall be combined into one(1) share of fully paid and non-assessable common stock of the Company (the "Reverse Split Ratio"). No fractional shares of common stock of the Company shall be issued in connection with the reverse split. A holder of common stock, who immediately prior to the Effective Date owns a number of shares of common stock of the Company which is not evenly divisible by the Reverse Split Ratio shall, with respect to the fractional interest, be issued a number of shares of new common stock of the Company rounded to the nearest whole number." All per share and per share amounts have been adjusted retroactively in these financial statements for the reverse split. b. INCORPORATION OF JOINT VENTURE IN MACAO SPECIAL ADMINISTRATIVE REGION On December 20, 2002, PacificNet Inc. entered into an agreement with International Elite Limited ("IEL"), a leading provider of value-added telecom services in the Greater China region, to establish "PacificNet Communications Limited - Macao Commercial Offshore," an equity joint venture company ("PacMOC"), which will be registered in the Macao Special Administrative Region (SAR) of China. The scope of the business to be provided by PacMOC shall include, value-added telecom services including call center, CRM, telemarketing, and data-mining services, and mobile data services such as Short Message Service (SMS), Multimedia Message Service (MMS), unified messaging service (UMS), location-based service (LBS), Wireless application Protocol (WAP), and Binary Runtime Environment for Wireless based Code Division Multiple Access (BREW-based CDMA) applications, mobile commerce, roaming, paging, wireless internet, Virtual Private Network (VPN) and Voice over IP (VoIP) services in the Greater China Region. PacMOC will be owned 50.1% by PacificNet and 49.9% by the shareholders of IEL. IEL will assign and contribute to PacMOC certain telecom business contracts, which have been valued at \$23.1 million, and the Company will contribute to PacMOC as its capital contribution, restricted shares of its common stock valued at its closing price on December 20, 2002, which will be held by an escrow agent to be released in tranches upon completion of certain agreed upon milestones of PacMOC. Pursuant to the terms of the agreement, all of the restricted shares held in escrow shall be released by the Escrow Agent provided, that, PacMOC generates \$3 million of net income for the fiscal year December 2003 according to U.S. generally accepted accounting principles, consistently applied. In the event less than \$3 million in net income is generated by PacMOC, the shareholders of IEL have agreed to pay the Company an amount in cash equal to the amount of the shortfall in net income. On February 24, 2003, PacificNet received a letter from Nasdaq stating that Nasdaq staff has determined that the transaction with IEL would not trigger the application of Marketplace Rule 4330(f), in that it would not constitute a "Reverse Merger". The Company plans to seek approval of the joint venture at its next meeting of stockholders. PacificNet will provide dates and additional disclosure within the Company's proxy statement related to its upcoming stockholders' meeting. c. Related Parties Transactions The Company has an

employment agreement with its Vice President, Executive Director and Company Secretary. The employment agreement provides for the officer to earn a \$48,000 cash compensation plus \$10,000 annual stock compensation annually until March 26, 2006. The officer is also eligible for an annual bonus for each fiscal year of the Company during the term based on performance standards as the Board or compensation committee designates. Other benefits include monthly housing allowance of \$2,000 and monthly automobile allowance of \$500. ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE. The Company dismissed Deloitte Touche Tohmatsu as its independent accountant and approved Clancy and Co., P.L.L.C. as its new independent accountants. The decision to change accountants was recommended and approved by the audit committee in response to the proposed change in control of the company. Deloitte Touche Tohmatsu did not perform an audit of the Company's financial statements for the year ended December 31, 2001. There were no disagreements with Deloitte Touche Tohmatsu on any matter of accounting principles or practices, financial statement disclosure or auditing scope or procedure for the three-month interim periods ended June 30, 2001, September 30, 2001 and through March 12, 2002. Deloitte Touche Tohmatsu was not engaged to perform an audit or review of the Company's financial statements for any period prior to the three-month period ended June 30, 2001. 30 PART III ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT. The information required by this Item is hereby incorporated by reference to the Company's definitive Proxy Statement for its 2003 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission. ITEM 10. EXECUTIVE COMPENSATION. The information required by this Item is hereby incorporated by reference to the Company's definitive Proxy Statement for its 2003 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission. ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT. The information required by this Item is hereby incorporated by reference to the Company's definitive Proxy Statement for its 2003 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission. ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS. The information required by this Item will be hereby incorporated by reference to the Company's definitive Proxy Statement for its 2003 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission. ITEM 13. CONTROLS AND PROCEDURES Under the supervision and with the participation of our management, including our chief executive officer and the chief financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934, within 90 days of the filing date of this report (the "Evaluation Date"). Based on this evaluation, our chief executive officer and chief financial officer concluded as of the Evaluation Date that our 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 Pacificnet, including our consolidating subsidiaries, and was made known to them by others within those entities, particularly during the period when this report was being prepared. Additionally, there were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the Evaluation Date. We have not identified any significant deficiencies or material weaknesses in our internal controls, and therefore there were no corrective actions taken. 31 ITEM 14. EXHIBITS AND REPORTS ON FORM 8-K. (a) Exhibits The following exhibits are filed as part of this report: EXHIBIT NUMBER DESCRIPTION ----- 2.1 Share Exchange Agreement by and among Davin Enterprises, Inc., Carl Tong, Leo Kwok and Acma Strategic Holdings Limited dated December 15, 1997. (1) 2.2 Share Exchange Agreement dated February 17, 2000, between Registrant and holders of membership interests in PacificNet.com LLC. (3) 2.3 Supplement to Share Exchange Agreement dated April 29, 2000, between Registrant and holders of membership interests in PacificNet.com LLC. (3) 2.4 Agreement dated September 30, 2000, among the Company and the "Purchasers" named therein. (4) 2.5 Supplemental Agreement dated October 3, 2000, among the Company and the "Purchasers" named therein. (4) 2.6 Deed of Waiver, dated October 3, 2000, by Creative Master Limited in favor of the Company. (4) 3.1 Certificate of Incorporation, as amended. Certificate of amendment of Certificate of Incorporation. 3.2 By Laws of the Company. (5) 3.3 Amendment to By Laws of the Company. (2) 4 Specimen Stock Certificate of the Company. 10.1 Form of Indemnification Agreement with officers and directors. (1) 10.2 Amendment to 1998 Stock Option Plan. 10.3 Form of Notice of Stock Option Grant and Stock Option Agreement under the 1998 Stock Option Plan. (3) 10.4 Amendment dated January 31, 2002 to the Subscription Agreement by and between the Company and Sino Mart Management Ltd.,

dated as of December 9, 2001 (6) 10.5 19.9% Private Placement Agreement and Amendments between Ho Shu-Jen and PacificNet.com, Inc. 10.6 Sub-Lease Agreement dated August 30, 2002. 99.1 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. 99.2 Subscription Agreement by and between the Company and Sino Mart Management Ltd., dated as of December 9, 2001 (6) ----- (1) Incorporated by reference to the Company's Form SB-2 filed on October 21, 1998. (2) Incorporated by reference to the Company's Form 10-KSB filed on March 30, 1999. (3) Incorporated by reference to the Company's Form 8-K filed on August 11, 2000. (4) Incorporated by reference to the Company's Form 8-K filed on October 17, 2000. (5) Incorporated by reference to the exhibits of the Company's registration statement (file no. 33-14521-NY) (6) Incorporated by reference to the Company's Form 8-K filed on March 20, 2002. (7) Incorporated by reference to the Company's Form 8-K filed on March 28, 2002. (8) Incorporated by reference to the Company's Form 10-KSB filed on April 16, 2002. (9) Incorporated by reference to the Company's Form 8-K filed on September 30, 2002. (10) Incorporated by reference to the Company's Form 8-K filed on December 24, 2002. (b) Reports on Form 8-K: The Company filed a Form 8-K on December 24, 2000, under Item 5 Other Events and Required FD Disclosure. 32 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: March 28, 2003 By: /s/ TONY I. TONG Tony I. Tong Chief Executive Officer (Principal Executive Officer) Date: March 28, 2003 By: /s/ WANG SHAO JIAN Wang Shao Jian Chief Financial Officer (Principal Financial Officer) Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated. NAME TITLE DATE ---- - - - - /s/ TONY I. TONG Director, Chairman and CEO March 28, 2003 ----- Tony I. Tong /s/ VICTOR TONG Director, Vice-President and Secretary March 28, 2003 ----- Victor Tong /s/ WANG SHAO JIAN Director and CFO March 28, 2003 ----- Wang Shao Jian /s/ TONG CHO SAM Director March 28, 2003 ----- Tong Cho Sam /s/ LO CHI HO RICHARD Director March 28, 2003 ----- Lo Chi Ho, Richard /s/ TANG YUE Director March 28, 2003 ----- Tang Yue /s/ FISHER DAVID Director March 28, 2003 ----- Fisher David /s/ FU YONG JUN Director March 28, 2003 ----- Fu Yong Jun 33 INDEX TO EXHIBITS EXHIBIT NUMBER DESCRIPTION ----- 2.1 Share Exchange Agreement by and among Davin Enterprises, Inc., Carl Tong, Leo Kwok and Acma Strategic Holdings Limited dated December 15, 1997. (1) 2.2 Share Exchange Agreement dated February 17, 2000, between Registrant and holders of membership interests in PacificNet.com LLC. (3) 2.3 Supplement to Share Exchange Agreement dated April 29, 2000, between Registrant and holders of membership interests in PacificNet.com LLC. (3) 2.4 Agreement dated September 30, 2000, among the Company and the "Purchasers" named therein. (4) 2.5 Supplemental Agreement dated October 3, 2000, among the Company and the "Purchasers" named therein. (4) 2.6 Deed of Waiver, dated October 3, 2000, by Creative Master Limited in favor of the Company. (4) 3.1 Certificate of Incorporation, as amended. Certificate of amendment of Certificate of Incorporation. 3.2 By Laws of the Company. (5) 3.3 Amendment to By Laws of the Company. (2) 4 Specimen Stock Certificate of the Company. 10.1 Form of Indemnification Agreement with officers and directors. (1) 10.2 Amendment to 1998 Stock Option Plan. 10.3 Form of Notice of Stock Option Grant and Stock Option Agreement under the 1998 Stock Option Plan. (3) 10.4 Amendment dated January 31, 2002 to the Subscription Agreement by and between the Company and Sino Mart Management Ltd., dated as of December 9, 2001 (6) 10.5 19.9% Private Placement Agreement and Amendments between Ho Shu-Jen and PacificNet.com, Inc. 10.6 Sub-Lease Agreement dated August 30, 2002. 99.1 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. 99.2 Subscription Agreement by and between the Company and Sino Mart Management Ltd., dated as of December 9, 2001 (6) 34 CERTIFICATION I, Tony Tong, certify that: 1. I have reviewed this annual report on Form 10-KSB of Pacificnet, Inc.; 2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report; 3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report; 4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and

15d-14) for the registrant and have: a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared; b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date; 5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions): a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and 6. The registrant's other certifying officers and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses. Date: March 28, 2003 /s/ Tony Tong ----- Tony Tong, Chairman and Chief Executive Officer (Principal Executive Officer) 35 I, Wang Shao Jian, certify that: 1. I have reviewed this annual report on Form 10-KSB of Pacificnet, Inc.; 2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report; 3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report; 4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have: a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared; b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date; 5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions): a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and 6. The registrant's other certifying officers and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses. Date: March 28, 2003 /s/ Wang Shao Jian ----- Wang Shao Jian, Chief Financial Officer, (Principal Financial Officer) 36