

SIFY LIMITED AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In Rupees thousands, except share data and as otherwise stated)

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 unaudited condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("Consolidated 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 quarter ended September 30, 2004 have been translated into United States dollars at the noon buying rate in New York City on September 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. 45.91. 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 September 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 September 30, 2004 amounted to Rs 1,458,914 (Rs 1,325,803 as on March 31, 2004). This excludes restricted cash included in current assets of Rs 31,478 (Rs 101,587 as on March 31, 2004) and restricted cash included in non-current assets of Rs 20,227 (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 India of Rs 10,000 and Videsh Sanchar Nigam Limited of Rs 21,549 and letters of credits for Axxcelera Broadband Wireless Inc., of Rs 3,427 and JQ Network of Rs 1,623.

4. E Alcatraz Consulting Private Limited

The Company acquired the business of E Alcatraz Consulting Private Limited ("EAP") for cash on March 1, 2004. As a result of this acquisition, the Company would offer value-added consulting services, such as security risk assessment, security policy and procedure consulting and Managed Security Services, which would provide end to end security solutions to the Company's corporate clients.

During the quarter ended September 30, 2004 the total purchase price has been 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 asset relating to customer relationship	29,084
	<hr/>
	Rs. 32,755

The Company has considered the Financial Accounting Standards Board Statement No. 141 (“SFAS 141”), Business Combinations and relevant interpretive guidance for allocation of the purchase price and has estimated the fair value of the customer contracts, customer relationship at Rs 29,084 with a weighted average useful life of five years.

5. Goodwill and intangibles

At September 30, 2004, the Company’s goodwill and other intangible assets amounted to Rs 14,595 and Rs 84,493, respectively (Rs 14,595 and Rs 105,890 as on September 30, 2003 respectively).

	Weighted average life	As at September 30, 2004		As at September 30, 2003	
		Gross carrying amount	Accumulated amortization	Gross carrying amount	Accumulated amortization
Technical know how fees	4.89	Rs. 90,314	Rs. 61,974	Rs. 90,314	Rs. 44,270
Portals and web content	5.00	100,360	76,647	100,361	56,265
Customer contracts, Customer relationships and others	4.04	93,584	61,144	27,001	11,251
Employment contracts	2.00	-	-	37,500	37,500
Total		Rs. 284,258	Rs. 199,765	Rs. 255,176	Rs. 149,286

The aggregate amortization expense for the quarter ended September 30, 2004 was Rs 14,876 (Rs 48,828 for the quarter ended September 30, 2003).

Estimated amortization expense

For the year ended March 31,

2005	Rs. 52,408
2006	35,474
2007	11,975
2008	5,837
2009	5,332

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, the Company does not amortise goodwill but tests it for impairment on an annual basis. The Company has not recognized any impairment of goodwill during the years ended March 31, 2003 and 2004 and for the six months ended September 30, 2004.

6. Employee Stock Options

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

	Quarter ended September 30,		Six months ended September 30,	
	2003	2004	2003	2004
Net loss – as reported	Rs. (84,795)	Rs. (46,203)	Rs. (291,948)	Rs. (100,941)
Add: Stock based compensation expense included in reported net loss	7,052	3,045	15,887	6,710
Less: Stock based compensation expense determined under fair value method	16,466	13,952	24,650	39,331
Pro forma net loss	Rs. (94,209)	Rs.(57,110)	Rs. (300,711)	Rs. (133,562)
Loss per share:				
Basic and diluted – reported	Rs.(2.44)	Rs.(1.32)	Rs. (8.55)	Rs.(2.88)
Basic and diluted – proforma	Rs.(2.71)	Rs. (1.63)	Rs. (8.80)	Rs.(3.81)

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

	Quarter ended September 30,		Six months ended September 30,	
	2003	2004	2003	2004
Dividend yield	-	-	-	-
Expected volatility	103.4%	103.4 – 116.6%	103.4%	103.4 – 116.6%
Risk-free interest rate	5.25%	7.50%	5.25%	7.50%
Expected term	12-36 months	12-36 months	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 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, *Employers' Accounting for Pensions*.

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

	Quarter ended September 30,		Six months ended September 30,	
	2003	2004	2003	2004
Accumulated benefit obligation	7,902	10,284	7,902	10,284
Change in projected benefit obligation				
Projected benefit obligation at the beginning of the year	Rs. 13,697	Rs 18,311	Rs. 11,659	Rs. 16,093
Service cost	1,148	1,422	2,296	2,844
Interest cost	233	275	465	550
Divestiture / acquisition	-	-	-	-
Actuarial (gain)/loss	(774)	(1,575)	(116)	(1,054)
Benefits paid	31	530	31	530
Projected benefit obligation at the end of the year	14,273	17,903	Rs. 14,273	Rs. 17,903
Change in plan assets				
Fair value of plan assets at the beginning of the year	3,788	4,501	3,720	4,436
Actual return on plan assets	69	68	137	133
Employer contributions	-	697	-	697
Acquisition	-	-	-	-
Benefits paid from plan assets	31	530	31	530
Fair value of plan assets at the end of the year	3,826	4,736	3,826	4,736
Funded status of the plans	(10,447)	(13,167)	(10,447)	(13,167)
Unrecognized transition obligation (asset)	-	-	-	-
Unrecognized prior service cost (benefit)	-	-	-	-
Unrecognized net actuarial gain/(loss)	(742)	(1,474)	(1,962)	(3,897)
Accrued benefit cost	(11,189)	(14,641)	(12,409)	(17,064)

Quarter ended September 30,		Six months ended September 30,	
2003	2004	2003	2004

The components of net gratuity costs are reflected below:

Service cost	1,148	1,422	2,296	2,844
Interest cost	233	275	465	550
Expected returns on plan assets	(87)	(136)	(175)	(272)
Amortization	-	-	-	-
Recognized net actuarial (gain)/ loss	(14)	(33)	(28)	(65)
Net gratuity costs	1,280	1,528	2,558	3,057

	Quarter ended September 30,		Six months ended September 30,	
	2003	2004	2003	2004
Principal actuarial assumptions:				
Discount rate	8.0%	7.0%	8.0%	7.0%
Long-term rate of compensation increase	7.0%	6.0%	7.0%	6.0%
Rate of return on plan assets	7.5%	6.0%	7.5%	6.0%

The company'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:

<u>For the year ending</u>	
<u>March 31,</u>	
2005	Rs. 1,329
2006	1,683
2007	2,452
2008	2,927
2009	4,693
2010 to 2014	26,713

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 and from provision of digital certificates;
- 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.

The components of deferred revenue for these segments are:

	As at	
	March 31, 2004	September 30, 2004
Corporate network / Data services	Rs. 166,648	Rs. 209,276
Internet access services	157,241	164,007
Online portal services	2,895	1,126

Other services	15,169	5,821
	Rs. 341,953	Rs. 380,230

9. Advertising costs

Advertising costs incurred during the quarter have been expensed. The total amount of advertising costs expensed during the quarters ended September 30, 2003 and 2004 was Rs 18,072 and Rs 11,777 respectively.

10. Products and services

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

	Quarter ended September 30,		Six months ended September 30,	
	2003	2004	2003	2004
<i>Revenue</i>				
Services revenue	Rs. 558,688	Rs. 694,400	Rs. 1,091,894	Rs. 1,330,520
Initial franchisee fee	25,305	30,758	42,085	50,683
Installation services revenue	32,220	57,827	49,435	102,822
	Rs. 616,213	Rs. 782,985	Rs. 1,183,414	Rs. 1,484,025
Products revenue	Rs. 47,542	Rs. 77,812	Rs 81,366	Rs. 154,609
	Rs. 663,755	Rs. 860,797	Rs. 1,264,780	Rs. 1,638,634
<i>Cost of revenues</i>				
Products	Rs. 40,991	Rs 64,924	Rs 73,000	Rs 132,307
Services	295,921	392,324	584,755	756,185
	Rs. 336,912	Rs.457,248	Rs 657,755	Rs. 888,492

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 connectivity services, messaging services, security consultancy services and web hosting to businesses;
- Internet access services to homes and through cybercafes;
- Online portal 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.

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

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.

National bandwidth refers to the inter-city link bandwidth implemented within the country. Inter-city link 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, such as 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 September 30, 2004 and 2003 is presented below:

	Quarter ended September				
30, 2004	Corporate Network / Data Services	Internet Access Services	Online Portal Services	Other Services	Total
Revenues	478,235	339,644	24,652	18,266	860,797
Operating expenses	(294,290)	(320,120)	(24,642)	(13,694)	(652,746)
Equity in profits of affiliates			6,236		6,236
Minority interest					
Segment operating income / (loss)	183,945	19,524	6,246	4,572	214,287
Unallocated corporate expenses					(148,923)
Foreign exchange gain / (loss), net					(3,436)

Other income / (expense), net	7,836
Profit from sale of business	15,710
Depreciation and amortization	(142,526)
Interest income, net	10,849
Net loss	(46,203)

	Quarter ended				
	September 30, 2003				
	Corporate Network / Data Services	Internet Access Services	Online Portal Services	Other Services	Continuing Operations
Revenues	Rs 322,619	Rs 254,153	Rs 20,094	Rs 66,889	Rs 663,755
Operating expenses	(197,826)	(292,693)	(26,523)	(20,206)	(537,248)
Equity in losses of affiliates			(2,230)		(2,230)
Minority interest			532		532
Segment operating income / (loss)	Rs 124,793	Rs (38,540)	Rs (8,127)	Rs 46,683	Rs 124,809
Unallocated Corporate expenses					(144,212)
Foreign exchange gain / (loss)					(8,529)
Other income / (expense), net					89,774
Depreciation and amortization					(160,131)
Interest income, net					13,565
Income taxes					(71)
Net loss					Rs (84,795)

	Six months ended September 30, 2004				
	Corporate Network / Data Services	Internet Access Services	Online Portal Services	Other Services	Continuing Operations
Revenues	916,312	631,447	46,478	44,397	1,638,634
Operating expenses	(580,412)	(608,820)	(48,044)	(28,544)	(1,265,820)
Equity in losses of affiliates			18,271		18,271
Minority interest					
Segment operating income / (loss)	335,900	22,627	16,705	15,853	391,085
Unallocated Corporate expenses					(291,694)
Foreign exchange gain / (loss)					29,812
Other income / (expense), net					8,154
Profit from sale of investments					15,710
Depreciation and amortization					(277,512)
Interest income, net					23,504
Net loss					(100,941)

30, 2003	Six months ended September				
	Corporate Network / Data Services	Internet Access Services	Online Portal Services	Other Services	Continuing Operations
Revenues	Rs 605,221	Rs 487,407	Rs 45,853	Rs 126,299	Rs 1,264,780
Operating expenses	(397,542)	(563,279)	(525,456)	(43,590)	(1,059,867)
Equity in losses of affiliates			(15,744)		(15,744)
Minority interest			70		70

Segment operating income / (loss)	Rs 207,679	Rs (75,872)	Rs (25,277)	Rs 82,709	Rs 189,239
Unallocated Corporate expenses					(270,582)
Foreign exchange gain / (loss)					(22,628)
Other income / (expense), net					96,104
Depreciation and amortization					(304,016)
Interest income, net					20,007
Income taxes					(72)
Net loss					<u>Rs (291,948)</u>

12. Leases

The Company's leasing arrangement consist of leasing various types of routers, modems and other equipment for setting up virtual private network and providing bandwidth to its customers in corporate connectivity business. The leases are classified as Sales-Type Leases and expire after a period of three years.

The following lists the components of the net investment in sales-type leases as of September 30, 2004:

Minimum lease payments receivable	Rs. 884
Less: Unearned income	Rs. 172
Net investment in sales-type leases	Rs. 712

The minimum lease payments for each of the fiscal years are as follows:

<u>For the year ending</u>	
<u>March 31,</u>	
2005	Rs. 66
2006	300
2007	300
2008	234

The Company's leasing operations include sales-type leases with Satyam Computer Services Limited, a related party, for leasing networking equipment over a period of 3 years with an annual minimum lease payment of Rs. 300. The sale value of the assets covered under the lease for the quarter ended September 30, 2004 was Rs 727.

13. 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 ADSs 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, is estimated to be USD 3.9 million, an amount we believe 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 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 the outcome of this matter will not have any material adverse financial effect on the Company.

Sify is party to additional legal actions arising in the ordinary course of business. Based on the available information, as at September 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.