

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 (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 and nine months ended December 31, 2004 have been translated into United States dollars at the noon buying rate in New York City on December 31, 2004 for cable transfers in Indian rupees, as certified for customs purposes by the Federal Reserve Bank of New York of US\$1 = Rs. 43.27. 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 December 31, 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 December 31, 2004 amounted to Rs. 1,561,852 (Rs. 1,325,803 as on March 31, 2004). This excludes restricted cash included in current assets of Rs. 16,883 (Rs. 101,587 as on March 31, 2004) and restricted cash included in non-current assets of Rs. 7,472 (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 letters of credit for Axxcelera Broadband Wireless Inc., of Rs. 1,864, JQ Network of Rs. 1,573, Wipro Limited of Rs. 1,433 and Controller of Certifying Authorities of Rs. 10,000.

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 offers value-added consulting services, such as security risk assessment, security policy and procedure consulting and managed security services, which 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	Rs. 2,909
Tangible assets	762
Intangible asset relating to customer relationship	29,084
	<hr/>
	Rs. 32,755

the customer contracts, and customer relationship at Rs. 29,084 with a weighted average useful life of five years.

5. Goodwill and intangibles

At December 31, 2004, the Company's goodwill and other intangible assets amounted to Rs. 14,595 and Rs. 71,556 respectively (Rs. 14,595 and Rs. 93,786 as on December 31, 2003 respectively). The following are the details of other intangible assets:

	Weighted average life	As at December 31, 2004		As at December 31, 2003	
		Gross carrying amount	Accumulated amortization	Gross carrying amount	Accumulated amortization
Technical know how fees	4.80	Rs. 90,313	Rs. 66,111	Rs. 90,313	Rs. 49,027
Portals and web content	4.95	100,360	81,743	100,360	61,360
Customer contracts, Customer relationships and others	4.04	56,085	27,348	27,001	13,501
Employment contracts	2.00	-	-	37,500	37,500
Total		Rs. 246,758	Rs. 175,202	Rs. 255,174	Rs. 161,388

The aggregate amortization expense for the quarters ended December 31, 2003 and 2004 was Rs. 12,103 and Rs. 12,938, respectively, and the nine months ended December 31, 2003 and 2004 was Rs. 60,931 and Rs. 39,471, respectively.

Estimated amortization expense

For the year ended March 31,

2005	Rs.52,409
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 nine months ended December 31, 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 December 31,	Nine months ended December 31,
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Net loss – as reported	Rs. (102,473)	Rs. (95,012)	Rs. (394,421)	Rs. (195,953)
Add: Stock based compensation expense included in reported net loss	6,620	2,690	22,507	9,400
Less: Stock based compensation expense determined under fair value method	16,170	21,318	33,758	60,649
Pro forma net loss	Rs. (112,023)	Rs. (113,640)	Rs. (405,672)	Rs. (247,202)
Loss per share:				
Basic and diluted – reported	Rs. (2.94)	Rs. (2.70)	Rs. (11.47)	Rs. (5.59)
Basic and diluted – proforma	Rs. (3.21)	Rs. (3.23)	Rs. (11.79)	Rs. (7.05)

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

	Quarter ended December 31,		Nine months ended December 31,	
	2003	2004	2003	2004
Dividend Yield	-	-	-	-
Assumed Volatility	131 - 157.3%	103.4 – 116.6%	131 - 157.3%	103.4 - 116.6%
Risk-Free Interest Rate	5.25%	7.5%	5.25%	7.5%
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 financial statements.

	Quarter ended December 31,		Nine months ended December 31,	
	2003	2004	2003	2004
Accumulated benefit obligation	8,255	10,881	8,255	10,881
Change in projected benefit obligation				
Projected benefit obligation at the beginning of the year	Rs. 14,273	Rs. 17,903	Rs. 11,659	Rs. 16,093
Service cost	1,149	1,422	3,445	4,266
Interest cost	232	275	697	825
Divestiture / acquisition	-	-	-	-
Actuarial (gain)/loss	(699)	(522)	(815)	(1,576)
Benefits paid	(40)	(154)	(71)	(684)

	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>
Projected benefit obligation at the end of the year	14,915	18,924	14,915	18,924

	<u>Quarter ended December 31,</u>		<u>Nine months ended December 31,</u>	
	2003	2004	2003	2004
Change in plan assets				
Fair value of plan assets at the beginning of the year	3,826	4,735	3,720	4,436
Actual return on plan assets	68	66	205	198
Employer contributions	-	-	-	697
Acquisition	-	-	-	-
Benefits paid from plan assets	(40)	(154)	(71)	(684)
Fair value of plan assets at the end of the year	3,854	4,647	3,854	4,647
Funded status of the plans	(11,060)	(14,276)	(11,060)	(14,276)
Unrecognized transition obligation (asset)	-	-	-	-
Unrecognized prior service cost (benefit)	-	-	-	-
Unrecognized net actuarial (gain)/loss	(2,627)	(4,317)	(2,627)	(4,317)
Accrued benefit cost	(13,687)	(18,593)	(13,687)	(18,593)

	<u>Quarter ended December 31,</u>		<u>Nine months ended December 31,</u>	
	2003	2004	2003	2004
The components of net gratuity costs are reflected below:				
Service cost	1,149	1,422	3,445	4,266
Interest cost	232	275	697	825
Expected returns on plan assets	(88)	(136)	(263)	(408)
Amortization	-	-	-	-
Recognized net actuarial (gain)/ loss	(15)	(32)	(43)	(97)
Net gratuity costs	1,278	1,529	3,836	4,586

	<u>Quarter ended December 31,</u>		<u>Nine months ended December 31,</u>	
	2003	2004	2003	2004
Principal actuarial assumptions:				
Discount rate	8.00%	7.00%	8.00%	7.00%
Long-term rate of compensation increase	7.00%	6.00%	7.00%	6.00%
Rate of return on plan assets	7.50%	6.00%	7.50%	6.00%

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:

For the year ending

2003	Rs. 1,472
2006	1,757
2007	2,466
2008	3,039
2009	4,940
2010 to 2014	31,361

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	
	<u>March 31, 2004</u>	<u>December 31, 2004</u>
Corporate network / Data services	Rs. 166,648	Rs. 230,543
Internet access services	157,241	168,906
Online portal services	2,895	1,548
Other services	15,169	16,572
Total	<u>Rs. 341,953</u>	<u>Rs. 417,569</u>

9. Advertising costs

Advertising costs incurred during the quarter have been expensed. The total amount of advertising costs expensed during the quarters ended December 31, 2003 and 2004 was Rs. 4,778 and Rs. 8,715, respectively, and nine months ended December 31, 2003 and 2004 was Rs. 35,074 and Rs. 22,613, respectively.

10. Products and services

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

	<u>Quarter ended December 31,</u>		<u>Nine months ended December 31,</u>	
	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>
<i>Revenue</i>				
Services revenue	Rs. 604,550	Rs. 741,973	Rs. 1,696,444	Rs. 2,072,493
Initial franchisee fee	29,951	30,439	72,036	81,122
Installation services revenue	30,089	60,143	79,524	162,965
	<u>Rs. 664,590</u>	<u>Rs. 832,555</u>	<u>Rs. 1,848,004</u>	<u>Rs. 2,316,580</u>
Products revenue	Rs. 46,857	Rs. 113,084	Rs. 128,223	Rs. 267,693
	<u>Rs. 711,447</u>	<u>Rs. 945,639</u>	<u>Rs. 1,976,227</u>	<u>Rs. 2,584,273</u>
<i>Cost of revenues</i>				
Products	Rs. 41,663	Rs. 102,477	Rs. 114,663	Rs. 234,784
Services	334,703	426,730	919,458	1,182,915
	<u>Rs. 376,366</u>	<u>Rs. 529,207</u>	<u>Rs. 1,034,121</u>	<u>Rs. 1,417,699</u>

11. Segment reporting

SFAS No 131, "Disclosures about Segments of an Enterprise and Related Information," establishes standards for the way

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 cybercafés;
- 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* cybercafés 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 because 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 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 quarters and nine months ended December 31, 2003 and 2004 is presented below:

Quarter ended December 31, 2003

Corporate Network / Data Services	Internet Access Services	Online Portal Services	Other Services	Continuing Operations
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Equity in losses of affiliates			9,321		9,321
Minority interest			9		9
Segment operating income / (loss)	Rs. 140,673	Rs. (24,317)	Rs. 4,522	Rs. 44,201	Rs. 165,079
Unallocated corporate expenses					(140,920)
Foreign exchange gain / (loss), net					(1,831)
Other income / (expense), net					389
Depreciation and amortization					(140,046)
Interest income, net					14,856
Income taxes					-
Net loss					Rs. (102,473)

Quarter ended December 31, 2004

	Corporate Network / Data Services	Internet Access Services	Online Portal Services	Other Services	Total
Revenues	Rs. 525,246	Rs. 377,703	Rs. 26,298	Rs. 16,392	Rs. 945,639
Operating expenses	(357,035)	(355,545)	(24,592)	(19,375)	(756,547)
Equity in profits of affiliates			17,294		17,294
Minority interest					
Segment operating income / (loss)	Rs. 168,211	Rs. 22,158	Rs. 19,000	Rs. (2,983)	Rs. 206,386
Unallocated corporate expenses					(154,780)
Foreign exchange gain / (loss), net					(32,852)
Other income / (expense), net					19,938
Depreciation and amortization					(145,725)
Interest income, net					12,021
Net loss					Rs. (95,012)

Nine months ended December 31, 2003

	Corporate Network / Data Services	Internet Access Services	Online Portal Services	Other Services	Continuing Operations
Revenues	Rs. 954,769	Rs. 764,430	Rs. 63,253	Rs. 193,775	Rs. 1,976,227
Operating expenses	(606,417)	(864,619)	(77,664)	(66,865)	(1,615,565)
Equity in losses of affiliates			(6,423)		(6,423)
Minority interest			79		79
Segment operating income / (loss)	Rs. 348,352	Rs. (100,189)	Rs. (20,755)	Rs. 126,910	Rs. 354,318
Unallocated corporate expenses					(411,502)
Foreign exchange gain / (loss), net					(24,459)
Other income / (expense), net					92,427
Depreciation and amortization					(444,062)
Interest income, net					38,929
Income taxes					(72)
Net loss					Rs. (394,421)

Nine months ended December 31, 2004

	Corporate Network / Data Services	Internet Access Services	Online Portal Services	Other Services	Continuing Operations
Revenues	Rs. 1,441,558	Rs. 1,009,150	Rs. 72,776	Rs. 60,789	Rs. 2,584,273
Operating expenses	(937,447)	(964,365)	(72,636)	(47,919)	(2,022,367)
Equity in profits of affiliates			35,565		35,565
Minority interest					
Segment operating income / (loss)	Rs. 504,111	Rs. 44,785	Rs. 35,705	Rs. 12,870	Rs. 597,471
Unallocated corporate expenses					(446,474)
Foreign exchange gain / (loss), net					(3,040)
Other income / (expense), net					28,092

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 December 31, 2004:

Minimum lease payments receivable	Rs. 34,672
Less: Unearned income	Rs. 3,240
Net investment in sales-type leases	Rs. 31,432

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

For the year ending March 31,	
2005	Rs. 4,539
2006	10,971
2007	10,971
2008	9,988

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 December 31, 2004 was Rs. NIL.

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

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 US\$ 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 December 31, 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.

14. ISP License Matters

In December 2004, the Government of India ("GOI") issued guidelines for permission to offer Virtual Private Network ("VPN") services by Internet Service Providers ("ISPs"). Consequently, the Company applied for the permission and the GOI has issued a Letter of Intent ("LOI") to the Company on December 30, 2004 for amendment of the existing ISP license to include provision of VPN services. In January 2005, the Company paid Rs.100,000 as a one time entry fee and submitted a financial bank guarantee of Rs. 10,000 as required by the LOI.

On January 11, 2005 the GOI issued provisional permission to the Company to offer VPN service in accordance with the new guidelines. Final permission to offer VPN service shall be effective only after the Company signs the amendment to the license agreement. However the provisional permission does not carry any terms and conditions relating to the license.

The Indian Department of Telecommunications, or DOT, also requires the ISP licensees to pay an annual fee of 8% of the gross revenues generated under the ISP license. To date, the DOT has not issued any guidelines or procedures for implementing this decision. However, it is our understanding that the license fee provisions will become effective only after amendments to the license. We believe that this will not have any effect on Sify's net earnings / losses for periods prior to January 1, 2005. The ISPAI has been contesting the DOT decision. If not successful, the DOT decision will have an impact on the earnings to the extent of annual fee and amortization of the license fee.

15. Recent Accounting Pronouncements

Recently, the Financial Accounting Standards Board issued FASB Statement No. 123 (revised 2004), *Share Based Payment*, requiring companies to change their accounting policies to record the fair value of stock options issued to employees as an expense. Currently, the Company does not deduct the expense of the employee stock options grants from its income based on the fair value method as it had adopted the pro forma disclosure provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*. The unamortized stock compensation expense as of December 31, 2004, determined under the fair value method is approximately \$0.29 million. The Company is required to adopt SFAS 123R on July 1, 2005. The Company is evaluating the impact of the standard on the existing grants of employee stock options and future grants, if any.