

SIFY LIMITED AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share data and as stated otherwise)

1. Description of business

Sify Limited (Sify) together with its subsidiaries (the Company) and its affiliates is engaged in providing various services, such as Corporate Network and Data Services, Internet Access Services, Online Portal and Content Offerings.

2. Summary of significant accounting policies

a. Basis of preparation of financial statements

The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States (US GAAP) in Indian Rupees (Rs.), the national currency of India. Solely for the convenience of the reader, the financial statements as of and for the year ended June 30, 2004 have been translated into United States dollars at the noon buying rate in New York City on June 30, 2004 for cable transfers in Indian rupees, as certified for customs purposes by the Federal Reserve Bank of New York of US\$1 = Rs. 45.99. No representation is made that the Indian rupee amounts have been, could have been or could be converted into United States dollars at such a rate or at any other rate on June 30, 2004 or at any other date.

b. Interim Information

Interim information presented in the condensed consolidated financial statements has been prepared by the management without audit and, in the opinion of management, includes all adjustments of a normal recurring nature that are necessary for the fair presentation of the financial position, results of operations, and cash flows for the periods shown, is in accordance with the generally accepted accounting principles in the United States. These financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company's annual report on Form 20-F for the fiscal year ended March 31, 2004.

3. Cash and cash equivalents

Cash and cash equivalents as on June 30, 2004 amounted to Rs 1,340,844 (Rs 1,325,803 as on March 31, 2004). This excludes restricted cash included in current assets of Rs 30,891 (Rs 101,587 as on March 31, 2004) and restricted cash included in non-current assets of Rs 110,245 (Rs 10,146 as on March 31, 2004) representing deposits held under lien against bank guarantees given by the Company towards future performance obligations and letters of credit given to suppliers of the Company against purchase obligations.

The restricted cash balances in current and non-current assets represent deposits earmarked against financial guarantees and letters of credit procured in the course of business, including guarantees given to The Telegraph Authority of Rs 10,000 Videsh Sanchar Nigam Limited of Rs 21,549 and letter of credits for Axxcelera Broadband Wireless Inc., of Rs 20,527 and JQ Network of Rs 14,606.

4. E Alcatraz Consulting Private Limited

The Company acquired the business of E Alcatraz Consulting Private Limited ("EAP") for cash, on March 1, 2004. Management believes that as a result of this acquisition, the Company will get into the value added consulting space like security risk assessment, security policy and procedure consulting and Managed Security Services which would serve as end to end security solutions to the Company's corporate clients. The purchase consideration includes a waiver of a loan extended to EAP for Rs. 2,400 and the balance amounts will be paid in agreed installments by September 30, 2004.

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The total purchase price has been preliminarily allocated to the acquired assets and assumed liabilities as follows:

Purchase price	Rs. 32,630
Direct transaction costs	125
	<hr/>
	32,755
Allocated to:	
Net current assets	2,909
Tangible assets	762
Intangible assets pending final allocation	29,084
	<hr/>
	Rs. 32,755

The purchase consideration has been allocated on a preliminary basis to the assets acquired and liabilities assumed as of the date of acquisition based on management's estimates. However, certain independent appraisals reports are yet to be received by the Company. Finalization of the purchase price allocation, which is expected to be completed within one year from the date of acquisition, may result in certain adjustments to the above-reflected allocations. As the purchase price allocation is preliminary and as management does not expect the fair values of the amortizable intangible assets to be material, no amortization expense/ deferred tax liabilities have been recognized as part of the purchase price allocation.

5. Goodwill and intangibles

At June 30, 2004, the Company's goodwill and other intangible assets amounted to Rs 14,595 and Rs 99,370 respectively.

Acquired and amortized intangible assets

		<u>As at June 30, 2004</u>	
	Weighted average life	Gross carrying amount	Accumulated amortization
Technical know how fees	4.89	90,313	57,834
Portals and web content	5.00	100,360	71,552
Customer contracts and others	3.00	56,084	18,001
Total		246,757	147,387

The aggregate amortization expense for the quarter ended June 30, 2004 was Rs 11,657.

Estimated amortization expense

For the year ending	
March 31,	
2005	46,108
2006	29,657
2007	6,158
2008	20

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The Company has stopped amortizing goodwill pursuant to SFAS No. 142. The Company has not recognized any impairment of goodwill during the years ended March 31, 2003 and 2004.

6. Employee Stock Options

The Company has adopted pro forma disclosure provisions of SFAS No. 123 and SFAS No. 148. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB statement No. 123, Accounting for Stock Based Compensation to stock based employee compensation.

	Quarter ended June 30,	
	2003	2004
Net loss – as reported	Rs. (207,153)	Rs. (54,739)
Add: Stock based compensation expense included in reported net loss	8,835	3,665
Less: Stock based compensation expense determined under fair value method	(23,266)	(25,379)
Pro forma net loss	<u>Rs. (221,584)</u>	<u>Rs. (76,453)</u>
Loss per share:		
Basic and diluted – reported	(6.18)	(1.56)
Basic and diluted – proforma	(6.61)	(2.18)

The fair value of each option is estimated on the date of grant using the Black-Scholes model with the following assumptions:

	Quarter ended June 30,	
	2003	2004
Dividend yield	-	-
Expected volatility	140 %	131% to 157.3%
Risk-free interest rate	5.25 %	4.50% to 5.25%
Expected term	12-36 months	12-36 months

7. Gratuity

The Company provides for gratuity, a defined benefit retirement plan (the Gratuity Plan) covering all employees. The Gratuity Plan commenced on April 1, 1997. The plan provides a lump sum payment to vested employees at retirement or termination of employment an amount based on the respective employee's salary and the years of employment with the Company. The Company provides the gratuity benefit through annual contributions to a fund managed by the Life

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Insurance Corporation of India (LIC). Under this scheme, the settlement obligation remains with the Company, although the LIC administers the scheme and determines the contribution premium required to be paid by the Company. The Gratuity Plan is accounted for in accordance with SFAS No. 87.

The following table sets out the funded status of the Gratuity Plan and the amounts recognized in the Company's balance sheet.

	Quarter ended June 30, 2004	Year ended March 31, 2004
Accumulated benefit obligation	10,331	8,968
Change in projected benefit obligation		
Projected benefit obligation at the beginning of the year	Rs. 16,093	Rs. 11,659
Service cost	1,422	4,593
Interest cost	275	929
Divestiture / acquisition	-	309
Actuarial (gain)/loss	521	(1,274)
Benefits paid	-	(123)
Projected benefit obligation at the end of the year	Rs. 18,311	Rs. 16,093
Change in plan assets		
Fair value of plan assets at the beginning of the year	4,436	3,720
Actual return on plan assets	65	269
Employer contributions	-	263
Acquisition	-	309
Benefits paid from plan assets	-	(124)
Fair value of plan assets at the end of the year	4,501	4,437
Funded status of the plans	13,810	11,656
Unrecognized transition obligation (asset)	-	-
Unrecognized prior service cost (benefit)	-	-
Unrecognized net actuarial gain/(loss)	2,423	3,048
Accrued benefit cost	Rs. 16,233	Rs. 14,704
		Quarter ended June 30, 2004
The components of net gratuity costs are reflected below:		
Service cost		Rs. 1,422
Interest cost		275
Expected returns on plan assets		(136)
Amortization		-
Recognized net actuarial (gain)/ loss		(32)
Net gratuity costs		Rs. 1,529

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	Quarter ended June 30, 2004
Principal actuarial assumptions:	
Discount rate	7%
Long-term rate of compensation increase	6%
Rate of return on plan assets	6%

The employer's best estimate of contributions expected to be paid to the plan during the year ending March 31, 2005 amounts to Rs 10,000. Further, the benefits expected to be paid in each of the next five fiscal years, and in the aggregate for the five fiscal years thereafter are:

For the year ending	
March 31,	
2005	1,161
2006	1,621
2007	2,106
2008	3,110
2009	4,545
2010 to 2014	25,769

Due to non-availability of fund status as on June 30, 2003, the Company has not disclosed the corresponding previous period.

8. Deferred revenue:

Deferred revenue includes the following amounts of unearned income:

- for the Company's corporate network / data services division, revenue relating to the connectivity / hosting charges;
- for the Company's internet access services and online portal services divisions, revenue relating to the internet access charges and the advertisement charges respectively; and
- for the Company's other service division, revenue relating to development of e- learning software and from provision of digital certificates.

The components of deferred revenue for these segments are:

	As at March 31, 2004	As at June 30, 2004
Corporate network / Data services	Rs. 166,648	Rs. 189,591
Internet access services	157,241	152,959
Online portal services	2,895	973
Other services	15,169	4,171
	Rs. 341,953	Rs. 347,694

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9. Advertising costs

Advertising costs incurred during the quarter have been expensed. The total amount of advertising costs expensed during the quarter ended June 30, 2003 and 2004 was Rs 12,224 and Rs 2,121 respectively.

10. Products and services

Breakup of revenues and cost of revenues against products and services are as follows:

	Quarter ended June 30,	
	2003	2004
<i>Revenue</i>		
Products revenue	Rs. 33,824	Rs. 75,767
Services revenue	533,206	637,150
Initial franchisee fee	16,780	19,925
Installation services revenue	17,215	44,995
	<u>567,201</u>	<u>702,070</u>
	<u>Rs. 601,025</u>	<u>Rs. 777,837</u>
<i>Cost of revenues</i>		
Products	Rs. 32,009	Rs. 67,383
Services	288,835	363,861
	<u>Rs. 320,844</u>	<u>Rs. 431,244</u>

11. Segment reporting

SFAS No 131, “Disclosures about Segments of an Enterprise and Related Information”, establishes standards for the way that public business enterprises report information about operating segments and related disclosures about products and services, geographic areas and major customers. The Company’s operations predominantly relate to connectivity to enterprises and providing Internet access to retail subscribers (both home access and public access). The Company also operates a portal, “Sify.com”, that provides a variety of India-related content to audiences both in India and abroad, and which generates revenue from advertisements and other value added services. The Company also has a subsidiary, which deals with digital signatures and internet security.

The primary operating segments of the Company are:

- Corporate network/data services, which provides private network services, messaging services and web hosting to businesses;
- Internet access services to homes and through cybercafes;
- Online portals services and content offerings; and
- Other services such as development of e-learning software.

The chief operating decision maker (“CODM”) evaluates the Company’s performance and allocates resources to various strategic business units that are identified based on the products and services that they offer and on the basis of the market catered to. Revenue in relation to segments is categorized based on items that are individually identifiable to that segment.

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Bandwidth costs, which form a significant part of the total expenses, are of three kinds – international, inter-city and last mile. These are allocated primarily between the corporate network/data services and internet access services businesses as described below:

The international bandwidth refers to bandwidth that is required for access to sites and offices outside the country. For all these businesses bandwidth is allocated based on actual utilization captured by monitoring traffic per IP pool assigned, at the egress points. The company has packet shapers in the main locations to monitor bandwidth use by each of the above categories of users. This information is used in determining norms like bandwidth per port and bandwidth per PC. The actual utilization are cross validated against assumptions / norms for each business.

The national bandwidth refers to the inter-city link bandwidth implemented within the country. Inter city bandwidth was allocated based on the number of subscribers or iway cafes at “non gateway” points and the bandwidth sold to and used by business enterprises (determined using packet shapers). However, due to strategic reasons aimed at furthering the corporate business, the national backbone was enhanced to carry traffic to the international fibre gateways moving away from its hybrid Satellite and Fibre gateways to only fibre gateways for international bandwidth. Local exit of international traffic through the satellite gateways has reduced and this traffic has been loaded onto the national backbone. National bandwidth costs are now allocated based on International bandwidth allocation ratios. This is since most of the traffic carried on the national backbone is finally aimed towards the international gateways. The Company believes that the resulting allocations are reasonable.

Last mile costs in the dial up access (E1/R2 costs) and spectrum fees for wireless connectivity that can be directly identified to the businesses are allocated directly.

Certain expenses, like depreciation and overheads incurred by the support functions including finance, human resources, administration, technology and corporate, which form a significant component of total expenses, are not specifically allocable to specific segments as the underlying services are used interchangeably. Management believes that it is not practical to provide segment disclosure of these expenses and, accordingly, they are separately disclosed as “unallocated corporate expenses” and adjusted only against the total income of the Company.

A significant part of the fixed assets used in the Company’s business are not identifiable to any of the reportable segments and can be used interchangeably between segments. Management believes that it is not practicable to provide segment disclosures relating to total assets since a meaningful segregation of the available data is onerous. The Company’s operating segment information for the quarter ended June 30, 2004 and 2003 is presented below:

	Quarter ended June 30, 2004				
	Corporate Network / Data Services	Internet Access Services	Online Portal Services	Other Services	Total
Revenues	438,077	291,804	21,826	26,130	777,837
Operating expenses	(286,122)	(288,700)	(23,402)	(14,849)	(613,073)
Equity in profits of affiliates			12,035		12,035
Minority interest					
Segment operating income / (loss)	151,955	3,104	10,459	11,281	176,799
Unallocated corporate expenses					(142,773)
Foreign exchange gain / (loss), net					33,248
Other income / (expense), net					318
Depreciation and amortization					(134,986)
Interest income, net					12,655
Net loss					(54,739)

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	Quarter ended June 30, 2003				
	Corporate Network / Data Services	Internet Access Services	Online Portal Services	Other Services	Continuing Operations
Revenues	282,602	233,254	25,759	59,410	601,025
Operating expenses	(199,716)	(270,586)	(28,933)	(23,384)	(522,619)
Equity in losses of affiliates			(13,514)		(13,514)
Minority interest			(462)		(462)
Segment operating income / (loss)	82,886	(37,332)	(17,150)	36,026	64,430
Corporate expenses					(128,243)
Foreign exchange gain / (loss)					(14,099)
Other income / (expense), net					6,330
Depreciation & amortization					(143,885)
Interest income, net					8,314
Net loss					(207,153)

12. Legal proceedings

Sify and certain of its officers and directors are named as defendants in a securities class action lawsuit filed in the United States District Court for the Southern District of New York. This action, which is captioned *In re Satyam Infoway Ltd. Initial Public Offering Securities Litigation*, also names several of the underwriters involved in Sify's initial public offering of American Depositary Shares as defendants. This class action is brought on behalf of a purported class of purchasers of Sify's ADS from the time of Sify's Initial Public Offering (IPO) in October 1999 through December 2000. The central allegation in this action is that the underwriters in Sify's IPO solicited and received undisclosed commissions from, and entered into undisclosed arrangements with, certain investors who purchased Sify's ADS's in the IPO and the aftermarket. The complaint also alleges that Sify violated the United States federal securities laws by failing to disclose in the IPO prospectus that the underwriters had engaged in these allegedly undisclosed arrangements. More than 300 issuers have been named in similar lawsuits.

In July 2002, an omnibus motion to dismiss all complaints against issuers and individual defendants affiliated with issuers was filed by the entire group of issuer defendants in these similar actions. In October 2002, the cases against the Company's executive officers who were named as defendants in this action were dismissed without prejudice. In February 2003, the court in this action issued its decision on defendants' omnibus motion to dismiss. This decision denied the motion to dismiss the Section 11 claim as to the Company and virtually all of the other issuer defendants. The decision also denied the motion to dismiss the Section 10(b) claim as to numerous issuer defendants, including the Company. On June 26, 2003, the plaintiffs in the consolidated IPO class action lawsuits currently pending against Sify and over 300 other issuers who went public between 1998 and 2000, announced a proposed settlement with Sify and the other issuer defendants. The proposed settlement provides that the insurers of all settling issuers will guarantee that the plaintiffs recover \$1 billion from non-settling defendants, including the investment banks who acted as underwriters in those offerings. In the event that the plaintiffs do not recover \$1 billion, the insurers for the settling issuers will make up the difference. The Company believes that it has sufficient insurance coverage to cover the maximum amount that it may be responsible for under the proposed settlement. It is possible that the Federal District Court may not approve the settlement in whole or part. The maximum financial exposure under this, in the event that the plaintiffs recover nothing from the underwriter, would be USD 3.9 million, which is fully recoverable from Sify's insurer.

The charges for international gateways and other services presently being provided by Videsh Sanchar Nigam Limited (VSNL) are the subject of a dispute pending before the Telecom Regulatory Authority of India ("TRAI") and the Telecom Disputes Settlement and Appellate Tribunal between VSNL and private Internet service providers, including Sify, represented by the Internet Service Providers Association of India ("ISPAI"). VSNL has priced these services at

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levels that Sify believes are inconsistent with the terms and conditions on which VSNL has secured the bandwidth for its international gateways. The Telecom Disputes Settlement and Appellate Tribunal remanded the matter back to the TRAI, which decided against the ISPAI. The ISPAI has not yet decided on a further course of action. Sify is currently paying for bandwidth from VSNL at the higher rates and therefore believes that there is no adverse financial effect to the Company.

Sify is party to additional legal actions arising in the ordinary course of business. Based on the available information, as at June 30, 2004, Sify believes that it has adequate legal defenses for these actions and that the ultimate outcome of these actions will not have a material adverse effect on Sify. However in the event of adverse judgment in all these cases, the maximum financial exposure would be Rs 2,274.