

LJ INTERNATIONAL INC
Form 20-F
March 31, 2005

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**U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

FORM 20-F

**o REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g)
OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

**p ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2004

OR

**o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission file number 0-29620

LJ INTERNATIONAL INC.

(Exact name of Registrant as specified in its charter)

LJ INTERNATIONAL INC.

(Translation of Registrant's name into English)

British Virgin Islands

(Jurisdiction of incorporation or organization)

Unit #12, 12/F, Block A

Focal Industrial Centre

21 Man Lok Street

Hung Hom, Kowloon, Hong Kong

(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

None

N/A

Securities registered or to be registered pursuant to Section 12(g) of the Act.

\$.01 Par Value Common Stock (Common Stock)
(Title of Class)

Warrants to Purchase Common Stock (Warrants)
(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.

None
(Title of Class)

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 the annual report:

12,304,658 Common Stock
1,679,000 Warrants

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 which financial statement item the registrant has elected to follow.

Item 17 Item 18

(APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PAST FIVE YEARS)

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

Not Applicable.

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**SPECIAL NOTE REGARDING
FORWARD-LOOKING STATEMENTS**

This annual report contains forward-looking statements that involve risks and uncertainties. These include statements about our expectations, plans, objectives, assumptions or future events. In some cases, you can identify forward-looking statements by terminology such as anticipate, estimate, plans, potential, projects, continuing, ongoing, expects, management believes, we believe, we intend and similar expressions. These statements involve estimates, assumptions and uncertainties that could cause actual results to differ materially from those expressed for the reasons described in this annual report. You should not place undue reliance on these forward-looking statements.

You should be aware that our actual results could differ materially from those contained in the forward-looking statements due to a number of factors:

dependence upon certain customers

dependence on key personnel

control by principal shareholder

competitive factors

the operation of our business

general economic conditions

You should also consider carefully the statements under Risk Factors and other sections of this annual report, which address additional factors that could cause our actual results to differ from those set forth in the forward-looking statements and could materially and adversely affect our business, operating results and financial condition. All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the applicable cautionary statements.

The forward-looking statements speak only as of the date on which they are made, and, except to the extent required by federal securities laws, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

We use data and industry forecasts in this annual report which we have obtained from internal surveys, market research, publicly available information and industry publications. Industry publications generally state that the information they provide has been obtained from sources believed to be reliable but that the accuracy and completeness of such information is not guaranteed. Similarly, we believe that the surveys and market research we or others have performed are reliable, but we have not independently verified this information.

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Certification of CEO

Certification of CFO

Certification of CEO

Certification of CFO

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Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION**A. SELECTED FINANCIAL DATA.****SELECTED CONSOLIDATED FINANCIAL DATA
(Dollars in thousands, except per share amounts)**

The following selected consolidated financial data with respect to the year ended April 30, 2002, the eight-month period ended December 31, 2002 and each of the two-year period ended December 31, 2004 have been derived from our audited consolidated financial statements. The following selected consolidated financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and Notes included elsewhere in this annual report.

Selected Financial Data

| | Year ended | | Eight-month period ended | | Year ended | | |
|--------------------------------------|-------------------|---------|-------------------------------------|---------------------|---------------------|----------------------|----------|
| | April 30, 2001 | 2002 | December 31, 2001 (Unaudited) | 2002 (Unaudited) | 2002 (Unaudited) | December 31, 2003 | 2004 |
| Statement of Operations Data: | | | | | | | |
| Revenues | 46,285 | 39,240 | 25,042 | 31,809 | 46,007 | 58,167 | 77,379 |
| Cost of Goods sold | 31,540 | 35,731 | 18,602 | 22,820 | 39,951 | 44,947 | 61,265 |
| Gross profit | 14,745 | 3,509 | 6,440 | 8,989 | 6,056 | 13,220 | 16,114 |
| Operating expenses | | | | | | | |
| Selling, general and administrative | (9,398) | (8,963) | (5,905) | (6,433) | (9,525) | (9,133) | (11,578) |
| | 44 | (660) | (119) | (435) | (975) | (162) | (482) |

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| | | | | | | | |
|--|---------|---------|--------|--------|---------|---------|---------|
| Unrealized gain (loss) on derivatives | | | | | | | |
| Depreciation | (808) | (1,031) | (565) | (863) | (1,328) | (1,184) | (1,032) |
| Impairment on property, plant and equipment | | (345) | | (108) | (417) | (84) | |
| Amortization and impairment loss on goodwill | (27) | (242) | (18) | (400) | (624) | (200) | |
| Income (loss) from operations | 4,556 | (7,732) | (167) | 750 | (6,814) | 2,457 | 3,022 |
| Other revenues | 570 | 352 | 265 | 205 | 291 | 453 | 844 |
| Interest expenses | (1,780) | (652) | (424) | (441) | (668) | (753) | (902) |
| Issuance costs for convertible debentures | | | | | | | |
| Impairment loss on investment security | | | | (200) | (200) | | |
| Operating income (loss) before income taxes and minority | 3,346 | (8,032) | (326) | 314 | (7,391) | 2,157 | 2,964 |
| Incomes taxes (expense) credit | (211) | 101 | (39) | (101) | 39 | (352) | (277) |
| Income (Loss) before minority interests | 3,135 | (7,931) | (365) | 213 | (7,352) | 1,805 | 2,687 |
| Minority interests in consolidated subsidiaries | | 30 | | 120 | 150 | 8 | |
| Net income (loss) | 3,135 | (7,901) | (365) | 333 | (7,202) | 1,813 | 2,687 |
| Net income (loss) per share: | | | | | | | |
| Basic | 0.37 | (0.91) | (0.04) | 0.04 | (0.84) | 0.21 | 0.24 |
| Diluted | 0.37 | (0.91) | (0.04) | 0.04 | (0.84) | 0.19 | 0.22 |
| Pro forma basic | 0.13 | (0.91) | (0.04) | 0.04 | (0.84) | 0.19 | 0.23 |
| Pro forma diluted | 0.13 | (0.91) | (0.04) | 0.04 | (0.84) | 0.17 | 0.21 |
| Weighted average number of shares | | | | | | | |
| Basic | 8,567 | 8,672 | 8,672 | 8,493 | 8,551 | 8,757 | 11,119 |
| Diluted | 8,617 | 8,779 | 8,832 | 8,493 | 8,551 | 9,706 | 12,107 |
| Pro forma basic | 8,567 | 8,672 | 8,672 | 8,493 | 8,551 | 8,757 | 11,119 |
| Pro forma diluted | 8,617 | 8,779 | 8,832 | 8,493 | 8,551 | 9,706 | 12,107 |
| Balance Sheet Data: | | | | | | | |
| Working capital | 20,153 | 12,115 | 18,537 | 11,896 | 11,896 | 17,053 | 23,617 |
| Total assets | 48,094 | 43,523 | 51,062 | 48,888 | 48,888 | 60,686 | 75,039 |
| Long-term obligation | 287 | 8 | 12 | | | 77 | 58 |
| Total stockholders equity | 31,161 | 23,557 | 30,943 | 23,294 | 23,294 | 27,902 | 34,156 |

Note: Pro forma information has been prepared as if compensation expense for stock options be determined based on the fair value at the date of grant and been amortized over the period from the date of grant to the date that the award is vested, consistent with the provisions of SFAS No. 123.

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B. CAPITALIZATION AND INDEBTEDNESS.

Not applicable.

C. REASONS FOR THE OFFER AND USE OF PROCEEDS.

Not applicable.

D. RISK FACTORS.

We depend upon one customer for at least 10% of our sales and we cannot be certain that these sales will continue. If they do not, our revenues will likely decline.

Although we sell to a large number of customers in a variety of markets, at least 10% of our sales involves offerings to one customer. For the fiscal years ended December 31, 2003 and 2004, this customer accounted for approximately 9% and 11% of our sales. Although we have maintained a good and longstanding relationship with this customer, we do not have any long-term contracts with it, who orders only on a purchase order basis. The loss of this customer or a significant reduction in its orders would have a materially adverse effect.

We are controlled by one of our existing shareholders, whose interests may differ from other shareholders.

Our largest shareholder beneficially owns or controls approximately 27.7% of our outstanding shares as of December 31, 2004. Accordingly, he has controlling influence in determining the outcome of any corporate transaction or other matter submitted to the shareholders for approval, including mergers, consolidations and the sale of all, or substantially all, of our assets, election of directors, and other significant corporate actions. He also has the power to prevent or cause a change in control. In addition, without the consent of this shareholder, we could be prevented from entering into transactions that could be beneficial to us. The interests of this shareholder may differ from the interests of the other shareholders.

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We face significant competition from larger competitors.

The making and distribution of jewelry is a highly competitive industry characterized by the diversity and sophistication of the product. We compete with major domestic and international companies with substantially greater financial, technical and marketing resources and personnel than us. There can be no assurance other jewelry makers will not similarly develop low-cost, high-volume production capability or an even better process, providing greater competition for us and materially affecting our business prospects.

There are numerous factors relating to the operations of our business that could adversely affect our success and results.

As a maker and merchandiser of low-cost, high-quality gem-set jewelry, our existing and future operations are and will be influenced by several factors, including:

technological developments in the mass production of jewelry;

our ability to meet the design and production requirements of our customers efficiently;

the market acceptance of our customers' jewelry;

increases in expenses associated with continued sales growth;

our ability to control costs;

our management's ability to evaluate the public's taste and new orders to target satisfactory profit margins;

our capacity to develop and manage the introduction of new designed products; and

our ability to compete.

Quality control is also essential to our operations since customers demand compliance with design and product specifications and consistency of production. We cannot assure that revenue growth will occur on a quarterly or annual basis.

Our production facilities are located in China. Our results of operations and financial condition may, therefore, be influenced by the economic, political, legal and social conditions in China.

Since 1978, the Chinese government has been reforming, and is expected to continue to reform, China's economic and political systems. Such reforms have resulted in significant social progress. Other political, economic and social factors could also lead to further readjustment of the reform measures. This refinement and readjustment process may not always have a positive effect on our operations in China. At times, we may also be adversely affected by changes in policies of the Chinese government such as changes in laws and regulations or their interpretation, the introduction of additional measures to control inflation, changes in the rate or

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method of taxation and imposition of additional restrictions on currency conversion and remittances abroad.

Our products are currently made at our production facility located in Shenzhen, China. However, our insurance may not adequately cover any losses due to fire, casualty or theft.

We have obtained fire, casualty and theft insurance aggregating approximately \$35.0 million, covering several of our stock in trade, goods and merchandise, furniture and equipment and production facility in China. The proceeds of such insurance may not be sufficient to cover material damage to, or the loss of, our production facility due to fire, severe weather, flood or other cause, and such damage or loss would have a material adverse effect on our financial condition, business and prospects. Consistent with the customary practice among enterprises in China and due to the cost in relation to the benefit, we do not carry any business interruption insurance in China.

Sales of our jewelry to retailers are generally stronger during the quarter ending December 31 of each year due to the importance of the holiday selling season.

The approximately 34% of our sales during the fiscal year ended December 31, 2004 to our TV shopping channel customers was not seasonal in nature. It has been our management's experience that the remaining 66% of our total sales is seasonally sensitive and is greater during the quarter ending December 31 of each year.

Our holding company structure creates restrictions on the payment of dividends.

We have no direct business operations, other than the ownership of our subsidiaries. While we have no current intention of paying dividends, should we, as a holding company, decide in the future to do so, our ability to pay dividends and meet other obligations depends upon the receipt of dividends or other payments from our operating subsidiaries and other holdings and investments. In addition, our operating subsidiaries are subject to restrictions on their ability to make distributions to us, including as a result of restrictive covenants and minimum net worth requirements in loan agreements, restrictions on the conversion of local currency into U.S. dollars or other hard currency and other regulatory restrictions.

It may be difficult to serve us with legal process or enforce judgments against us or our management.

We are a British Virgin Islands holding company, and all or a substantial portion of our assets are located in China and Hong Kong. In addition, all but one of our directors and officers are non-residents of the United States, and all or substantial portions of the assets of such non-residents are located outside the United States. As a result, it may not be possible to effect service of process within the United States upon such persons. Moreover, there is doubt as to whether the courts of the British Virgin Islands, China or Hong Kong would enforce:

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judgments of United States courts against us, our directors or our officers based on the civil liability provisions of the securities laws of the United States or any state; or

in original actions brought in the British Virgin Islands, China or Hong Kong, liabilities against us or non-residents based upon the securities laws of the United States or any state.

Some information about us may be unavailable due to exemptions under the Exchange Act for a foreign private issuer.

We are a foreign private issuer within the meaning of the rules under the Exchange Act. As such, we are exempt from certain provisions applicable to United States public companies, including:

the rules under the Exchange Act requiring the filing with the Securities and Exchange Commission of quarterly reports on Form 10-Q or current reports on Form 8-K;

the provisions of Regulation FD aimed at preventing issuers from making selective disclosures of material information;

the sections of the Exchange Act regulating the solicitation of proxies, consents or authorizations in respect of a security registered under the Exchange Act; and

the sections of the Exchange Act requiring insiders to file public reports of their stock ownership and trading activities and establishing insider liability for profits realized from any short-swing trading transaction.

Because of these exemptions, investors are not provided with the same information which is generally available about public companies organized in the United States.

Since we are a British Virgin Islands company, the rights of our shareholders may be more limited than those of shareholders of a company organized in the United States.

Under the laws of most jurisdictions in the United States, majority and controlling shareholders generally have certain fiduciary responsibilities to the minority shareholders. Shareholder action must be taken in good faith, and actions by controlling shareholders which are obviously unreasonable may be declared null and void. British Virgin Island law protecting the interests of minority shareholders may not be as protective in all circumstances as the law protecting minority shareholders in U.S. jurisdictions. In addition, the circumstances in which a shareholder of a BVI company may sue the company derivatively, and the procedures and defenses that may be available to the company, may result in the rights of shareholders of a BVI company being more limited than those of shareholders of a company organized in the U.S.

Furthermore, our directors have the power to take certain actions without shareholder approval which would require shareholder approval under the laws of most U.S. jurisdictions. The directors of a BVI corporation, subject in certain cases to court approval but without shareholder approval, may implement a reorganization, merger or consolidation, the sale of any

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assets, property, part of the business, or securities of the corporation. Our ability to amend our Memorandum of Association and Articles of Association without shareholder approval could have the effect of delaying, deterring or preventing a change in our control without any further action by the shareholders, including a tender offer to purchase our common stock at a premium over then current market prices.

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ITEM 4. INFORMATION ON THE COMPANY

A. HISTORY AND DEVELOPMENT OF THE COMPANY.

LJ International Inc. (we) was incorporated as an international business company under the International Business Companies Act of the British Virgin Islands on January 30, 1997. We own all of the issued share capital in the following significant subsidiaries:

Lorenzo Jewelry Limited (Lorenzo Jewelry), a company incorporated in Hong Kong on February 20, 1987.

Lorenzo Gems Manufacturing (Shenzhen) Co., Ltd.

Lorenzo Jewellery (Shenzhen) Co., Ltd.

Shenzhen PGS Jewelry Mfg.

Lorenzo (Shenzhen) Co., Ltd.

Due to the restrictions on foreign ownership on the retail business of jewelries, the Company, through loans to the agents, established Lorenzo (Shenzhen) Co., Ltd (LSC) to carry out the retail business of jewelries in the PRC. LSC is a variable interest entity (VIE) owned by two individuals, who are acting as agents. Pursuant to various agreements entered into between the Company, the agents and LSC on May 21, 2004, the Company generally has control of LSC and is considered the primary beneficiary of LSC.

Our principal place of business and our executive offices are located at Units #09-#12, 12/F, Block A, Focal Industrial Centre, 21 Man Lok Street, Hung Hom, Kowloon, Hong Kong, telephone: (011) 852-2764-3622. We have designated CT Corporation, 111 Eighth Avenue, New York, New York 10011 as our agent for service of process in the United States.

During our last three fiscal years, we have made the following significant capital expenditures:

we purchased 68.8% of the common shares of iBBC Inc. for \$2,460,000 during the fiscal year ended April 30, 2002

we made a capital contribution of \$670,000 for our 95% equity interest in Lorenzo Giftware Inc. during the fiscal year ended December 31, 2002

we invested \$721,000 for the purchase of 3,502 square meters of production space in our Shenzhen, China facility during the fiscal year ended December 31, 2002

we invested \$390,000 for the purchase of 1,751 square meters of production space in our Shenzhen, China facility during the fiscal year ended December 31, 2003

B. BUSINESS OVERVIEW.

We are a totally vertically integrated company that designs, brands, markets and distributes a complete range of fine jewelry. While we specialize in the semi-precious jewelry segment, we also offer high-end pieces set in yellow gold, white gold, platinum or sterling silver

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and adorned with semi-precious stones, diamonds, pearls and precious stones. We distribute mainly to fine jewelers, department stores, national jewelry chains and electronic and specialty retailers throughout North America and Western Europe. Our product lines incorporate all major categories sought by major retailers, including earrings, necklaces, pendants, rings and bracelets.

We believe that our vertically integrated structure provides significant advantages over our competitors. All profits from value added processes are captured internally, rather than shared with third party manufacturers. This results in very competitive pricing for the retailer and enhanced profits for us. Innovative processes in stone cutting and production further enhance our competitive position.

We employ an international design team and all of our designs and merchandising strategies are proprietary. The exclusive and innovative concepts that we create offer brand potential. Our primary marketing focus has been in North America where we have sold directly to certain high volume customers that need specialized product development services, and through a marketing relationship with International Jewelry Connection (IJC) for those customers that need higher levels of service and training.

We organize our marketing and distribution strategies by retail distribution channels. Concepts are developed for the specific needs of different market segments. We have identified the following as prime retail targets:

fine jewelers;

national jewelry chains;

department stores;

TV shopping channels; and

discount chain stores.

For the years ended December 31, 2003 and 2004, approximately 74% and 73% of our sales were in North America.

The following is a breakdown of our total revenues (in thousands) by geographic market for each of our past three financial years:

| | Year ended | 8 Months ended | | Year ended December 31, | | |
|----------------------------|-------------------|-------------------------------------|----------------------|---|--------|--------|
| | April 30, 2002 | December 31, 2001 (Unaudited) | December 31, 2002 | December 31, 2002 2003 2004 (Unaudited) | | |
| | US\$ | US\$ | US\$ | US\$ | US\$ | US\$ |
| US & Canada | 28,810 | 19,373 | 24,545 | 33,275 | 42,851 | 56,186 |
| Hong Kong | 4,897 | 1,383 | 1,451 | 4,379 | 1,961 | 3,765 |
| Europe and other countries | 5,518 | 4,167 | 3,469 | 4,832 | 8,017 | 13,062 |
| PRC | 6 | | | | | 208 |
| Japan | 9 | 119 | 2,344 | 2,801 | 5,338 | 4,158 |
| | 39,240 | 25,042 | 31,809 | 45,287 | 58,167 | 77,379 |

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Our Industry

The jewelry industry is comprised of two major groups that distribute finished jewelry to retailers in the United States:

a small number of producers that make and distribute their own jewelry directly to retailers; and

a large number of wholesalers and distributors who purchase products or portions of products from third parties and resell those items to retailers.

We believe that vertically integrated companies that control costs by performing all value added processes enjoy a distinct competitive advantage over wholesalers and distributors who pay premium acquisition prices for items that they intend to resell. We further believe that large retailers want to rely upon prime producers because they believe that prime producers are reliable, low cost producers who can accommodate the large quantities of production that large retailers commonly purchase.

Our Business Strategy

Our business strategy is to:

increase our market share of moderately priced high-quality gem-set semi-precious and precious jewelry by capitalizing on our unique vertically integrated production processes to produce diamond and high-end precious stone jewelry in addition to high volume, high-quality semi-precious products;

further develop our existing customer relationships with our specialized services; and

expand aggressively into new distribution channels, particularly in the United States and throughout Western Europe, Japan, China, and Australia.

We are aggressively developing new product lines in exotic stones, which have high perceived values among semi-precious stones. We continue to expand into new product categories by:

marketing a line of sterling silver jewelry which are typically merchandised with a retail price range of \$30 to \$150

adding more lines into our Lorenzo branded products with a retail price range of \$199 to \$999

offering diamond jewelry and expanding this business to our current client base by adding diamonds to some of our settings, as well as offering newly designed jewelry

launching Lorenzo Gold , our new gold jewelry product line

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We intend to implement our business strategy by:

expanding our retail jewelry market in China

promoting visits with customers to coordinate and cater to their particular promotional sales needs and monitoring their on-hand inventory in order to promote more active sell-through

expanding our distribution channels to include all major TV shopping programs in North America, Japan, Korea and Australia and further developing business with top-40 Retail Jewelry Chains in the U.S.

Our Production Capability

We have established a sophisticated facility in China that performs stone cutting and polishing and jewelry production. The facility is located in the city of Shenzhen in Guangdong Province, China. Our production facility in Shenzhen has been operating for six years and has 9,232 square meters of production space. We currently employ approximately 2,500 skilled gemstone cutters and production personnel and turned out approximately two million pieces of finished fine jewelry during the fiscal year ended December 31, 2004.

We purchase imported choice gemstone material, which are from mines located in Africa, China and South America, especially those concentrated in Brazil. We source our diamonds mainly from suppliers in India. Gemstone craftsmen are trained and managed by our Hong Kong personnel to ensure that the highest levels of cutting and polishing quality are achieved. The professional skills possessed by our cutters are applied to a wide variety of shapes and sizes, maximizing the yield and value of the gemstone material that we purchase. By performing internally the value-added processes of cutting and polishing our semi-precious gemstones, we maximize quality control and improve our profitability. We specialize in a wide range of popular and exotic semi-precious gemstones ranging from amethyst, aquamarine and peridot to tanzanite and tourmaline.

Sales and Marketing

Our merchandising strategy is to provide unique and differentiated products that are enhanced by the favorable pricing that results from our vertically integrated structure. We invest significant effort in design and model making to produce items which are distinctly different from our competitors. We continue to devote our efforts towards brand development and utilize marketing concepts to enhance the saleability of our products. We recognize that retailers favor certain price points. As part of our product development strategy, we strive to align our wholesale prices to match retailers' target prices as a means of achieving these popular price targets.

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Our sales and marketing team is located in our executive offices in Hong Kong and Los Angeles, California. Our marketing and distribution strategy is to identify the strongest retail customers in each distribution channel and to focus design and sales efforts towards the largest and fastest growing retailers. We maintain a broad base of customers and concentrate our efforts on five major jewelry market segments:

fine jewelers;

national jewelry chains;

department stores;

TV shopping channels; and

discount chain stores.

In addition to direct sales to retailers, we also sell our products to retailers through International Jewelry Connection. The principal focus of IJC is on major U.S. department stores and jewelry retailers, who require specialized levels of marketing, service and training. These sales representatives are paid on a commission-only basis.

Our sales promotion efforts include attendance by our representatives at U.S. and international trade shows and conventions, including Las Vegas, Orlando, New York, Basel, Switzerland, Hong Kong and Japan. In addition, we advertise actively in trade journals and related industry publications.

Design and Product Development

We have 20 internationally trained designers who work from our Hong Kong, U.S. and China offices. Our designers create styles that have been accepted by our various clients worldwide. Our design teams attend trade fairs worldwide to gather product ideas and monitor the latest product trends.

We provide our customers with a broad selection of high-quality 10, 14 and 18 karat gold, platinum and sterling silver jewelry products that incorporate traditional yet fashionable styles and designs. We currently offer more than 40,000 different styles of rings, bracelets, necklaces, earrings, pendants and matching sets that are contemporary and desired in the market.

We study product trends that are emerging in the international market and adapt these trends to the needs of our retail customers. The jewelry offered for sale considers color, fabric and fashion trends, which are projected over a two-year period. We market our products as lifestyle inspired.

Production Process

We make our jewelry at our facility in Shenzhen, China. Our production processes combine vertical integration, modern technology, mechanization and handcraftsmanship to turn out contemporary and fashionable jewelry. Our production operations basically involve:

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cutting and polishing semi-precious gemstones;

combining pure gold, platinum or sterling silver with gemstones or diamonds to produce jewelry; and

finishing operations such as cleaning and polishing, resulting in high quality finished jewelry.

Supply

We cut our own semi-precious stones. We purchase imported gemstones which are from South America, Africa and China. South America is the major source of ametrine, amethyst, aquamarine, imperial topaz, tourmaline and white topaz, and Africa is the main source of tanzanite, mandarine garnet, aquamarine and topaz. We also purchase imported aquamarine, peridot and topaz from China. We source our diamonds mainly from suppliers in India. We believe that we have good relationships with our suppliers, most of whom have supplied us for many years.

We maintain our supply of inventory at our warehouse. The amount of our inventory of a particular gemstone determines the extent and size of our marketing program for that product. We purchase our gemstones and diamonds in advance and in anticipation of orders resulting from our marketing programs.

We purchase our gold from banks, gold refiners and commodity dealers who supply substantially all of our gold needs, which we believe is sufficient to meet our requirements.

Gold acquired for production is at least .995 fine and is combined with other metals to produce 10, 14 and 18 karat gold. The term karat refers to the gold content of alloyed gold, measured from a maximum of 24 karats, which is 100% fine gold. Varying quantities of metals such as silver, copper, nickel and zinc are combined with fine gold to produce 14 karat gold of different colors. These alloys are in abundant supply and are readily available to us.

We purchase our gold requirements within a reasonable period after each significant purchase order is received. We believe that any change in the price of gold would have had little, if any, impact on the valuation of our inventories.

We purchase supplies and raw materials from a variety of suppliers and we do not believe the loss of any of the suppliers would have a material adverse effect on our business. Alternative sources of supply for raw materials for production of jewelry are readily available.

Security

We have installed certain measures at our Shenzhen, China, production and our Hong Kong administrative facilities to protect against loss, including multiple alarm systems, infrared motion detectors and a system of closed circuit television cameras, which provide surveillance of all critical areas of our premises.

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We inspect carefully all materials sent and received from outside suppliers, monitor the location and status of all inventory, and have strict internal control procedures of all jewelry as it proceeds through the production process. A complete physical inventory of gold and gemstones is taken at our production and administrative facilities on a quarterly basis.

Insurance

We maintain primary all-risk insurance, with limits in excess of our current inventory levels, to cover thefts and damage to inventory located on our premises. We also maintain insurance covering thefts and damage to our owned inventory located off-site. The amount of coverage available under such policies is limited and may vary by location, but is generally in excess of the value of the gold and gemstones supplied by us. We carry transit insurance, the coverage of which includes the transportation of jewelry outside of our office.

Competition

The jewelry production industry is highly competitive, and our competitors include domestic and foreign jewelry manufacturers, wholesalers, and importers who may operate on a national, regional and local scale. Our competitive strategy is to provide competitively priced, high-quality products to the high-volume retail jewelry market. According to our management, competition is based on pricing, quality, service and established customer relationships. We believe that we have positioned ourselves as a low-cost producer without compromising our quality. Our ability to conceive, design and develop products consistent with the requirements of each retail distribution channel represents a competitive advantage.

We believe that few competitors have the capacity and production skills to be effective competitors. We believe that our vertically integrated production capabilities distinguish us from most of our competitors and enable us to produce very competitively priced, high quality and consistent products.

In North America, the market, although highly fragmented, does contain a number of major competitors, many of whom import much of their product from the Far East and many of whom sell higher priced items. The key United States competitors include E.E.A.C. Inc. and Fabrikant.

International competitors include Pranda International and Beauty Gems Limited. Most of these manufacturers/wholesalers have been successful vendors for many years and enjoy good relations with their clients. Although it may be difficult for a newcomer to break into established relationships, we have already made substantial inroads in the North American jewelry market and we believe we can remain competitive, based on our vertically integrated, low-cost, high-volume and high-quality production process.

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Private Placement Offering

On September 1, 2004, we entered into securities purchase agreements with a group of investors for issuance of common stock and five-year warrants to purchase shares of common stock. We sold to the investors 1,614,082 units at a price of \$2.20 per unit, each unit consisting of one share of common stock and one warrant to acquire up to 30% of the common stock so issued at an exercise price of \$2.98 per share, which expires on September 3, 2009. At the closing, we issued an aggregate of 1,614,082 shares and 484,221 warrants and received net proceeds after expenses of the transaction of approximately \$2.8 million.

We also entered into registration rights agreements with the investors. Pursuant to the terms of the registration rights agreements, we agreed to register the shares of common stock and the shares underlying the warrants for resale on behalf of the investors. The registration of the common stock and the shares underlying the warrants became effective on October 12, 2004.

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C. ORGANIZATIONAL STRUCTURE AS OF DECEMBER 31, 2004:

The following diagram provides a listing of our significant subsidiaries. The respective country of organization/incorporation is shown in brackets.

LJ INTERNATIONAL INC.
(British Virgin Islands)

100%

- **Lorenzo Jewelry Limited**
(Hong Kong)
- **Lorenzo Gems Manufacturing (Shenzhen) Co., Ltd.**
(P.R.C.)
- **Lorenzo Jewellery (Shenzhen) Co., Ltd.**
(P.R.C.)
- **Shenzhen PGS Jewelry Mfg.**
(P.R.C.)

D. PROPERTY, PLANTS AND EQUIPMENT.

Our principal executive offices are located at Units #9-#12, 12/F, Block A, Focal Industrial Centre, 21 Man Lok Street, Hung Hom, Kowloon, Hong Kong. We own approximately 4,800 square feet of office and showroom at this location.

Our jewelry production facility in Shenzhen, China consists of 9,232 square meters of building space located in the Shatoujiao Free Trade Zone, Shenzhen. We own approximately 5,254 square meters of this space. We also currently lease:

1,751 square meters for a term of five years expiring August 31, 2007 from an unaffiliated third party at a rental rate of \$3,817 per month;

1,751 square meters for a term of two years expiring June 30, 2006, at a rental rate of \$3,567 per month; and

475 square meters for a term of one year expiring December 31, 2005, at a rental rate of \$854 per month.

We own two warehouse facilities in Hung Hom and Aberdeen consisting of 5,432 square feet and 5,200 square feet. We also own additional properties in Sai Kung and Hung Hom. We

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lease all four of these properties to non-affiliated third parties. We have pledged all of our land and buildings to collateralize general banking facilities granted to us.

Our production facilities are currently utilized for one shift per day but are capable of being expanded to accommodate three shifts per day as necessary.

Table of Contents**ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

The following discussion and analysis should be read in conjunction with our financial statements and notes to the financial statements appearing elsewhere in this Form 20-F. See Special Note Regarding Forward-looking Statements. All amounts shown for the eight-month period ended December 31, 2001 and for the year ended December 31, 2002 are unaudited.

A. OPERATING RESULTS.**Reclassifications**

Certain prior year amounts have been reclassified to conform to the current year presentation.

Revenues

| (in thousands) | Eight-month period ended | | Year ended December 31, | | | Eight- month period | % change | |
|----------------|-----------------------------|------------------------|-------------------------|-----------|-----------|---------------------------|---------------------------|---------------------------|
| | | | | | | | Years ended | Years ended |
| | December 31, 2001 | 2002 | 2002 | 2003 | 2004 | 2001-2002 | December 31, 2002-2003 | December 31, 2003-2004 |
| Revenues | Unaudited \$ 25,042 | Unaudited \$ 31,809 | Unaudited \$ 46,007 | \$ 58,167 | \$ 77,379 | 27% | 26% | 33% |

The increase in revenue for the year ended December 31, 2004, compared with the year ended December 31, 2003, and the increases for the year ended December 31, 2003 compared the year ended December 31, 2002 were attributable to the acceptance of new products, the rise in orders from existing customers and new customers.

The increase in revenue for the eight-month period ended December 31, 2002, compared with the same period in 2001, was due to our successful marketing efforts in winning new, major blue chip customers, as well as the positive reception of our new products.

Table of Contents**Cost of Sales and Gross Profit**

| (in thousands) | Eight-month period ended | | Year ended December 31, | | | Eight-month period 2001-2002 | % change | |
|---|--------------------------|-----------|-------------------------|-----------|-----------|------------------------------|------------------------|------------------------|
| | December 31, | | December 31, | | | | Years ended | Years ended |
| | 2001 | 2002 | 2002 | 2003 | 2004 | | December 31, 2002-2003 | December 31, 2003-2004 |
| Cost of sales | Unaudited \$ 18,602 | \$ 22,820 | Unaudited \$ 34,241 | \$ 44,947 | \$ 61,265 | 23% | 31% | 36% |
| % of revenues | 74% | 72% | 75% | 77% | 79% | | | |
| Cost of sales - write down of inventory | \$ 0 | \$ 0 | \$ 5,710 | \$ 0 | \$ 0 | N/A | -100% | N/A |
| % of revenues | 0% | 0% | 12% | 0% | 0% | | | |
| Gross profit | \$ 6,440 | \$ 8,989 | \$ 6,056 | \$ 13,220 | \$ 16,114 | 40% | 118% | 22% |
| % of revenues | 26% | 28% | 13% | 23% | 21% | | | |

The gross profit margin dropped to 21% for the year ended December 31, 2004 from 23% for the year ended December 31, 2003. The decrease in gross profit margin was due to the rise in diamond price which we could not pass to customer for orders accepted before the rise in price and also the sales to discount chain stores.

The gross profit margin increased to 23% for the year ended December 31, 2003 from 13% for the year ended December 31, 2002. It was due to the following adjustments on inventory made for the year ended December 31, 2002.

\$5,394,000 for the write-down of cut stones for orders in relation to special programs that were later postponed or cancelled;

\$316,000 for the write-down of fine jewelry cost.

Excluding the above special charge on inventory, the gross profit margin was 25% for the year ended December 31, 2002.

The gross profit margin increased to 28% for the eight-month periods ended December 31, 2002 from 26% for the same period ended December 31, 2001.

Table of Contents**Selling, General and Administrative Expenses**

| (in thousands) | Eight-month period ended | | Year ended December 31, | | | Eight-month period 2001-2002 | % change | |
|--|--------------------------|----------|-------------------------|----------|-----------|------------------------------|------------------------|------------------------|
| | December 31, | | December 31, | | | | Years ended | Years ended |
| | 2001 | 2002 | 2002 | 2003 | 2004 | | December 31, 2002-2003 | December 31, 2003-2004 |
| | Unaudited | | Unaudited | | | | | |
| Selling, general and administrative expenses | \$ 5,905 | \$ 6,433 | \$ 9,525 | \$ 9,133 | \$ 11,578 | 9% | -4% | 27% |
| % of revenues | 24% | 20% | 21% | 16% | 15% | | | |

Selling, general and administrative (SG&A) expenses maintained at 15% of revenue for the year ended December 31, 2004, compared with 16% of revenue for the year ended December 31, 2003.

Selling, general and administrative (SG&A) expenses decreased by 5% of revenue for the year ended December 31, 2003, compared with the year ended December 31, 2002. Between 2002 and 2003, our SG&A expenses fell as a direct result of the corporate reengineering exercise we had undertaken right after the 9/11 terrorist attacks in the US. The measures we instituted led to substantial cost savings and administrative, sales and operational efficiencies.

Unrealized loss (gain) on derivatives

| (in thousands) | Eight-month period ended | | Year ended December 31, | | | Eight-month period 2001-2002 | % change | |
|---------------------------------------|--------------------------|--------|-------------------------|--------|--------|------------------------------|------------------------|------------------------|
| | December 31, | | December 31, | | | | Years ended | Years ended |
| | 2001 | 2002 | 2002 | 2003 | 2004 | | December 31, 2002-2003 | December 31, 2003-2004 |
| | Unaudited | | Unaudited | | | | | |
| Unrealised loss (gain) on derivatives | \$ 119 | \$ 435 | \$ 975 | \$ 162 | \$ 482 | 266% | -83% | 198% |
| % of revenues | 0% | 1% | 2% | 0% | 1% | | | |

(with the hedging mechanism in place since 2003, we have the realized gain on hedging activities included in Other Revenues.)

| | | | | | | | | |
|-------------------------------------|------|------|------|--------|--------|-----|-----|------|
| Realized gain on hedging activities | \$ 0 | \$ 0 | \$ 0 | \$ 249 | \$ 681 | N/A | N/A | 173% |
| % of revenues | 0% | 0% | 0% | 0% | 1% | | | |

We have secured gold loan facilities with various banks in Hong Kong, which typically bear a below-market interest rate. Under the gold loan arrangements, we may defer the purchase until such time as we decide appropriate, the price to be paid being the current market price at time of payment. The gold loan, however, does expose us to certain market risks associated with

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potential future increases in the price of gold. In the past, we did not hedge against such risks and at the close of each reporting period, the gold loan was valued at fair value with changes reflected on the income statement. However, the volatility of prices in the lead-up to the war in Iraq prompted us to make unrealized loss on derivatives of \$119,000 and \$435,000 for the eight months periods ended December 31, 2001 and December 31, 2002 respectively and to cover possible losses resulting from price fluctuations.

Since 2003, we have commenced hedging the fluctuations in the price of gold related to the gold loans by entering into contracts with financial institutions for the future purchase of gold. As a result, we have reduced the unrealized loss to \$162,000 for the year ended December 31, 2003, compared with the unrealized loss of \$975,000 for the year ended December 31, 2002 and have realized gain of \$249,000 before the hedging activities were in place.

With the hedging mechanism in place, we have incurred an unrealized loss of \$482,000 and realized gain of \$681,000 on derivatives, which has been included in Other Revenues of \$844,000, for the year ended December 31, 2004.

Depreciation

| (in thousands) | Eight-month period ended | | Year ended December 31, | | | Eight-month period 2001-2002 | % change | |
|----------------|--------------------------|-------------------|-------------------------|----------|----------|------------------------------|------------------------------------|------------------------------------|
| | December 31, 2001 | December 31, 2002 | 2002 | 2003 | 2004 | | Years ended December 31, 2002-2003 | Years ended December 31, 2003-2004 |
| | Unaudited | Unaudited | Unaudited | | | | | |
| Depreciation | \$ 565 | \$ 863 | \$ 1,328 | \$ 1,184 | \$ 1,032 | 53% | -11% | -13% |
| % of revenues | 2% | 3% | 3% | 2% | 1% | | | |

Depreciation decreased 13% to \$1,032,000 for the year ended December 31, 2004 from \$1,184,000 for the year ended December 31, 2003. It was due to a portion of furniture, fixtures and equipment acquired were fully depreciated during the year.

Depreciation decreased 11% to \$1,184,000 for the year ended December 31, 2003 from \$1,328,000 for the year ended December 31, 2002, as depreciation of \$158,000 on leasehold improvements in production facilities was included in April 2002 that we ceased to use before the expiry of their leases.

The increase in depreciation costs primarily represents the impact of on-going capital expenditures and assets acquired for the eight months ended December 2002. It also incorporated a provision of \$158,000 for the depreciation on leasehold improvements to production facilities we ceased to use before the expiry of their leases.

Table of Contents**Impairment on property, plant and equipment**

| (in thousands) | Eight-month period ended | | Year ended | | | Eight-month period 2001-2002 | % change | |
|---|--------------------------|--------|--------------|-------|------|---------------------------------|---------------------------|---------------------------|
| | December 31, | | December 31, | | | | Years ended | Years ended |
| | 2001 | 2002 | 2002 | 2003 | 2004 | | December 31, 2002-2003 | December 31, 2003-2004 |
| | Unaudited | | Unaudited | | | | | |
| Impairment on property, plant and equipment | \$ 0 | \$ 108 | \$ 417 | \$ 84 | \$ 0 | N/A | -80% | -100% |
| % of revenues | 0% | 0% | 1% | 0% | 0% | | | |

The impairment loss represents the write-off of property, plant and equipment as a result of the consolidation of production facilities.

Amortization and impairment loss on goodwill

| (in thousands) | Eight-month period ended | | Year ended | | | Eight-month period 2001-2002 | % change | |
|--|--------------------------|--------|--------------|--------|------|---------------------------------|---------------------------|---------------------------|
| | December 31, | | December 31, | | | | Years ended | Years ended |
| | 2001 | 2002 | 2002 | 2003 | 2004 | | December 31, 2002-2003 | December 31, 2003-2004 |
| | Unaudited | | Unaudited | | | | | |
| Amortization and impairment loss on goodwill | \$ 18 | \$ 400 | \$ 624 | \$ 200 | \$ 0 | 2122% | -68% | -100% |
| % of revenues | 0% | 1% | 1% | 0% | 0% | | | |

In July 2001, Financial Accounting Standards Board issued SFAS No. 142, Goodwill and Other Intangible Assets, which provides that goodwill and intangible assets with indefinite useful lives will not be amortized but rather will be tested at least annually for impairment.

In March 2002, goodwill is attributed to the acquisition of a jewelry retail company. Impairment loss of the related goodwill was charged for the eight-month period ended December 31, 2002 and for the year ended December 31, 2002 and for the year ended December 31, 2003.

Table of Contents**Interest cost**

| (in thousands) | Eight-month period ended | | Year ended December | | | Eight-month period 2001-2002 | % change | |
|-------------------|--------------------------|--------|---------------------|--------|--------|---------------------------------|--------------|--------------|
| | December 31, | | 31, | | | | Years ended | Years ended |
| | 2001 | 2002 | 2002 | 2003 | 2004 | | December 31, | December 31, |
| | Unaudited | | Unaudited | | | | 2002-2003 | 2003-2004 |
| Interest expenses | \$ 424 | \$ 441 | \$ 668 | \$ 753 | \$ 902 | 4% | 13% | 20% |
| % of revenues | 2% | 1% | 1% | 1% | 1% | | | |

Interest expenses increased for the years ended December 31, 2003 and 2004 was due to a higher utilization rate of credit line facilities as working capital.

Impairment loss on investment

| (in thousands) | Eight-month period ended | | Year ended | | | Eight-month period 2001-2002 | % change | |
|--|--------------------------|--------|--------------|------|------|---------------------------------|--------------|--------------|
| | December 31, | | December 31, | | | | Years ended | Years ended |
| | 2001 | 2002 | 2002 | 2003 | 2004 | | December 31, | December 31, |
| | Unaudited | | Unaudited | | | | 2002-2003 | 2003-2004 |
| Impairment loss on investment securities | \$ 0 | \$ 200 | \$ 200 | \$ 0 | \$ 0 | N/A | -100% | N/A |
| % of revenues | 0% | 1% | 0% | 0% | 0% | | | |

Impairment loss on investment was related to the acquisition in April 2001 for 20% equity interests in a company whose principal activities are the manufacturing and trading of rough and pre-formed gemstones (the Investee).

Pursuant to the purchase agreement dated January 1, 2005, the Company would pay US\$2,827,500 to the Investee for the issuance of 3,900 new shares therein (Acquisition). The Acquisition was completed on January 1, 2005. The Company then became the major stockholder holding 98% equity interests in the Investee, which became a subsidiary of the Company.

Table of Contents**Income taxes**

| (in thousands) | Eight-month period ended | | Year ended December | | | Eight-month period 2001-2002 | % change | |
|--------------------------------|--------------------------|--------|---------------------|--------|--------|------------------------------|------------------------|------------------------|
| | December 31, | | 31, | | | | Years ended | Years ended |
| | 2001 | 2002 | 2002 | 2003 | 2004 | | December 31, 2002-2003 | December 31, 2003-2004 |
| Incomes taxes expense (credit) | \$ 39 | \$ 101 | \$ (39) | \$ 352 | \$ 277 | 159% | -1003% | -21% |
| % of revenues | 0% | 0% | 0% | 1% | 0% | | | |

We were incorporated in the British Virgin Islands and, under current law of the British Virgin Islands, are not subject to tax on income or on capital gains.

For our subsidiaries in Hong Kong, the prevailing corporate income tax rate is 17.5%.

Two of our subsidiaries in China are registered to qualify as Foreign Investment Enterprises in China and are eligible for certain tax holidays and concessions. Accordingly, certain of our Chinese subsidiaries are exempt from Chinese income tax for two years starting from their first profit-making year, followed by a 50% reduction of tax for the next three years.

One of our subsidiaries in China is currently enjoying the tax concessions which will expire in fiscal 2005. Another subsidiary in China is enjoying the tax holiday as its first profit-making year in 2004. PRC income tax is calculated at the applicable rates relevant to these subsidiaries which currently are 15%.

For other subsidiaries in China, the prevailing corporate income tax rate is 15%.

During the years ended December 31, 2003 and 2004, there included tax overprovision adjustment of \$92,000 and \$22,000 respectively, after the finalization of tax assessment for prior year.

Inflation

We do not consider inflation to have had a material impact on our results of operations over the last three years.

Foreign Exchange

More than 99% of our sales are denominated in U.S. Dollars whereas the other sales are basically denominated in Hong Kong Dollars. The largest portion of our expenses are denominated in Hong Kong Dollars, followed by U.S. Dollars and Renminbi. The exchange rate

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of the Hong Kong Dollar is currently pegged to the U.S. Dollar, but during the past several years the market exchange rate has fluctuated within a narrow range. The Chinese government principally sets the exchange rate between the Renminbi and all other currencies. As a result, the exchange rates between the Renminbi and the U.S. Dollar and the Hong Kong Dollar have fluctuated in the past and may fluctuate in the future. If the value of the Renminbi or the Hong Kong Dollar decreases relative to the U.S. Dollar, such fluctuation may have a positive effect on the results of our operations. If the value of the Renminbi or the Hong Kong Dollar increases relative to the U.S. Dollar, such fluctuation may have a negative effect on the results of our operations. We do not currently hedge our foreign exchange positions.

Governmental economic and political policies and factors

For information regarding governmental economic, fiscal, monetary and political policies that could materially affect our operations, directly or indirectly, please refer to the Risk Factors section on pages 7 to 10.

B. LIQUIDITY AND CAPITAL RESOURCES.

We have no direct business operations other than the ownership of our subsidiaries and investment securities. Our ability to pay dividends and meet other obligations depends upon our receipt of dividends or other payments from our operating subsidiaries and investment securities.

Cash Flows

| (in thousands) | Eight-month period ended | | Years ended December 31, | | |
|--|--------------------------|----------|--------------------------|----------|------------|
| | 2001 (Unaudited) | 2002 | 2002 (Unaudited) | 2003 | 2004 |
| Net cash provided by (used in) operating activities | \$ (787) | \$ 3,374 | \$ 4,276 | \$ 1,489 | \$ (5,690) |
| Net cash provided by (used in) investing activities | (384) | (2,207) | (4,941) | (468) | (1,179) |
| Net cash provided by (used in) financing activities | 185 | (824) | 1,009 | 704 | 7,375 |
| Effect of foreign exchange rate change | | (68) | (68) | | |
| Net increase (decrease) in cash and cash equivalents | (986) | 275 | 276 | 1,725 | 506 |
| | | -26- | | | |

Table of Contents**Operating Activities:**

The negative cash flow from operating activities for the year ended December 31, 2004 and the decrease in net cash provided by operating activities in the year ended December 31, 2003 compared with the year ended December 31, 2002 reflected our accumulation of inventory of cut stones, diamond in anticipation of significant increase in sales for the new fiscal year, and the build up of inventory for retail business in Hong Kong and China. The rise in the cost of rough gemstones, the build-up of more sample lines of jewelry and the maintaining of sufficient inventory for block-orders also accentuated the negative cash flow.

The increase in cash flow in the eight-month period ended December 31, 2002 compared with the same period in 2001 resulted from growth in revenues and improved working capital management.

Investing Activities:

For the year ended December 31, 2004, net cash used in investing activities was for the capital expenditures, mainly for renovation and improvement of the existing production facilities in Shenzhen and renovation of shops for the new retail business and other on-going business necessities, and for increase in restricted cash deposits for securing new banking facilities.

For the year ended December 31, 2003, net cash used in investing activities was for the capital expenditures, mainly for new production facilities in Shenzhen, and for other on-going business necessities, reduced by the release of restricted cash deposits from the bank.

In addition to on-going capital expenditures and restricted cash deposits, we undertook various one-off investments that contributed to changes in our net cash positions for the various reporting periods. The increase in cash used in investing activities for the years ended December 31, 2002, 2003 and 2004 and for the eight-month period ended December 31, 2002, was due to new manufacturing facilities in China, as well as an increase in restricted cash deposits for securing banking facilities.

Our capital expenditure by category for the periods presented were:

Capital expenditure

| (in thousands) | Eight-month period ended | | Years ended December 31, | | |
|-----------------------------------|-------------------------------------|----------|--------------------------|--------|--------|
| | December 31, 2001 (Unaudited) | 2002 | 2002 (Unaudited) | 2003 | 2004 |
| Land & buildings | \$ | \$ 721 | \$ 721 | \$ 330 | \$ |
| Leasehold improvement | \$ 95 | \$ 159 | \$ 279 | \$ 190 | \$ 487 |
| Furniture, fixtures and equipment | \$ 239 | \$ 382 | \$ 324 | \$ 250 | \$ 189 |
| Plant and machinery | \$ 21 | \$ 282 | \$ 285 | \$ 93 | \$ 51 |
| Motor vehicles | \$ | \$ 12 | \$ 12 | \$ 133 | \$ |
| Total | \$ 355 | \$ 1,556 | \$ 1,621 | \$ 996 | \$ 727 |

Table of Contents**Financing Activities:**

Net cash provided by financing activities for the year ended December 31, 2004 was \$7,375,000, which included proceeds of \$2,746,000 from private placement of common stock, \$810,000 from issuance of shares upon exercise of stock options, increase of new loans and offset by the repayment of matured bank loans, and reduction of bank overdrafts utilization level.

Net cash provided by financing activities for the year ended December 31, 2003 was \$704,000. It was represented by the proceeds from issuance of shares upon exercise of stock options of \$2,245,000 and sales of treasury stock of \$541,000, raise of new bank loans, reduced by repayment of matured bank loans, and decrease in utilization of bank overdraft facilities.

The negative net cash from financing activities for the eight-month period ended December 31, 2002, compared with the same period in 2001, reflected the repayment of gold loan of \$2,474,000 and the repurchase of common stock of the Company at an aggregate consideration of \$391,000. The positive net cash provided by financing activities in each of the other periods mainly reflected our gold loan arrangement and the utilization of overdraft facilities.

Our cash and cash equivalents are mainly held in U.S. dollars and HK dollars.

Financing Sources**Banking Facilities and Notes Payables**

We have various letters of credit, factoring facilities and overdrafts under banking facilities. The banking facilities are collateralized by land and buildings, investment properties, restricted cash deposits, factored receivables and personal guarantees of and properties owned by one of our directors.

Letters of Credit, overdrafts and others:

| (in thousands) | As of December 31, | | | |
|----------------------------|---------------------------|-------------|-------------|-------------|
| | 2001 | 2002 | 2003 | 2004 |
| | (Unaudited) | | | |
| Letters of credit | \$ 14,424 | \$ 12,985 | \$ 19,005 | \$ 26,833 |
| Overdraft | \$ 3,532 | \$ 3,244 | \$ 3,397 | \$ 3,461 |
| | 17,956 | 16,229 | 22,402 | 30,294 |
| Utilized : | | | | |
| Letters of credit utilized | \$ 8,197 | \$ 8,559 | \$ 13,619 | \$ 15,423 |
| Overdraft utilized | \$ 2,313 | \$ 3,107 | \$ 1,312 | \$ 607 |
| | 10,510 | 11,666 | 14,931 | 16,030 |

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The letters of credit and bank overdrafts are denominated in H.K. dollars and U.S. dollars, bear interest at the floating commercial bank lending rates in Hong Kong, and are renewable annually with the consent of the relevant banks.

The factoring facilities granted are limited to the extent of accounts receivable collateralized to the banks.

Notes payable:

| (in thousands) | As of December 31, | | | |
|----------------|---------------------|----------|----------|----------|
| | 2001 (Unaudited) | 2002 | 2003 | 2004 |
| Notes payable | \$ 447 | \$ 1,073 | \$ 1,516 | \$ 2,487 |

We have term loans classified under notes payable which are related to the Group's properties. These loans are denominated in H.K. dollars and Renminbi, bear interest at pre-fixed rates in Hong Kong and China upon renewal.

Gold Loan Facilities:

| (in thousands) | As of December 31, | | | |
|---|---------------------|-----------|-----------|-----------|
| | 2001 (Unaudited) | 2002 | 2003 | 2004 |
| Gold loans outstanding (in \$) | \$ 3,627 | \$ 3,700 | \$ 3,118 | \$ 6,488 |
| Gold loans outstanding (in troy ounces) | 12,450 | 12,950 | 10,900 | 17,920 |
| Gold loan interest rate | 1.65%-4.1% | 1.5%-2.4% | 1.6%-2.4% | 2.1%-2.5% |

We have also secured gold loan facilities with various banks in Hong Kong, which bear a below-market interest rate. Due to lower interest rates charged for gold loans, our cost through our gold loan program has been substantially less than the costs that would have been incurred if we were to finance the purchase of all of our gold requirements with borrowings under our letter of credit facility or other credit arrangements. The gold loan, however, does expose us to certain market risks associated with potential future increases in the price of gold, so in 2003, we have put in place mechanisms to hedge against such risks. Under the gold loan arrangements, we may defer the purchase until such time as we deem appropriate, the price to be paid being the current market price at time of payment. At the close of each reporting period, the gold loan is valued at fair value with changes reflected on the income statement.

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Looking Forward:

We anticipate that cash flow from operations, borrowings available under our existing credit line and our gold loan arrangement will be sufficient to satisfy our capital needs for the next twelve months.

Impact of recently issued US GAAP accounting standards

See Note 2(y) to the Consolidated Financial Statements in this Form 20-F for a summary of recently issued accounting pronouncements.

C. RESEARCH AND DEVELOPMENT, PATENTS AND LICENSES, ETC.

During each of the last three fiscal years, we did not spend any significant amounts on company-sponsored research and development activities.

Table of Contents**D. TREND INFORMATION.**

The total production for fiscal year ending December 31, 2005 is estimated to be at least 10% greater than the level for fiscal year 2004. The sales for fiscal year 2005 are estimated at approximately US\$85 million, compared to US\$77 million for the fiscal year ended December 31, 2004. The gross profit margin for fiscal year 2005 is estimated to stay at the same 21% level as fiscal year 2004.

E. OFF-BALANCE SHEET ARRANGEMENTS.

Except for those disclosed in the Consolidated Financial Statements, we do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS.

As of the December 31, 2004, we had the following known contractual obligations:

Contractual Obligations
As of December 31, 2004

| | Total US\$ | Payments due by period | | | |
|-------------------------------------|---------------|-----------------------------|----------------------|----------------------|------------------------------|
| | | Less than 1 year US\$ | 1-3 years US\$ | 3-5 years US\$ | More than 5 years US\$ |
| Capital (Finance) Lease Obligations | 77 | 19 | 39 | 19 | |
| Operating Lease Obligations | 1,201 | 625 | 489 | 87 | |
| Total | 1,278 | 644 | 528 | 106 | |

We had entered into finance lease agreements for the purchase of motor vehicles in 2003. The financed amount was \$95,000, bearing interest at 5%-6% per annum, and repayable in 60 monthly installments beginning in 2003. A minimum finance charge may be charged if we pay off all the balance early.

Table of Contents**ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES****A. DIRECTORS AND SENIOR MANAGEMENT.**

Our senior management and directors are as follows:

| Name | Age | Position |
|------------------|------------|---|
| Yu Chuan Yih | 65 | Chairman of the Board of Directors, President and Chief Executive Officer |
| Ka Man Au | 40 | Chief Operating Officer, Secretary and Director |
| Hon Tak Ringo Ng | 45 | Chief Financial Officer and Director |
| Po Yee Elsa Yue | 40 | Non-Executive Director |
| Lionel C. Wang | 49 | Non-Executive Director |

None of our directors and officers was selected due to any agreement or understanding with any other person. There is no family relationship between any of our directors or executive officers and any other director or executive officer.

Mr. Yih established the business of Lorenzo Jewelry Ltd. and has served as president and managing director since 1987. Mr. Yih is primarily responsible for business development and overall company management. He has over 20 years of experience in semi-precious stone production and marketing. Mr. Yih had been a gemstone trader in Brazil and has extensive experience and relationships in gem sourcing and jewelry design. Mr. Yih is also the Founding Sponsor of the Hong Kong branch of the Gemological Institute of America (GIA), the nonprofit educational organization for the jewelry industry.

Ms. Au has served as a director of Lorenzo Jewelry Ltd. since its incorporation in 1987. Ms. Au has been our chief operating officer since January 1, 2002 and is primarily responsible for our general administration, human resources, operations and management.

Mr. Ng has served as our chief financial officer since September 1997 and as one of our directors since May 1, 2001. He received his Bachelor of Science degree in civil engineering from the University of London in 1984 and his Master of Commerce in accounting and commercial administration from the University of New South Wales in 1994. From July 1994 through September 1997, he was an audit senior with Moores Rowland C.A., Certified Public Accountants. Mr. Ng is a certified practising accountant of the Australian Society of CPAs.

Ms. Yue has served as a non-executive director since December 1999. She is a graduate gemologist from the Gemological Institute of America and served as vice president of GIA, Hong Kong, from August 1994 to December 2002. Her responsibilities included managing the Hong Kong office and administering their education programs, marketing and related activities. Since December 2002, Ms. Yue has served as a manager for a colored gems import and export trading company.

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Mr. Wang has served as a non-executive director since June 1998. He received his Bachelor of Commerce from Tamkung University, Taipei, Taiwan in 1978, his Master of Business Administration from California State Polytechnic University in 1980, and his Master of Science from Stanford University in 1981. From 1984 to 1990, Mr. Wang was a marketing research analyst and senior strategic planning analyst for The Gillette Company, Boston, Massachusetts. From 1990 to 1995, he served as associate director and then director of product development for Information Resources, Inc., Waltham, Massachusetts. From 1995 to 1996, Mr. Wang was vice-president at Nielsen North America, with responsibility for analytical and modeling projects on the Kraft Foods/White Plains account. From 1996 until June 2000, Mr. Wang served as director of analytical services for The NPD Group, Inc., Port Washington, New York. From June 2000 until June 2001, he was vice president of product development for NFO Interactive, Greenwich, Connecticut. Since June 2001, Mr. Wang has been president of his own firm, Marketing and Innovation, LLC., Greenwich, Connecticut.

B. COMPENSATION.

The aggregate compensation paid by us to all of our directors and executive officers as a group for the fiscal year ended December 31, 2004 on an accrual basis, for services in all capacities, was \$918,000. During the fiscal year ended December 31, 2004, we contributed an aggregate amount of \$22,000 toward the pension plans of our directors and executive officers.

Executive Service Contract

We entered into an employment agreement with Mr. Yu Chuan Yih, effective October 1, 2003, for a period of three years at an annual salary of \$233,000. Mr. Yih's remuneration package includes benefits with respect to an automobile. In addition, Mr. Yih is entitled to an annual management bonus of a sum to be determined by the board at its absolute discretion, having regard for our operating results and the performance of Mr. Yih during the relevant financial year. The amount payable to Mr. Yih will be decided by majority decision of the members of the board present in the meeting called for that purpose. Mr. Yih shall abstain from voting and not be counted in the quorum in respect of the resolution regarding the amount payable to him.

On July 1, 2003, we granted Mr. Yih options exercisable to acquire 800,000 shares of common stock at \$2.00 per share at any time through June 30, 2013.

C. BOARD PRACTICES.

Each of our five current directors was elected at our last annual meeting of shareholders held June 25, 2004 to serve a one-year term or until their successor is elected and qualified.

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There are no directors' service contracts with us or any of our subsidiaries providing for benefits upon termination of employment.

Our board of directors has established an audit committee, which currently consists of Messrs. Yih and Wang and Ms. Yue. Its functions are to:

- recommend annually to the board of directors the appointment of our independent public accountants;
 - discuss and review the scope and the fees of the prospective annual audit and review the results thereof with the independent public accountants;
 - review and approve non-audit services of the independent public accountants;
 - review compliance with our existing accounting and financial policies;
 - review the adequacy of our financial organization; and
 - review our management's procedures and policies relative to the adequacy of our internal accounting controls and compliance with federal and state laws relating to financial reporting.
- We do not have a remuneration committee of the board of directors.

D. EMPLOYEES.

As of December 31, 2004, we employed approximately 2,500 persons on a full-time basis for our production of jewelry and gemstone cutting and polishing. Approximately 100 of these people include our management and executive staff in Hong Kong and China. None of our employees is represented by a labor union and we believe that our employee relations are good.

E. SHARE OWNERSHIP.

The following table sets forth certain information regarding the beneficial ownership of our shares of common stock as of December 31, 2004 by:

- each person who is known by us to own beneficially more than 5% of our outstanding common stock;
- each of our current executive officers and directors; and
- all executive officers and directors as a group.

As of December 31, 2004, we had 12,304,658 shares of our common stock issued and outstanding.

This information gives effect to securities deemed outstanding pursuant to Rule 13d-3(d)(1) under the Securities Exchange Act of 1934, as amended.

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The address for each person named below is c/o LJ International Inc., Unit #12, 12/F, Block A, Focal Industrial Centre, 21 Man Lok Street, Hung Hom, Kowloon, Hong Kong.

| Name of Beneficial Holder | Number Shares Beneficially Owned | Percent Owned |
|---|-------------------------------------|------------------|
| Yu Chuan Yih | 3,842,853(1)(2) | 27.7% |
| Ka Man Au | 77,500(3) | * |
| Hon Tak Ringo Ng | 62,500(4) | * |
| Po Yee Elsa Yue | 4,000 | * |
| Lionel C. Wang | 0 | * |
| All directors and executive officers as a group (5 persons) | 3,986,853 | 28.4% |

* Represents less than 1% beneficial ownership

- (1) Of Mr. Yih's 2,267,853 shares, 1,500,000 shares are owned of record by Pacific Growth Developments Ltd., a British Virgin Islands corporation, which is owned by Mr. Yih (60%), his wife Tammy Yih (20%) and an adult daughter, Bianca Tzu Hsiu Yih (20%).
- (2) Includes options currently exercisable by Mr. Yih to acquire 775,000 shares of common stock at \$2.00 per share at any time until April 30, 2008 and 800,000 shares of common stock at \$2.00 per share at any time until June 30, 2013.
- (3) Represents options currently exercisable to acquire 40,000 shares of common stock at \$2.00 per share at any time until April 30, 2008 and 37,500 shares of common stock at \$2.00 per share at any time until June 30, 2013.
- (4) Represents options currently exercisable to acquire 25,000 shares of common stock at \$2.00 per share at any time until April 30, 2008 and 37,500 shares of common stock at \$2.00 per share at any time until June 30, 2013.

The 1998 Stock Compensation Plan

Effective June 1, 1998, we adopted and approved the 1998 Stock Compensation Plan. The purpose of the plan is to:

encourage ownership of our common stock by our officers, directors, employees and advisors;

provide additional incentive for them to promote our success and our business; and

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encourage them to remain in our employ by providing them with an opportunity to benefit from any appreciation of our common stock through the issuance of stock options.

Options constitute either incentive stock options within the meaning of Section 422 of the United States Internal Revenue Code of 1986, as amended, or options which constitute nonqualified options at the time of issuance of such options. The plan provides that incentive stock options and/or nonqualified stock options may be granted to our officers, directors, employees and advisors selected by the compensation committee. A total of 4,000,000 shares of common stock are authorized and reserved for issuance during the term of the plan, which expires in June 2008. The compensation committee has the sole authority to interpret the plan and make all determinations necessary or advisable for administering the plan. The exercise price for any incentive option must be at least equal to the fair market value of the shares as of the date of grant. Upon the exercise of the option, the exercise price must be paid in full either in cash, shares of our stock or a combination. If any option is not exercised for any reason, such shares shall again become available for the purposes of the plan.

On October 17, 2000, the Company offered each option holder the opportunity to cancel all or some of the stock options previously granted in exchange for the granting on April 30, 2001 of options to acquire an equal number of shares with an exercise price equal to the then last sale price of the stock on April 30, 2001, for a new term of seven years expiring April 30, 2008.

As of December 31, 2004, 1,507,500 options had been exercised and the following options to purchase shares of our common stock under the plan remained outstanding:

stock options to purchase 1,429,000 and 872,000 shares at \$2.00 per share through April 30, 2008 and June 30, 2013, respectively, of which 1,640,000 are held by our directors and officers as a group.

The 2003 Stock Compensation Plan

Effective July 1, 2003, we adopted and approved the 2003 Stock Compensation Plan, which our shareholders approved on December 5, 2003. The purpose of the plan is to:

encourage ownership of our common stock by our officers, directors, employees and advisors;

provide additional incentive for them to promote our success and our business; and

encourage them to remain in our employ by providing them with an opportunity to benefit from any appreciation of our common stock through the issuance of stock options.

Options constitute either incentive stock options within the meaning of Section 422 of the United States Internal Revenue Code of 1986, as amended, or options which constitute nonqualified options at the time of issuance of such options. The plan provides that incentive

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stock options and/or nonqualified stock options may be granted to our officers, directors, employees and advisors selected by the compensation committee. A total of 4,000,000 shares of common stock are authorized and reserved for issuance during the term of the plan, which expires in June 2013. The compensation committee has the sole authority to interpret the plan and make all determinations necessary or advisable for administering the plan. The exercise price for any incentive option or nonqualified option may be less than the fair market value of the shares as of the date of grant. Upon the exercise of the option, the exercise price must be paid in full either in cash, shares of our stock or a combination. If any option is not exercised for any reason, such shares shall again become available for the purposes of the plan.

As of December 31, 2004, 20,000 options had been exercised and the following options to purchase shares of our common stock under the plan remained outstanding:

stock options to purchase 1,258,000 shares at \$2.00 per share and 200,000 shares at \$2.35 per share through June 30, 2013, of which 312,000 are held by our directors and officers as a group.

Other Options and Warrants Outstanding

As of December 31, 2004, the following additional options and warrants to purchase shares of our common stock were outstanding:

1,679,000 common stock purchase warrants which are publicly traded and which we issued in our April 1998 initial public offering to purchase 1,679,000 shares of common stock at \$5.75 per share through April 15, 2005 (as amended)

146,000 stock purchase options to purchase 146,000 shares of common stock at \$8.25 per share through April 15, 2005 (as amended), which we sold to the IPO underwriter and/or persons related to the underwriter

warrants to purchase 87,500 shares at \$6.9375 per share through March 31, 2005 which we granted to two investors and a placement agent in connection with a tranche of our 3% Convertible Debentures on March 22, 2000

warrants to purchase 80,000 shares at \$4.57 per share through May 31, 2005 which we granted to a former financial consultant on June 1, 2001 for services rendered in connection with corporate development

warrants to purchase 200,000 shares at \$3.00 per share through August 15, 2006 which we granted to The Bauer Partnership, Inc. on August 16, 2001, in connection with a proposed debt placement which was never completed

warrants to purchase 484,221 shares at \$2.98 per share through September 3, 2009 which we sold to a group of investors pursuant to a private placement offering on September 1, 2004

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ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

A. MAJOR SHAREHOLDERS.

Please see Item 6.E. for share ownership information regarding our major shareholders. Our major shareholders do not have different voting rights.

As of December 31, 2004, we had 280 record holders of our common stock. Of the 12,304,658 shares outstanding as of December 31, 2004, 8,935,917 shares were held by CEDE & Co.

To the extent known to us, we are not directly or indirectly owned or controlled by another corporation, by any foreign government or by any other natural or legal persons severally or jointly.

To our knowledge, there are no arrangements the operation of which may at a subsequent date result in a change in control of our company.

B. RELATED PARTY TRANSACTIONS.

Certain of our banking facilities are collateralized by properties owned by Yu Chuan Yih and his personal guarantee to the extent of \$8,311,000, \$9,147,000 and \$12,971,000 as of December 31, 2002, 2003 and 2004. Mr. Yih has not received any additional compensation or consideration from us in return for his personal guarantees.

During the fiscal year ended April 30, 1999, we provided a guarantee to a bank in respect of mortgage loans granted to Yu Chuan Yih to the extent of \$632,000. As of December 31, 2004, the balance of the mortgage loans amounted to \$307,000.

C. INTERESTS OF EXPERTS AND COUNSEL.

Not applicable.

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ITEM 8. FINANCIAL INFORMATION

A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION.

The Consolidated Financial Statements are filed in this Annual Report as Item 18.

Export sales constitute significantly all of our total sales volume.

There are no legal or arbitration proceedings, including those relating to bankruptcy, receivership or similar procedures and those involving any third party, which may have, or have had in the recent past, significant effects on our financial position or profitability. We are not aware of any governmental proceedings pending or known to be contemplated.

We have no direct business operations, other than the ownership of our subsidiaries. While we have no current intention of paying dividends, should we, as a holding company, decide in the future to do so, our ability to pay dividends and meet other obligations depends upon the receipt of dividends or other payments from our operating subsidiaries and other holdings and investments. In addition, our operating subsidiaries are subject to restrictions on their ability to make distributions to us, including as a result of restrictive covenants and minimum net worth requirements in loan agreements, restrictions on the conversion of local currency into U.S. dollars or other hard currency and other regulatory restrictions.

B. SIGNIFICANT CHANGES.

We believe that no significant changes have occurred since the date of the annual financial statements included in this annual report.

Table of Contents**ITEM 9. THE OFFER AND LISTING****A. OFFER AND LISTING DETAILS.**

Our common stock is listed and quoted for trading on The Nasdaq National Market under the symbol JADE. The following table sets forth, during the periods indicated, the high and low last sale prices for the common stock as reported by Nasdaq:

| Period | High | Low |
|----------------------------------|-------------|------------|
| Year ended April 30, 2000 | \$ 6.69 | \$ 3.00 |
| Year ended April 30, 2001 | \$ 3.88 | \$ 1.63 |
| Year ended April 30, 2002 | \$ 2.79 | \$ 1.18 |
| Year ended December 31, 2002 | \$ 1.56 | \$ 1.11 |
| Year ended December 31, 2003 | \$ 5.00 | \$ 1.14 |
| Year ended December 31, 2004 | \$ 5.74 | \$ 2.21 |
| Quarter ended March 31, 2003 | \$ 1.30 | \$ 1.14 |
| Quarter ended June 30, 2003 | \$ 1.85 | \$ 1.17 |
| Quarter ended September 30, 2003 | \$ 5.00 | \$ 1.85 |
| Quarter ended December 31, 2003 | \$ 4.89 | \$ 3.44 |
| Quarter ended March 31, 2004 | \$ 5.74 | \$ 3.75 |
| Quarter ended June 30, 2004 | \$ 4.23 | \$ 3.14 |
| Quarter ended September 30, 2004 | \$ 3.79 | \$ 2.25 |
| Quarter ended December 31, 2004 | \$ 3.36 | \$ 2.21 |
| Month ended September 30, 2004 | \$ 2.80 | \$ 2.25 |
| Month ended October 31, 2004 | \$ 2.34 | \$ 2.21 |
| Month ended November 30, 2004 | \$ 2.82 | \$ 2.59 |
| Month ended December 31, 2004 | \$ 3.36 | \$ 2.85 |
| Month ended January 31, 2005 | \$ 3.15 | \$ 2.68 |
| Month ended February 28, 2005 | \$ 3.46 | \$ 2.85 |

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Our warrants are listed and quoted for trading on The Nasdaq National Market under the symbol JADEW. The following table sets forth, during the periods indicated, the high and low last sale prices for the warrants as reported by Nasdaq:

| Period | High | Low |
|----------------------------------|-------------|------------|
| Year ended April 30, 2000 | \$ 3.25 | \$ 1.00 |
| Year ended April 30, 2001 | \$ 1.38 | \$ 0.22 |
| Year ended April 30, 2002 | \$ 0.55 | \$ 0.02 |
| Year ended December 31, 2002 | \$ 0.15 | \$ 0.01 |
| Year ended December 31, 2003 | \$ 1.13 | \$ 0.02 |
| Year ended December 31, 2004 | \$ 1.30 | \$ 0.17 |
| Quarter ended March 31, 2003 | \$ 0.12 | \$ 0.04 |
| Quarter ended June 30, 2003 | \$ 0.12 | \$ 0.02 |
| Quarter ended September 30, 2003 | \$ 1.13 | \$ 0.12 |
| Quarter ended December 31, 2003 | \$ 1.08 | \$ 0.54 |
| Quarter ended March 31, 2004 | \$ 1.30 | \$ 0.61 |
| Quarter ended June 30, 2004 | \$ 0.83 | \$ 0.60 |
| Quarter ended September 30, 2004 | \$ 0.70 | \$ 0.23 |
| Quarter ended December 31, 2004 | \$ 0.53 | \$ 0.17 |
| Month ended September 30, 2004 | \$ 0.46 | \$ 0.23 |
| Month ended October 31, 2004 | \$ 0.44 | \$ 0.19 |
| Month ended November 30, 2004 | \$ 0.53 | \$ 0.17 |
| Month ended December 31, 2004 | \$ 0.35 | \$ 0.20 |
| Month ended January 31, 2005 | \$ 0.29 | \$ 0.16 |
| Month ended February 28, 2005 | \$ 0.19 | \$ 0.07 |

We do not believe that there is any principal non-United States trading market for our common stock or our warrants. We believe that Cede & Co. holds a substantial majority of the outstanding common stock and warrants as record holder.

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B. PLAN OF DISTRIBUTION.

Not applicable.

C. MARKETS.

Our common stock and our warrants have been listed and quoted for trading on The Nasdaq National Market System since April 15, 1998.

D. SELLING SHAREHOLDERS.

Not applicable.

E. DILUTION.

Not applicable.

F. EXPENSES OF THE ISSUE.

Not applicable.

ITEM 10. ADDITIONAL INFORMATION

A. SHARE CAPITAL.

Not applicable.

B. MEMORANDUM AND ARTICLES OF ASSOCIATION.

Corporate Powers. We have been registered in the British Virgin Islands since January 30, 1997, under British Virgin Islands International Business Companies number 216796. Clause 4 of our Memorandum of Association states that the objects for which we are established are to engage in any businesses which are not prohibited by law in force in the British Virgin Islands.

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Directors. A director who is materially interested in any transaction with us shall declare the material facts of and nature of his interest at the meeting of the Board of Directors. A director may vote or be counted as the quorum on any resolution of the Board in respect of any transaction in which he is materially interested. With the prior or subsequent approval by a resolution of members, the directors may, by a resolution of directors, fix the emoluments of directors with respect to services to be rendered in any capacity to us. The directors may, by a resolution of directors, exercise all the powers of the Company to borrow money. There is no age limit requirement for retirement or non-retirement of directors. A director shall not require a share qualification.

Share Rights, Preferences and Restrictions. Our authorized share capital is US\$1 million divided into 100 million shares of par value US\$0.01 per share. All dividends unclaimed for three years after having been declared may be forfeited by resolution of the directors for our benefit. All shares vote as one class and each whole share has one vote. Directors stand for reelection on an annual basis. Cumulative voting for directors is not authorized. We may redeem any of our own shares for such fair value as we by a resolution of directors determine. All shares have the same rights with regard to dividends and distributions upon our liquidation.

Changing Share Rights. The rights of each class and series of shares that we are authorized to issue shall be fixed by the resolution of directors. If the authorized capital is divided into different classes, the rights attached to any class may be varied with the consent in writing of the holders of not less than three-fourths of the issued shares of that class and of the holders of not less than three-fourths of the issued shares of any other class which may be affected by such variation.

Shareholder Meetings. The directors may convene meetings of our members at such times and in such manner and places as the directors consider necessary or desirable. The directors shall convene such a meeting upon the written request of members holding 10 percent or more of our outstanding voting shares. At least seven days notice of the meeting shall be given to the members whose names appear on the share register.

Restrictions on Rights to Own Securities. There are no limitations on the rights to own our securities.

Change in Control Provisions. There are no provisions of our Memorandum of Association and Articles of Association that would have an effect of delaying, deferring or preventing a change in our control and that would have operate only with respect to a merger, acquisition or corporate restructuring involving us.

Disclosure of Share Ownership. There are no bylaw provisions governing the ownership threshold above which shareholder ownership must be disclosed.

Applicable Law. Under the laws of most jurisdictions in the US, majority and controlling shareholders generally have certain fiduciary responsibilities to the minority shareholders.

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Shareholder action must be taken in good faith and actions by controlling shareholders which are obviously unreasonable may be declared null and void. BVI law protecting the interests of minority shareholders may not be as protective in all circumstances as the law protecting minority shareholders in US jurisdictions.

While BVI law does permit a shareholder of a BVI company to sue its directors derivatively, that is, in the name of, and for the benefit of, our company and to sue a company and its directors for his benefit and for the benefit of others similarly situated, the circumstances in which any such action may be brought, and the procedures and defenses that may be available in respect of any such action, may result in the rights of shareholders of a BVI company being more limited than those of shareholders of a company organized in the US.

Our directors have the power to take certain actions without shareholder approval, including an amendment of our Memorandum of Association or Articles of Association or an increase or reduction in our authorized capital, which would require shareholder approval under the laws of most US jurisdictions. In addition, the directors of a BVI corporation, subject in certain cases to court approval but without shareholder approval, may, among other things, implement a reorganization, certain mergers or consolidations, the sale, transfer, exchange or disposition of any assets, property, part of the business, or securities of the corporation, or any combination, if they determine it is in the best interests of the corporation, its creditors, or its shareholders. Our ability to amend our Memorandum of Association and Articles of Association without shareholder approval could have the effect of delaying, deterring or preventing a change in our control without any further action by the shareholders, including a tender offer to purchase our common stock at a premium over then current market prices.

The International Business Companies Act of the British Virgin Islands permits the creation in our Memorandum and Articles of Association of staggered terms of directors, cumulative voting, shareholder approval of corporate matters by written consent, and the issuance of preferred shares. Currently, our Memorandum and Articles of Association only provide for shareholder approval of corporate matters by written consent, but not for staggered terms of directors, cumulative voting or the issuance of preferred shares.

As in most US jurisdictions, the board of directors of a BVI corporation is charged with the management of the affairs of the corporation. In most US jurisdictions, directors owe a fiduciary duty to the corporation and its shareholders, including a duty of care, under which directors must properly apprise themselves of all reasonably available information, and a duty of loyalty, under which they must protect the interests of the corporation and refrain from conduct that injures the corporation or its shareholders or that deprives the corporation or its shareholders of any profit or advantage. Many US jurisdictions have enacted various statutory provisions which permit the monetary liability of directors to be eliminated or limited.

Under BVI law, liability of a corporate director to the corporation is primarily limited to cases of willful malfeasance in the performance of his duties or to cases where the director has not acted honestly and in good faith and with a view to the best interests of the corporation.

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However, under our Articles of Association, we are authorized to indemnify any director or officer who is made or threatened to be made a party to a legal or administrative proceeding by virtue of being one of our directors or officers, provided such person acted honestly and in good faith and with a view to our best interests and, in the case of a criminal proceeding, such person had no reasonable cause to believe that his conduct was unlawful. Our Articles of Association also enable us to indemnify any director or officer who was successful in such a proceeding against expense and judgments, fines and amounts paid in settlement and reasonably incurred in connection with the proceeding.

The above description of certain differences between BVI and US corporate laws is only a summary and does not purport to be complete or to address every applicable aspect of such laws. However, we believe that all material differences are disclosed above.

Changes in Capital. Requirements to effect changes in capital are not more stringent than is required by law.

C. MATERIAL CONTRACTS.

None.

D. EXCHANGE CONTROLS.

There are no material British Virgin Islands laws, decrees, regulations or other legislation that impose foreign exchange controls on us or that affect our payment of dividends, interest or other payments to non-resident holders of our capital stock. British Virgin Islands law and our Memorandum of Association and Articles of Association impose no limitations on the right of non-resident or foreign owners to hold or vote our common stock.

E. TAXATION.

The following is a summary of anticipated material U.S. federal income and British Virgin Islands tax consequences of an investment in our common stock. The summary does not deal with all possible tax consequences relating to an investment in our common stock and does not purport to deal with the tax consequences applicable to all categories of investors, some of which, such as dealers in securities, insurance companies and tax-exempt entities, may be subject to special rules. In particular, the discussion does not address the tax consequences under state, local and other non-U.S. and non-British Virgin Islands tax laws. Accordingly, each prospective investor should consult its own tax advisor regarding the particular tax consequences to it of an investment in the common stock. The discussion below is based upon laws and relevant interpretations in effect as of the date of this annual report, all of which are subject to change.

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United States Federal Income Taxation

The following discussion addresses only the material U.S. federal income tax consequences to a U.S. person, defined as a U.S. citizen or resident, a U.S. corporation, or an estate or trust subject to U.S. federal income tax on all of its income regardless of source, making an investment in the common stock. For taxable years beginning after December 31, 1996, a trust will be a U.S. person only if:

a court within the United States is able to exercise primary supervision over its administration; and

one or more United States persons have the authority to control all of its substantial decisions.

In addition, the following discussion does not address the tax consequences to a person who holds or will hold, directly or indirectly, 10% or more of our common stock, which we refer to as a 10% Shareholder. Non-U.S. persons and 10% Shareholders are advised to consult their own tax advisors regarding the tax considerations incident to an investment in our common stock.

A U.S. investor receiving a distribution of our common stock will be required to include such distribution in gross income as a taxable dividend, to the extent of our current or accumulated earnings and profits as determined under U.S. federal income tax principles. Any distributions in excess of our earnings and profits will first be treated, for U.S. federal income tax purposes, as a nontaxable return of capital, to the extent of the U.S. investor's adjusted tax basis in our common stock, and then as gain from the sale or exchange of a capital asset, provided that our common stock constitutes a capital asset in the hands of the U.S. investor. U.S. corporate shareholders will not be entitled to any deduction for distributions received as dividends on our common stock.

Gain or loss on the sale or exchange of our common stock will be treated as capital gain or loss if our common stock is held as a capital asset by the U.S. investor. Such capital gain or loss will be long-term capital gain or loss if the U.S. investor has held our common stock for more than one year at the time of the sale or exchange.

A holder of common stock may be subject to backup withholding at the rate of 31% with respect to dividends paid on our common stock if the dividends are paid by a paying agent, broker or other intermediary in the United States or by a U.S. broker or certain United States-related brokers to the holder outside the United States. In addition, the proceeds of the sale, exchange or redemption of common stock may be subject to backup withholding, if such proceeds are paid by a paying agent, broker or other intermediary in the United States.

Backup withholding may be avoided by the holder of common stock if such holder:

is a corporation or comes within other exempt categories; or

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provides a correct taxpayer identification number, certifies that such holder is not subject to backup withholding and otherwise complies with the backup withholding rules.

In addition, holders of common stock who are not U.S. persons are generally exempt from backup withholding, although they may be required to comply with certification and identification procedures in order to prove their exemption.

Any amounts withheld under the backup withholding rules from a payment to a holder will be refunded or credited against the holder's U.S. federal income tax liability, if any, provided that amount withheld is claimed as federal taxes withheld on the holder's U.S. federal income tax return relating to the year in which the backup withholding occurred. A holder who is not otherwise required to file a U.S. income tax return must generally file a claim for refund or, in the case of non-U.S. holders, an income tax return in order to claim refunds of withheld amounts.

British Virgin Islands Taxation

Under the International Business Companies Act of the British Virgin Islands as currently in effect, a holder of common stock who is not a resident of BVI is exempt from BVI income tax on dividends paid with respect to the common stock and all holders of common stock are not liable for BVI income tax on gains realized during that year on sale or disposal of such shares; BVI does not impose a withholding tax on dividends paid by a company incorporated under the International Business Companies Act.

There are no capital gains, gift or inheritance taxes levied by BVI on companies incorporated under the International Business Companies Act. In addition, the common stock is not subject to transfer taxes, stamp duties or similar charges.

There is no income tax treaty or convention currently in effect between the United States and the British Virgin Islands.

F. DIVIDENDS AND PAYING AGENTS.

Not applicable.

G. STATEMENT BY EXPERTS.

Not applicable.

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H. DOCUMENTS ON DISPLAY.

The documents concerning our company, which are referred to in this annual report, may be inspected at our principal executive offices at Unit #12, 12/F, Block A, Focal Industrial Centre, 21 Man Lok Street, Hung Hom, Kowloon, Hong Kong.

I. SUBSIDIARY INFORMATION.

Not applicable.

ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not believe that we have any material exposures to market risk associated with activities in derivative financial instruments, other financial instruments, derivative commodity instruments, and other market risk sensitive instruments, positions and transactions.

ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

PART II

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

None.

ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

Effective December 5, 2002, we announced a two-year extension of the exercise term to April 15, 2005 for our 1,679,000 outstanding registered common stock purchase warrants (Nasdaq: JADEW). Each warrant remains exercisable to purchase one share of common stock at \$5.75 per share.

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ITEM 15. CONTROLS AND PROCEDURES

(a) Disclosure Controls and Procedures.

We carried out an evaluation, under the supervision and with the participation of our chairman, chief financial officer and chief operating officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of our fiscal year. Based on this evaluation, which will be used as input for further improvement actions, they concluded that our disclosure controls and procedures are effective to timely alerting them to material information about LJ International Inc. and its consolidated subsidiaries.

There have been no significant changes in our internal controls or in other factors that could significantly affect those controls subsequent to the date of this evaluation.

(b) Management's annual report on internal control over financial reporting.

Not applicable.

ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our Board of Directors has determined that we currently do not have at least one audit committee financial expert serving on our audit committee. We intend to identify and retain an audit committee financial expert no later than July 31, 2005.

ITEM 16B. CODE OF ETHICS

We have adopted a code of ethics that applies to all of our employees, including our chief executive officer and our chief financial officer.

ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

(a) Audit Fees.

The aggregate fees billed for each of the last two fiscal years for professional services rendered by our principal accountant for the audit of our annual financial statements or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements for those fiscal years were \$120,000 for the fiscal year ended December 31, 2003 and \$140,000 for the fiscal year ended December 31, 2004.

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(b) Audit Related Fees.

No fees were billed in each of the last two fiscal years for assurance and related services by our principal accountant that are reasonably related to the performance of the audit or review of our financial statements and are not reported under paragraph (a) of this Item for the fiscal year ended December 31, 2003 and for the fiscal year ended December 31, 2004.

(c) Tax Fees.

The aggregate fees billed in each of the last two fiscal years for professional services rendered by our principal accountant for tax compliance, tax advice, and tax planning were \$8,000 for the fiscal year ended December 31, 2003 and \$8,000 for the fiscal year ended December 31, 2004. The nature of the services comprising these fees included data gathering for preparation, review and submission as agent of tax filing.

(d) All Other Fees.

No fees were billed in each of the last two fiscal years for products and services provided by our principal accountant, other than the services reported in paragraphs (a) through (c) of this Item for the fiscal year ended December 31, 2003 and for the fiscal year ended December 31, 2004.

(e) Audit Committee Pre-Approval Policies and Procedures.

To ensure continuing auditor objectivity and to safeguard the independence of our auditors, our audit committee has determined a framework for the type and authorization of non-audit services which our auditors, Moores Rowland Mazars, may provide.

The audit committee has adopted policies for the pre-approval of specific services that may be provided by our principal auditors. These policies are kept under review and amended as necessary to meet the dual objectives of ensuring that we benefit in a cost effective manner from the cumulative knowledge and experience of our auditors whilst also ensuring that the auditors maintain the necessary degree of independence and objectivity.

Our audit committee approved the engagement of Moores Rowland Mazars as our auditors to render audit and non-audit services before Moores Rowland Mazars was engaged by us.

All of the services described in each of paragraphs (b) through (d) of this Item were approved by the audit committee pursuant to paragraph (c)(7)(i)(C) of Rule 2-01 of Regulation S-X.

(f). Not applicable.

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ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES.

Not applicable.

ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS.

In September 2001, we announced a common stock repurchase program pursuant to which we may repurchase up to 1,000,000 shares of common stock from time to time in the open market and in negotiated transactions, including block transactions, and may be discontinued at any time without prior notice.

We did not repurchase any of our shares of common stock during the fiscal year ended December 31, 2004.

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PART III

ITEM 17. FINANCIAL STATEMENTS

Not applicable.

ITEM 18. FINANCIAL STATEMENTS

The following financial statements are being filed as part of this Annual Report on Form 20-F:

Report of Independent Auditors

Consolidated statements of operations for the year ended April 30, 2002 and for the eight-month period ended December 31, 2002 and for the years ended December 31, 2003 and 2004.

Consolidated balance sheets as of December 31, 2002, 2003 and 2004.

Consolidated statements of shareholders' equity for the year ended April 30, 2002 and for the eight-month period ended December 31, 2002 and for the years ended December 31, 2003 and 2004.

Consolidated statements of cash flows for the year ended April 30, 2002 and for the eight-month period ended December 31, 2002 and for the years ended December 31, 2003 and 2004.

Notes to and forming part of the financial statements

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LJ INTERNATIONAL INC.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To The Shareholders and The Board of Directors of
LJ International Inc.

We have audited the accompanying consolidated balance sheets of LJ International Inc. and its subsidiaries as of December 31, 2004, December 31, 2003 and December 31, 2002 and the related consolidated statements of operations, shareholders' equity and cash flows for each of the years in the two-year period ended December 31, 2004, for the eight-month period ended December 31, 2002 and for the year ended April 30, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of LJ International Inc. and its subsidiaries as of December 31, 2004, December 31, 2003 and December 31, 2002, and the consolidated results of their operations and their cash flows for each of the years in the two-year period ended December 31, 2004, for the eight-month period ended December 31, 2002 and for the year ended April 30, 2002, in conformity with U.S. generally accepted accounting principles.

As discussed in note 2 to the consolidated financial statements, the Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 46 (Revised December 2003), Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 (FIN 46(R)) and, accordingly, began consolidating a variable interest entity as of May 21, 2004.

/s/ Moores Rowland Mazars

Moores Rowland Mazars

Chartered Accountants

Certified Public Accountants, Hong Kong

Dated: March 24, 2005

Table of Contents**LJ INTERNATIONAL INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

(Amounts in thousands, except share and per share data)

| | | Year ended December 31, 2004 US\$ | Year ended December 31, 2003 US\$ | 8 months ended December 31, 2002 US\$ | Year ended April 30, 2002 US\$ |
|---|-------------|--|---|--|---|
| Operating revenue | <i>2(c)</i> | 77,379 | 58,167 | 31,809 | 39,240 |
| Costs of goods sold | | (61,265) | (44,947) | (22,820) | (35,731) |
| Gross profit | | 16,114 | 13,220 | 8,989 | 3,509 |
| Operating expenses | | | | | |
| Selling, general and administrative expenses | | (11,578) | (9,133) | (6,433) | (8,963) |
| Unrealized loss on derivatives | | (482) | (162) | (435) | (660) |
| Depreciation | | (1,032) | (1,184) | (863) | (1,031) |
| Impairment on property, plant and equipment | | | (84) | (108) | (345) |
| Amortization and impairment loss on goodwill | <i>8</i> | | (200) | (400) | (242) |
| Operating income (loss) | | 3,022 | 2,457 | 750 | (7,732) |
| Other revenue and expense | | | | | |
| Other revenues | <i>2(c)</i> | 844 | 453 | 205 | 352 |
| Interest expenses | | (902) | (753) | (441) | (652) |
| Impairment loss on investment securities | <i>9</i> | | | (200) | |
| Income (loss) before income taxes and minority interests | | 2,964 | 2,157 | 314 | (8,032) |
| Income taxes (expense) credit | <i>11</i> | (277) | (352) | (101) | 101 |
| Income (Loss) before minority interests | | 2,687 | 1,805 | 213 | (7,931) |
| Minority interests in consolidated subsidiaries | | | 8 | 120 | 30 |

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| | | | | | |
|---|------|-------------------|-----------|-----------|-----------|
| Net income (loss) | | 2,687 | 1,813 | 333 | (7,901) |
| Numerator: | | | | | |
| Net income (loss) used in computing basic earnings (loss) per share | | 2,687 | 1,813 | 333 | (7,901) |
| Denominator: | | | | | |
| Weighted average number of shares used in calculating basic earnings (loss) per share | | 11,118,995 | 8,757,266 | 8,492,851 | 8,671,615 |
| Effect of dilutive potential ordinary shares: | | | | | |
| Warrants | | 55,693 | 183,151 | | 7 |
| Stock options | | 932,786 | 765,267 | | 106,759 |
| Weighted average number of shares used in calculating diluted earnings (loss) per share | | 12,107,474 | 9,705,684 | 8,492,851 | 8,778,381 |
| Earnings (loss) per share: | | | | | |
| Basic | 2(g) | 0.24 | 0.21 | 0.04 | (0.91) |
| Diluted | 2(g) | 0.22 | 0.19 | 0.04 | (0.91) |

The accompanying notes are an integral part of these financial statements.

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LJ INTERNATIONAL INC.
CONSOLIDATED BALANCE SHEETS

(Amounts in thousands, except share and per share data)

| | <i>Notes</i> | As of December 31, | | |
|--|--------------|---------------------------|--------|--------|
| | | 2004 | 2003 | 2002 |
| | | US\$ | US\$ | US\$ |
| ASSETS | | | | |
| Current asset | | | | |
| Cash and cash equivalents | | 3,228 | 2,722 | 997 |
| Restricted cash | | 6,393 | 5,931 | 6,358 |
| Trade receivables, net of allowance for doubtful accounts (December 31, 2004: US\$284; December 31, 2003: US\$159; December 31, 2002: US\$280) | | 15,653 | 15,243 | 10,962 |
| Derivatives | | | 651 | |
| Inventories | 5 | 36,629 | 21,487 | 17,932 |
| Prepayments and other current assets | | 2,539 | 3,726 | 1,233 |
| Total current assets | | 64,442 | 49,760 | 37,482 |
| Properties held for lease, net | 6 | 1,452 | 1,506 | 1,561 |
| Property, plant and equipment, net | 7 | 4,673 | 4,931 | 5,153 |
| Due from related parties | 16(b) | 491 | 508 | 511 |
| Goodwill, net | 8 | 1,521 | 1,521 | 1,721 |
| Investment securities, net | 9 | 2,460 | 2,460 | 2,460 |
| Total assets | | 75,039 | 60,686 | 48,888 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | | | |
| Current liabilities | | | | |
| Bank overdrafts | 10 | 607 | 1,312 | 3,107 |
| Notes payable | 10 | 2,487 | 1,516 | 1,073 |
| Capitalized lease obligation, current portion | | 19 | 18 | 23 |
| Letters of credit, gold and others | 10 | 21,911 | 16,737 | 12,259 |
| Derivatives | | 1,462 | 1,430 | 739 |
| Trade payables | | 9,553 | 8,417 | 6,620 |
| Accrued expenses and other payables | | 4,631 | 2,864 | 1,696 |
| Income taxes payable | | 68 | 326 | 69 |
| Deferred taxation | | 87 | 87 | |
| Total current liabilities | | 40,825 | 32,707 | 25,586 |
| Capitalized lease obligation, non-current | | 58 | 77 | |

| | | | | |
|---|-------|---------------|--------|--------|
| Total liabilities | | 40,883 | 32,784 | 25,586 |
| Minority interest | | | | 8 |
| Commitments and contingencies | 12 | | | |
| Shareholders equity | | | | |
| Common stocks, par value US\$0.01 each, Authorized - 100 million shares, Issued 12,304,658 shares as of December 31, 2004; 9,890,006 shares as of December 31, 2003 and 8,671,615 shares as of December 31, 2002 | 13 | 123 | 99 | 87 |
| Additional paid-in capital | | 23,382 | 19,802 | 17,410 |
| Treasury stock | 13(b) | | | (391) |
| Accumulated other comprehensive loss | | (151) | (151) | (151) |
| Unearned compensation | 2(q) | (37) | | |
| Retained earnings | | 10,839 | 8,152 | 6,339 |
| Total shareholders equity | | 34,156 | 27,902 | 23,294 |
| Total liabilities and shareholders equity | | 75,039 | 60,686 | 48,888 |

The accompanying notes are an integral part of these financial statements.

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LJ INTERNATIONAL INC.
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(Amounts in thousands, except share and per share data)

| | Notes | Common stock | | Additional Paid-in Capital US\$ | Treasury stock Number of shares | Accumulated other comprehensive income | | Unearned compensation US\$ | Retained earnings US\$ | Total US\$ |
|---|----------|---------------------|----------------------|--|---------------------------------------|---|-------|----------------------------------|------------------------------|---------------|
| | | Number of shares | Par Value US\$ | | | Cost US\$ | US\$ | | | |
| Balance as of April 30, 2001 Comprehensive loss: | | 8,671,615 | 87 | 17,167 | | | | | 13,907 | 31,161 |
| Net loss | | | | | | | | | (7,901) | (7,901) |
| Compensation costs for stock-based transactions | 15(b) | | | 297 | | | | | | 297 |
| Balance as of April 30, 2002 Comprehensive income: | | 8,671,615 | 87 | 17,464 | | | | | 6,006 | 23,557 |
| Net income | | | | | | | | | 333 | 333 |
| Translation adjustment | | | | | | | (151) | | | (151) |
| Total comprehensive income | | | | | | | | | | 182 |
| Reversal of cancelled warrants | | | | (54) | | | | | | (54) |
| Purchase of treasury stock | 13(b)(i) | | | | (318,200) | (391) | | | | (391) |
| Balance as of December 31, 2002 | | 8,671,615 | 87 | 17,410 | (318,200) | (391) | (151) | | 6,339 | 23,294 |
| Comprehensive income: | | | | | | | | | | |
| Net income | | | | | | | | | 1,813 | 1,813 |
| Issuance of common stock | 13(a)(i) | 1,122,500 | 11 | 2,234 | | | | | | 2,245 |

| | | | | | | | | | |
|--|------------|-------------------|------------|---------------|---------|--------------|-------------|---------------|---------------|
| upon exercise of stock options | | | | | | | | | |
| Issuance of common stock upon exercise of warrants | 13(a)(i) | 95,891 | 1 | (1) | | | | | |
| Compensation costs for stock-based transactions | 15(b) | | | 9 | | | | 9 | |
| Sales of treasury stock | 13(b)(i) | | | 150 | 318,200 | 391 | | 541 | |
| | | | | | | | | | |
| Balance as of December 31, 2003 | | 9,890,006 | 99 | 19,802 | | (151) | 8,152 | 27,902 | |
| | | | | | | | | | |
| Comprehensive income: | | | | | | | | | |
| Net income | | | | | | | 2,687 | 2,687 | |
| Issuance of common stock on private placement | 13(a)(ii) | 1,614,082 | 16 | 2,730 | | | | 2,746 | |
| Issuance of common stock upon exercise of stock options | 13(a)(iii) | 405,000 | 4 | 806 | | | | 810 | |
| Issuance of common stock upon exercise of warrants | 13(a)(iii) | 395,570 | 4 | (4) | | | | | |
| Stock options granted | 2(q) | | | 48 | | (48) | | | |
| Compensation expense recognized during the year | 2(q) | | | | | | 11 | 11 | |
| | | | | | | | | | |
| Balance as of December 31, 2004 | | 12,304,658 | 123 | 23,382 | | (151) | (37) | 10,839 | 34,156 |

The accompanying notes are an integral part of these financial statements.

Table of Contents**LJ INTERNATIONAL INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Amounts in thousands, except share and per share data)

| | Year ended December 31, 2004 US\$ | Year ended December 31, 2003 US\$ | 8 months ended December 31, 2002 US\$ | Year ended April 30, 2002 US\$ |
|--|--|---|--|--|
| Notes | | | | |
| Cash flows from operating activities: | | | | |
| Net income (loss) | 2,687 | 1,813 | 333 | (7,901) |
| Adjustments to reconcile income (loss) to net cash (used in) provided by operating activities: | | | | |
| Depreciation of property, plant and equipment and properties held for lease | 1,032 | 1,184 | 863 | 1,031 |
| Impairment loss on property, plant and equipment | | 84 | 108 | 345 |
| Amortization and impairment loss on goodwill | | 200 | 400 | 242 |
| Impairment loss on investment securities | | | 200 | |
| Unrealized loss on derivatives | 482 | 162 | 435 | 660 |
| (Gain) Loss on disposal and write-off of property, plant and equipment | (3) | 2 | | 214 |
| Allowance for doubtful debts | 125 | 5 | 61 | 82 |
| Write-down of inventories | | | | 5,710 |
| Minority interests | | (8) | (120) | (30) |
| Costs associated with stock-based transactions | 11 | 9 | (54) | 297 |
| Changes in operating assets and liabilities: | | | | |
| Trade receivables | (535) | (4,286) | (2,448) | (1,873) |
| Inventories | (15,142) | (3,555) | (2,130) | (647) |
| Prepayments and other current assets | 1,187 | (2,493) | (30) | 830 |
| Due from related parties | 17 | 3 | 10 | |
| Trade payables | 1,136 | 1,797 | 3,310 | (120) |
| Accrued expenses and other payables | 1,767 | 1,168 | 19 | (1,101) |
| Due to a director | | | | (247) |
| Letters of credit and others | 1,804 | 5,060 | 2,351 | 2,069 |
| Income taxes payable and deferred taxation | (258) | 344 | 66 | (314) |
| Net cash (used in) provided by operating activities | (5,690) | 1,489 | 3,374 | (753) |

Cash flows from investing activities:

| | | | | | |
|--|---|----------------|--------------|----------------|----------------|
| Change in restricted cash | | (462) | 427 | (715) | (328) |
| Advance to related parties | | | | | (5,442) |
| Purchase of property, plant and equipment | | (727) | (897) | (1,556) | (420) |
| Purchase of subsidiary | 3 | | | | (2,381) |
| Proceeds on disposals of property, plant and equipment | | 10 | 2 | 64 | 12 |
| Repayment from related parties | | | | | 6,311 |
| Net cash used in investing activities | | (1,179) | (468) | (2,207) | (2,248) |

The accompanying notes are an integral part of these financial statements.

Table of Contents**LJ INTERNATIONAL INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Amounts in thousands, except share and per share data)

| | Year ended December 31, 2004 US\$ | Year ended December 31, 2003 US\$ | 8 months ended December 31, 2002 US\$ | Year ended April 30, 2002 US\$ |
|---|--|--|--|---|
| Notes | | | | |
| Cash flows from financing activities: | | | | |
| Change in bank overdrafts | (705) | (1,795) | 500 | (655) |
| Proceeds from issuance of shares upon exercise of stock options | 810 | 2,245 | | |
| Net proceeds from issuance of shares in private placement | 2,746 | | | |
| Loans acquired | 7,624 | 1,516 | 1,695 | 3,190 |
| Repayment of loans | (3,082) | (1,777) | (2,597) | (490) |
| Repayment of capitalized lease obligation | (18) | (26) | (31) | (28) |
| Sale (Purchase) of treasury stock | | 541 | (391) | |
| Net cash provided by (used in) financing activities | 7,375 | 704 | (824) | 2,017 |
| Effect of foreign exchange rate change | | | (68) | |
| Net increase (decrease) in cash and cash equivalents | 506 | 1,725 | 275 | (984) |
| Cash and cash equivalents, as of beginning of period | 2,722 | 997 | 722 | 1,706 |
| Cash and cash equivalents, as of end of period | 3,228 | 2,722 | 997 | 722 |
| Supplemental disclosure information: | | | | |
| Interest expense | 872 | 728 | 424 | 638 |
| Income taxes paid | 535 | 9 | 31 | 212 |

Non-cash transactions:

Purchase of property, plant and equipment
under capitalized leases

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The accompanying notes are an integral part of these financial statements.

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LJ INTERNATIONAL INC.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

1. NATURE OF BUSINESS AND BASIS OF FINANCIAL STATEMENTS

LJ International Inc. (LJI), its subsidiaries and variable interest entity (VIE) (collectively referred as the Company) are principally involved in the design, manufacture, marketing and sale of precious and semi-precious gemstones as well as diamond jewelry. While the Company is based in Hong Kong, its manufacturing operations are in the People's Republic of China (PRC) and most of its sales are currently in the United States of America (US). The Company also owns certain commercial and residential properties located in Hong Kong, which are held primarily for investment purposes.

The Company changed to a calendar-year basis of reporting financial results effective May 1, 2002. As a requirement of the change in fiscal year, the Company is reporting consolidated results of operations and cash flows for a special transition period for the eight months ended December 31, 2002. The comparative consolidated balance sheets are as of December 31, 2003 and December 31, 2002.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of accounting

The financial statements are prepared in accordance with U.S. generally accepted accounting principles.

(b) Principles of consolidation and goodwill

The consolidated financial statements include the financial information of LJI, its subsidiaries and VIE for which the Company is the primary beneficiary. The results of subsidiaries and VIE acquired or disposed of during the year/period are consolidated from or to their effective dates of acquisition or disposal respectively. All material intercompany balances and transactions have been eliminated on consolidation.

During 2004, the Company adopted Financial Accounting Standards Boards (FASB) Interpretation No. 46 (Revised December 2003), Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 (FIN 46(R)). FIN 46(R) requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties.

Lorenzo (Shenzhen) Co., Ltd. (LSC) is a VIE owned by 2 individuals, who are acting as agents. The Company does not have any ownership interest in LSC. The Company is incorporated in the BVI and is considered a foreign entity under the PRC laws. Due to the restrictions on foreign ownership on the retail business of jewelries, the Company, through loans to the agents, established LSC to carry out the retail business of jewelries in the PRC. Pursuant to various agreements entered into between the Company, the agents and LSC on May 21, 2004, the Company generally has control of LSC and is considered the primary beneficiary of LSC. Accordingly, the results of LSC are consolidated in the financial statements of the Company since May 21, 2004.

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LJ INTERNATIONAL INC.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(b) Principles of consolidation and goodwill (Continued)

The application of the consolidation provisions of FIN 46(R) resulted in a decrease in assets and an increase in liabilities as of December 31, 2004 by US\$141 and US\$82 respectively and an increase in net loss of US\$223 for the year ended December 31, 2004.

Goodwill represents the excess of cost over fair value of acquired net assets. Prior to May 1, 2002, goodwill arising on acquisition of subsidiaries had been amortized on a straight-line basis over 10 years. Following the adoption of Statement of Financial Accounting Standard (SFAS) No. 142, *Goodwill and Other Intangible Assets*, issued by the FASB, goodwill is no longer amortized but subject to annual impairment tests. As part of an ongoing review of the valuation of goodwill, management assesses the fair value of the reporting units to determine if changes in facts and circumstances suggest that they may be impaired. If this review indicates that the goodwill is not recoverable, as determined by a discounted cash flow analysis, the carrying value of the Company's goodwill would be reduced to its estimated fair value.

(c) Revenue recognition

Operating revenue represents sale of goods at invoiced value to customers, net of returns and discounts, and is recognized when goods are delivered and title has passed to customers.

Other revenue is recognized on the following basis:

- (i) Interest income is accrued on a time proportion basis on the principal outstanding and at the interest rate applicable; and
- (ii) Rental income from investment properties under operating leases is recognized in the period in which the properties are let out and on the straight-line basis over the lease terms.

(d) Sales return reserve

The Company has allowed sales returns and its sales generally include specified return policy for certain customers. The Company reserves for sales returns as a reduction of revenue at the time the operating revenue is recognized based on historical sales return experience.

(e) Shipping and handling costs

The shipping and handling costs are included in costs of goods sold. The amounts of revenue received for shipping and handling are included in operating revenue.

(f) Advertising and promotion costs

Advertising and promotion expenses are generally expensed when incurred. Advertising costs included in costs of goods sold were US\$364, US\$871, US\$316 and US\$455 for the years ended December 31, 2004 and 2003, for the eight-month period ended December 31, 2002 and for the year ended April 30, 2002 respectively.

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LJ INTERNATIONAL INC.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(g) Earnings (loss) per share

The calculation of basic earnings (loss) per share is based on net income (loss) for the year/period attributable to shareholders and on the weighted average number of ordinary shares outstanding during the year/period.

The calculation of diluted earnings (loss) per share is based on net income (loss) for the year/period attributable to shareholders and on the weighted average number of ordinary shares outstanding during the year/period, adjusted for the effects of all dilutive potential ordinary shares. The dilutive effect of convertible securities is reflected in diluted earnings (loss) per share by application of the if-converted method.

(h) Fair value of financial instruments

The financial instruments used by the Company in the normal course of business, including cash and cash equivalents, trade receivables, trade payables, notes payable and letter of credit, gold and other loans, have fair values which approximate their recorded value as the financial instruments are either short term in nature or carry interest rate that approximate market rates.

(i) Accounts receivable

Accounts receivable are stated at the amount billed to customers, net of discounts. The Company provides an allowance for doubtful accounts, which is based upon a review of outstanding receivables, historical collection information and existing economic conditions. No interest is chargeable to customers for accounts that are unpaid after the due date. Accounts past due more than one year are considered delinquent. Delinquent receivables are written off based on individual credit evaluation and specific circumstances of the customer.

(j) *Inventories*

Inventories are stated at the lower of cost and market. Cost, which comprises all costs of purchase and, where applicable, costs of conversion and other costs that have been incurred in bringing the inventories to their present location and condition, is calculated using the first-in, first-out method. Estimated losses on inventories represent reserves for obsolescence, excess quantities, irregulars and slow moving inventory. The Company estimates the loss/write-down on the basis of its assessment of the inventory's net realizable value based upon current market conditions and historical experience.

Specifically, gemstones built up, prior to the year ended April 30, 2002, which were intended to meet orders in relation to special programs were stated at net realizable value as those orders did not materialize. Slow moving fine jewelry inventories in this respect were stated at net realizable value based on forecasts for close-out sales in the ensuing years. The

effect of such estimate has resulted
in a write-down of inventories
amounting to US\$5,710 being
recognized in costs of goods sold
for the year ended April 30, 2002.

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Table of Contents**LJ INTERNATIONAL INC.****NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS**

(Amounts in thousands, except share and per share data)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)*(k) Properties held for lease*

Properties held for lease are carried at cost, less accumulated depreciation, which is computed using the straight-line method over the estimated useful lives of the assets. Rental income from these properties is recorded on a monthly basis in accordance with the lease terms.

(l) Property, plant and equipment (PPE) and depreciation

PPE are stated at cost, less accumulated depreciation and accumulated impairment loss, and include expenditure that substantially increases the useful lives of existing assets. Maintenance and repairs are charged to current operations as incurred. Upon sale, retirement, or other disposition of these assets, the cost and related accumulated depreciation and accumulated impairment loss are removed from the respective accounts, and any gain or loss is included in the consolidated statement of operations.

Depreciation is provided by using the straight-line method over the estimated useful lives of the related assets at the following annual rates:

| | |
|-----------------------------------|--|
| Leasehold land and buildings | 2% or over the unexpired term of leases |
| Leasehold improvement | shorter of 10% or the unexpired term of leases |
| Furniture, fixtures and equipment | 20% to 50% |
| Plant and machinery | 10% |
| Motor vehicles | 20% |

(m) Impairment of long-lived assets

Long-lived assets are reviewed at least annually for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to undiscounted future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, impairment is measured as the difference between the carrying amount and fair value of the asset. Goodwill will not be allocated to long-lived assets, when tested for impairment.

(n) Investment securities

Investment in non-marketable securities held for an identified long term purpose are stated at cost and subject to impairment review at each reporting date to reflect any diminution in their value, which is expected to be other than temporary. The amount of impairment is recognized as an expense in the period in which the decline occurs.

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LJ INTERNATIONAL INC.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(o) Gold loans and embedded derivative

Gold loans are commodity-indexed debts with an embedded derivative. The loan is recorded at its original amount and adjusted for additional borrowings and repayments. The embedded derivative component was valued at fair value, considering the market price of gold, volatility of gold and the time value of money. Any changes in fair value of embedded derivative are included in the consolidated statement of operations and an asset or liability representing the value of the embedded derivative portion is included in the consolidated balance sheet.

(p) Derivatives

The Company enters into derivative contracts to hedge the future settlement of gold loans in order to mitigate the risk of market price fluctuations. They consist of contracts that are used to hedge against changes in the fair value of gold price when the Company settles the gold loans.

The derivative contracts and the embedded derivative are valued at fair value. Changes in fair value of derivative contracts are included in the consolidated statement of operations, net of changes in fair value of embedded derivative set out in note 2(o).

(q) Stock-based compensation

The Company records compensation expense for stock-based employee compensation plans using the intrinsic value method pursuant to APB Opinion No. 25 in which compensation expense is measured as the excess of the market price of the stock over the exercise price of the award on the measurement date. Compensation expense is charged to income as when incurred if the benefit was fully vested at the date of grant or is recognized proportionately over the vesting period. Unearned compensation is shown separately as a reduction of the stockholders' equity.

At December 31, 2004, the Company has two stock-based employee compensation plans, details of which are set out in note 15(a). In 2004, the Company recorded an unearned compensation of US\$48 in the stockholders' equity in relation to the option to purchase 150,000 shares of the common stock of the Company granted to an employee, for which the exercise price was below the market price of the underlying stock at the date of grant. This amount is accrued proportionately as compensation expense over the vesting period. For the year ended December 31, 2004, the Company recognized compensation expense of US\$11 in its statement of operations. Other than the above, the exercise price of the Company's incentive stock options was same as or higher than the market price of the underlying stock on the date of grant, no compensation expense was recognized for these stock options granted to employees.

Had compensation expense for the same stock options been determined based on the fair value on the date of grant and been amortized over the period from the date of grant to the date that the award is vested, consistent with the provisions of SFAS No. 123, the Company's net income and earnings per share would have been reported as follows:

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LJ INTERNATIONAL INC.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(q) Stock-based compensation (Continued)

| | Year ended December 31, 2004 US\$ | Year ended December 31, 2003 US\$ | 8 months ended December 31, 2002 US\$ |
|--|---|---|--|
| Net income, as reported | 2,687 | 1,813 | 333 |
| Add : Stock-based employee compensation expenses included in reported net income, net of tax | 11 | | |
| Deduct: Total stock-based employee compensation expenses determined under fair value based method for all awards, net of tax | (159) | (160) | |
| Pro forma net income | 2,539 | 1,653 | 333 |

| | Year ended December 31, 2004 US\$ | Year ended December 31, 2003 US\$ | 8 months ended December 31, 2002 US\$ |
|---|---|---|--|
| Earnings per share: Basic, as reported | 0.24 | 0.21 | 0.04 |
| Basic, pro forma | 0.23 | 0.19 | 0.04 |
| Diluted, as reported | 0.22 | 0.19 | 0.04 |
| Diluted, pro forma | 0.21 | 0.17 | 0.04 |

There were no stock options granted to employees during the year ended April 30, 2002 and accordingly no pro forma net loss and loss per share for the same year is presented.

Table of Contents**LJ INTERNATIONAL INC.****NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS**

(Amounts in thousands, except share and per share data)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)*(q) Stock-based compensation (Continued)*

The fair value of these options was estimated on the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions:

| | Year ended December 31, 2004 | Year ended December 31, 2003 | 8 months ended December 31, 2002 |
|---------------------------------|---|---------------------------------------|--|
| Expected dividend yield | | | |
| Expected stock price volatility | 61% | 9% | 7% |
| Risk-free interest rate | 4.15% | 3.56% | 4.47% |
| Expected life of options | 3 years | 3 years | 3 years |

The weighted average fair value per option granted during the years ended December 31, 2004 and 2003 and the eight-month period ended December 31, 2002 was US\$1.06, US\$0.14 and US\$Nil respectively.

(r) Income taxes

The Company accounts for income taxes under the liability method. Deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

(s) Foreign currencies

LJI's functional currency is United States dollars. The functional currencies of foreign subsidiaries are their respective local currencies. The assets and liabilities of foreign subsidiaries are translated at the exchange rates in effect at the balance sheet date and related revenue and expenses are translated at average exchange rates during the year. Related transaction gains or losses are reported as a separate component of accumulated other comprehensive income (loss). Foreign currency transaction gains and losses are included in the consolidated statement of operations.

(t) Treasury Stock

The Company applies the cost method of accounting for treasury stock. The cost method requires the Company to record the cost of acquiring treasury stock as a deduction from the total capital. The treasury stock account is debited for the cost of the shares acquired and will be credited upon reissuance at cost on a first-in-first-out basis. If the treasury stock is reissued at a price in excess of acquisition cost, the excess will be credited to additional paid-in capital in excess of par value from treasury stock. If the treasury stock is

reissued at less than acquisition cost, the deficiency will be treated first as a reduction of any capital in excess of par related to previous reissuances or retirements. If the balance in capital in excess of par value from treasury stock is insufficient to absorb the deficiency, the remainder is recorded as a reduction of retained earnings.

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LJ INTERNATIONAL INC.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(u) Cash equivalents

The Company considers all short-term, highly liquid investments with maturities of three months or less to be cash equivalents.

(v) Uses of estimates

The preparation of the Company's financial statements in conformity with generally accepted accounting principles requires the Company's management to make estimates and assumptions that affect the amounts reported in these financial statements and accompanying notes. Actual amounts could differ from those estimates.

(w) Related parties

Parties are considered to be related if one party has the ability, directly or indirectly, to control the other party, or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or common significant influence.

(x) Dividends

The Directors of the Company have never declared or paid any cash dividends on the Company's capital stock and do not anticipate paying cash dividends in the foreseeable future. The ability to pay dividends depends upon receipt of dividends or other payments from subsidiaries and other holdings and investments. In addition, the operating subsidiaries from time to time may be subject to restrictions on their ability to make distributions to the Company, including as a result of restrictive covenants in loan agreements, restrictions on the conversion of local currency into US dollars or other currencies and other regulatory restrictions. Currently, none of the subsidiaries has such restriction during the periods presented except for the covenants as set out in note 10 to the financial statements.

(y) New accounting pronouncements

In November 2004, the FASB issued SFAS No. 151 Inventory Costs, an amendment of ARB No. 43, Chapter 4. This statement amends ARB No. 43, Chapter 4 to clarify that abnormal amounts of idle facility expense, freight, handling costs, and spoilage should be recognized as current-period charges regardless of whether they meet the criterion of so abnormal and that fixed production overheads should be allocated to inventory based on the normal capacity of the production facilities. The guidance is effective for inventory costs incurred during fiscal years beginning after June 15, 2005; however, earlier application is permitted for inventory costs incurred during fiscal years beginning after November 23, 2004. The provisions of SFAS No. 151 should be applied prospectively. The Company considered that SFAS No. 151 does not have significant impact on its financial statements when it is adopted.

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LJ INTERNATIONAL INC.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(y) *New accounting pronouncements (Continued)*

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment*. This statement provides investors and other users of financial statements with more complete and neutral financial information by requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. SFAS No. 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. SFAS 123(R) replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Public entities (other than those filing as small business issuers) will be required to apply this statement as of the first interim or annual reporting period that begins after June 15, 2005. Management has not yet determined whether the adoption of SFAS No. 123(R) will result in amounts that are materially different from those currently provided under the pro forma disclosures under SFAS No. 123 in note 2(q) to the consolidation financial statements. The adoption of SFAS No. 123(R) is not expected to have a material impact on the financial condition, results of operations, or cash flows of the Company.

In December 2004, the FASB issued SFAS No. 153 *Exchanges of Non-monetary Assets*, an amendment of APB Opinion No. 29 *Accounting for Non-monetary Transactions*. The amendments made by SFAS No. 153 are based on the principle that exchanges on non-monetary assets should be measured based on the fair value of the assets exchanged. Further, the amendments eliminate the narrow exception for non-monetary exchanges of similar productive assets and replace it with a broader exception for exchanges of non-monetary assets that do not have commercial substance. A non-monetary exchange has commercial substance if the future cash flows of the entity expected to change significantly as a result of the exchange. SFAS No. 153 is effective for non-monetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Earlier application is permitted for non-monetary asset exchanges occurring in fiscal periods beginning after the date of issuance. The provisions of SFAS No. 153 should be applied prospectively. The Company considered that SFAS No. 153 does not have significant impact on its financial statements when it is adopted.

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Table of Contents**LJ INTERNATIONAL INC.****NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS**

(Amounts in thousands, except share and per share data)

3. ACQUISITIONS

During the year ended April 30, 2001, the Company acquired 12,000,000 common stocks (16.8% equity interest) of iBBC Inc., a company engaged in marketing jewelry from its display cases in retail shops, for the consideration of US\$600. For further expansion through vertical integration and the development of distribution channel, the Company further acquired 49,200,000 common stocks (68.8% equity interest) of iBBC Inc. from entities controlled by a director for a consideration of US\$2,460 on March 21, 2002. The objective of the acquisition was to acquire the know-how of interactive showcase as well as the established distribution retail network in the US and therefore increase shareholders' value.

Details of the identifiable assets and liabilities acquired at the date of acquisition are as follows:

| | 2002 US\$ |
|---|--------------|
| Net assets acquired: | |
| Property, plant and equipment | 1,056 |
| Trade receivables | 6 |
| Inventories | 43 |
| Other receivables | 160 |
| Cash and cash equivalents | 79 |
| Trade payables | (133) |
| Accrued expenses and other payables | (115) |
| | 1,096 |
| Minority interests | (157) |
| Goodwill arising from acquisition | 2,121 |
| | 3,060 |
| Total purchase consideration | 3,060 |
| | 2002 US\$ |
| Satisfied by cash paid in the financial year: | |
| 2001 | 600 |
| 2002 | 2,460 |
| | 3,060 |

None of the amount of goodwill is expected to be deductible for tax purposes.

The Company's consolidated results of operations have incorporated iBBC Inc.'s activity on a consolidated basis from the date of acquisition, which was March 21, 2002. The following unaudited consolidated results of operations reflect pro forma results of operations for the year ended April 30, 2002, as if the acquisition had occurred on May 1, 2001, and after giving effect to purchase accounting adjustments. The pro forma results have been prepared for comparative purposes only and do not purport to be indicative of what operating results would have been had the acquisitions actually taken place on May 1, 2001 and may not be indicative of future operating results.

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Table of Contents**LJ INTERNATIONAL INC.****NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS**

(Amounts in thousands, except share and per share data)

3. ACQUISITIONS (CONTINUED)

| | Year ended April 30, 2002 US\$ |
|----------------------------|---|
| Pro forma: | |
| Operating revenue | 39,296 |
| Net income (loss) | (9,900) |
| Earnings (loss) per share: | |
| Basic | (1.14) |
| Diluted | (1.14) |

4. OPERATING RISKS*(a) Concentrations of credit risks*

Details of major customers from which the Company derived operating revenue are shown in note 17(b).

Credit risk represents the accounting loss that would be recognized at the reporting date if counterparties failed completely to perform as contracted. Concentrations of credit risk (whether on or off balance sheet) that arise from financial instruments exist for groups of customers or counterparties when there are similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. The major concentration of credit risk arises from the Company's receivables. Even though the Company does have major customers, it does not consider itself to be exposed to significant credit risk with regards to collection of the related receivables. Historical losses have not been significant.

(b) Country risks

The Company may also be exposed to certain risks as a result of its manufacturing operation being located in the PRC and its properties held for lease in Hong Kong which are not typically associated with companies operating in North America and Western Europe. These include risks associated with, among others, the political, economic and legal environments and foreign currency exchange. The Company's results may be adversely affected by changes in the political and social conditions in the PRC, and by changes in governmental policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation, among other things. The Company's management believe these risks not to be significant. There can be no assurance, however, that changes in political, social

and other conditions will not result in any adverse impact.

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Table of Contents**LJ INTERNATIONAL INC.****NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS**

(Amounts in thousands, except share and per share data)

4. OPERATING RISKS (CONTINUED)*(c) Cash and time deposits*

The Company maintains its cash balances and investments in time deposits with various banks and financial institutions. In common with local practice, such amounts are not insured or otherwise protected should the financial institutions be unable to meet their liabilities. There has been no history of credit losses.

5. INVENTORIES

Inventories consisted of the following:

| | As of December 31, 2004 US\$ | As of December 31, 2003 US\$ | As of December 31, 2002 US\$ |
|------------------|---|--|--|
| Raw materials | 25,810 | 14,774 | 12,892 |
| Work-in-progress | 1,423 | 742 | 341 |
| Finished goods | 9,396 | 5,971 | 4,699 |
| | 36,629 | 21,487 | 17,932 |

6. PROPERTIES HELD FOR LEASE, NET

The Company owns leasehold land and buildings in Hong Kong and leases them out for lease terms of 2 years. Properties held for lease consists of the following:

| | As of December 31, | | |
|--------------------------------|---------------------------|--------------|--------------|
| | 2004 US\$ | 2003 US\$ | 2002 US\$ |
| Leasehold land and buildings | 2,037 | 2,037 | 2,037 |
| Less: Accumulated depreciation | (585) | (531) | (476) |
| | 1,452 | 1,506 | 1,561 |

The Company pledged all properties held for lease as collateral for general banking facilities granted to the Company as of December 31, 2004, 2003 and 2002 (see note 10).

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LJ INTERNATIONAL INC.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

6. PROPERTIES HELD FOR LEASE, NET (CONTINUED)

The future aggregate minimum rental receivables under non-cancellable operating leases are as follows:

| | As of December 31, 2004 US\$ |
|------|---|
| 2005 | 88 |
| 2006 | 22 |
| | 110 |

7. PROPERTY, PLANT AND EQUIPMENT, NET

Property, plant and equipment consist of the following:

| | As of December 31, | | |
|--|---------------------------|---------|---------|
| | 2004 | 2003 | 2002 |
| | US\$ | US\$ | US\$ |
| Leasehold land and buildings | 1,995 | 1,995 | 1,665 |
| Leasehold improvement | 3,326 | 2,839 | 2,650 |
| Furniture, fixtures and equipment | 3,656 | 3,475 | 3,246 |
| Plant and machinery | 2,493 | 2,442 | 2,349 |
| Motor vehicles | 423 | 455 | 322 |
| | 11,893 | 11,206 | 10,232 |
| Less: Accumulated depreciation and impairment losses | (7,220) | (6,275) | (5,079) |
| | 4,673 | 4,931 | 5,153 |

The Company pledged leasehold land and buildings with net book values of US\$1,495, US\$1,232 and US\$898 as of December 31, 2004, 2003 and 2002 respectively as collateral for general banking facilities granted to the Company (see note 10).

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(Amounts in thousands, except share and per share data)

8. GOODWILL, NET

Following the adoption of SFAS No. 142, the Company discontinued amortization of goodwill effective May 1, 2002. As of December 31, 2004, goodwill is attributed to the acquisition of a jewelry retail company in 2002 (see note 3).

| | Year ended December 31, 2004 US\$ | Year ended December 31, 2003 US\$ | 8 Months ended December 31, 2002 US\$ |
|--|--|--|--|
| Carrying value, beginning of year/period | 1,521 | 1,721 | 2,121 |
| Impairment loss | | (200) | (400) |
| Carrying value, end of year/period | 1,521 | 1,521 | 1,721 |

The Company conducts annual impairment tests. The testing included the determination of each reporting unit's fair value using the market multiples and discount cash flow analysis. The Company's reduced earnings and cash flow forecast, primarily due to the prolonged downturn in the economy, uncertain demand, and competitive industry conditions, resulted in the Company determining that no goodwill impairment charge was necessary.

The accumulated amortization and impairment losses were US\$869, US\$869, and US\$669 as of December 31, 2004, 2003 and 2002 respectively.

9. INVESTMENT SECURITIES, NET

| | As of December 31, | | |
|-------------------------------------|---------------------------|----------------------|----------------------|
| | 2004 US\$ | 2003 US\$ | 2002 US\$ |
| Equity securities at cost, unlisted | 2,660 | 2,660 | 2,660 |
| Less: Accumulated impairment losses | (200) | (200) | (200) |
| | 2,460 | 2,460 | 2,460 |

During the year ended April 30, 2001, the Company acquired 20% equity interests in a company whose principal activities are the manufacturing and trading of rough and pre-formed gemstones, of which the Company had no significant control and influence over its operating and financial policies.

The directors of the Company consider such acquisition would enhance the Company by forward and backward vertical integration.

No impairment loss was recognized for the years ended December 31, 2004 and 2003 and April 30, 2002. The amount of impairment loss charged to the consolidated statement of operations for the eight-month period ended December 31, 2002 was US\$200.

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Table of Contents**LJ INTERNATIONAL INC.****NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS**

(Amounts in thousands, except share and per share data)

10. BANKING FACILITIES AND OTHER LOANS

| | Note | As of December 31, | | |
|--|------|--------------------|--------------|--------------|
| | | 2004 US\$ | 2003 US\$ | 2002 US\$ |
| Bank overdrafts | (a) | 607 | 1,312 | 3,107 |
| Notes payable: | | | | |
| Current portion | (b) | 2,487 | 1,516 | 1,073 |
| Letters of credit, gold and others: | | | | |
| Letters of credit and others | (a) | 15,423 | 13,619 | 8,559 |
| Gold loan | (c) | 6,488 | 3,118 | 3,700 |
| | | 21,911 | 16,737 | 12,259 |

The Company's banking facilities are collateralized by leasehold land and buildings (see notes 6 and 7), restricted cash deposits, factored receivables, and personal guarantees of and properties owed by a director (see note 16(b)).

The material provisions of indentures relating to the Company's various banking facility agreements contain covenants pertaining to (i) maintenance of the net worth of LJI and one of its subsidiaries amounting to US\$25,000 and US\$4,487 respectively; and (ii) cross-default provisions of the subsidiary in the event of default in aggregate of at least US\$10,000 under separate loan facilities. In the event of default, the bank would at its discretion to cancel the facilities and demand immediate repayment of all principal, interest, fees and other amount outstanding. As of December 31, 2004, both LJI and the subsidiary maintained the minimum net worth requirement, and the subsidiary did not breach any cross-default provision.

- (a) As of December 31, 2004, the Company had various revolving bank facilities of overdrafts, letters of credit and factoring facilities granted by banks, amounting to US\$3,461, US\$14,487 and US\$12,346 respectively.

The bank overdrafts are denominated in Hong Kong dollars, bear interest at the floating commercial bank lending rates in Hong Kong, which ranged from 1.125% to 6.25% per annum as of December 31, 2004.

The factoring facilities granted are limited to the extent of accounts receivable collateralized to the banks.

Under the banking facilities arrangements, the Company is required to maintain certain cash balances based on the amount of facilities granted. These balances are reflected as restricted cash in the balance

sheet.

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Table of Contents**LJ INTERNATIONAL INC.****NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS**

(Amounts in thousands, except share and per share data)

10. BANKING FACILITIES AND OTHER LOANS (CONTINUED)

- (b) The Company also had term loans classified under notes payable which are related to the Company's leasehold land and buildings. These loans aggregated to US\$2,487 as of December 31, 2004. The expected maturities of these notes payable are within one year. Interest charges on these loans ranged from 2.7% to 3.5% per annum as of December 31, 2004.
- (c) The Company had outstanding loans to purchase 17.9 oz of gold as of December 31, 2004 with the related balances being US\$6,488. These loans are due within the following year, however, have been historically renewed. These loans bear interest at 2.1% to 2.5% per annum as of December 31, 2004 and can be repaid in cash at the current exchange rate of gold any time prior to maturity.

11. INCOME TAXES

The Company is subject to income taxes on an entity basis on income arising in or derived from the tax jurisdiction in which it is domiciled and operated. Income tax (expense) credit comprises of the following:

| | Year ended December 31, 2004 US\$ | Year ended December 31, 2003 US\$ | 8 months ended December 31, 2002 US\$ | Year ended April 30, 2002 US\$ |
|---|--|--|--|---|
| Current taxes arising in foreign subsidiaries: | | | | |
| For the year/period | (299) | (357) | (101) | (2) |
| Over provision in prior years | 22 | 92 | | 103 |
| Total current tax | (277) | (265) | (101) | 101 |
| Deferred taxes arising in foreign subsidiaries: | | | | |
| For the year/period | | (87) | | |
| Income taxes (expense) credit | (277) | (352) | (101) | 101 |

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Table of Contents**LJ INTERNATIONAL INC.****NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS**

(Amounts in thousands, except share and per share data)

11. INCOME TAXES (CONTINUED)

Reconciliation to the expected statutory tax rate in Hong Kong of 17.5% (2003: 17.5% and 2002: 16%) is as follows:

| | Year ended December 31, 2004 % | Year ended December 31, 2003 % | 8 months ended December 31, 2002 % | Year ended April 30, 2002 % |
|---|--|--|---|---|
| Statutory rate | 17.5 | 17.5 | 16.0 | (16.0) |
| Tax effect of net operating losses | 19.9 | 20.0 | 106.2 | 6.7 |
| Non taxable profits, net | (25.3) | (25.8) | (147.9) | |
| Impairment loss on goodwill and investment securities | | 1.6 | 30.6 | |
| Others | (2.8) | 3.0 | 27.3 | 8.0 |
| Effective rate | 9.3 | 16.3 | 32.2 | (1.3) |

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets and liabilities are as follows:

| | As of December 31, | | |
|---------------------------|--------------------|--------------|--------------|
| | 2004 US\$ | 2003 US\$ | 2002 US\$ |
| Deferred tax assets: | | | |
| Net operating loss | 2,826 | 2,595 | 1,789 |
| Depreciation | 98 | 103 | 47 |
| Start up costs | 23 | 22 | 32 |
| | 2,947 | 2,720 | 1,868 |
| Valuation allowance | (2,911) | (2,658) | (1,868) |
| Total deferred tax assets | 36 | 62 | |

Deferred tax liabilities:

| | | |
|------------------------------|-------|-------|
| Accelerated tax allowance | (123) | (149) |
| Net deferred tax liabilities | (87) | (87) |

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Table of Contents**LJ INTERNATIONAL INC.****NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS**

(Amounts in thousands, except share and per share data)

11. INCOME TAXES (CONTINUED)

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. The increase in valuation allowance for the years ended December 31, 2004 and 2003, the eight-month period ended December 31, 2002 and the year ended April 30, 2002 amounted to US\$253, US\$790, US\$740 and US\$1,074 respectively.

Based on the history of the Company's profitability, management believes that it is more likely than not that the Company will realize the benefits of the deferred tax assets of US\$36 and US\$62, net of valuation allowances as of December 31, 2004 and 2003.

12. COMMITMENTS AND CONTINGENCIES

(a) Commitments

The Company leases certain of its office and factory premises under various operating leases. Rent expenses under these leases totalled approximately US\$717, US\$657, US\$430 and US\$599 for the years ended December 31, 2004 and 2003, for the eight-month period ended December 31, 2002 and for the year ended April 30, 2002 respectively.

Future minimum rental payments under capitalized leases and non-cancelable operating leases are approximately as follows:

| | As of December, 31 2004 | |
|-------------------------------------|--|--------------------------------------|
| | Capitalized leases US\$ | Operating leases US\$ |
| 2005 | 22 | 625 |
| 2006 | 22 | 358 |
| 2007 | 22 | 131 |
| 2008 | 20 | 87 |
| Thereafter | | |
| Total future minimum lease payments | 86 | 1,201 |
| Less: Amount representing interest | (9) | |
| | 77 | |

In addition to the above future minimum lease payments, the terms of the leases in respect of the retail shops in the PRC provide for the payment of contingent rentals based on a percentage of sales in excess of a stipulated amount.

As of December 31, 2004, the Company had capital expenditure commitments of US\$64.

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LJ INTERNATIONAL INC.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

12. COMMITMENTS AND CONTINGENCIES (CONTINUED)

(b) Contingencies

As of December 31, 2004, 2003 and 2002, the Company provided guarantee in respect of bank mortgage loans granted to a director, Mr. Yih Yu Chuan to the extent of US\$307, US\$370 and US\$437 respectively.

13. COMMON STOCK AND WARRANTS OTHER THAN STOCK-BASED COMPENSATION

(a) *Common stock*

- (i) During the year ended December 31, 2003, warrants to purchase 150,000 shares of common stock and 1,122,500 stock options were exercised. As a warrant holder elected to take the cashless exercise of 95,891 shares of common stock, a total of 1,218,391 shares of common stock of the Company were issued accordingly.
- (ii) In September 2004, the Company completed a private placement of 1,614,082 shares of common stock and 484,221 warrants at a price of US\$2.20 per share. The Company sold all of the shares and the placement raised US\$2,746 after underwriting discounts and placement costs.
- (iii) During the year ended December 31, 2004, warrants to purchase 600,000 shares of common stock and 405,000 stock options were exercised. As a warrant holder elected to take the cashless exercise of 395,570 shares of common stock, a total of 800,570 shares of common stock of the Company were issued accordingly.

As of December 31, 2004, the Company had 12,304,658 shares of common stock issued.

(b) *Treasury stock*

- (i) During the eight-month period ended December 31, 2002, the Company repurchased, through open market purchases, 318,200 shares of common stock of the Company at an aggregate consideration of US\$391. In July 2003, the Company sold all these shares to a non-affiliated party for a consideration of US\$541.

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LJ INTERNATIONAL INC.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

**13. COMMON STOCK AND WARRANTS OTHER THAN STOCK-BASED COMPENSATION
(CONTINUED)***(c) Warrants other than stock-based compensation*

| | | 2004 | As of December 31, | |
|--------------------------------|-------------|------------------|---------------------------|------------------|
| | | Number | 2003 | 2002 |
| | <i>Note</i> | of | Number of | Number of |
| | | warrants | warrants | warrants |
| Outstanding, beginning of year | | 1,922,500 | 2,068,500 | 2,068,500 |
| Granted | <i>(i)</i> | 484,221 | | |
| Expired | | (45,000) | (146,000) | |
| Outstanding, end of year | | 2,361,721 | 1,922,500 | 2,068,500 |

The following table shows the warrants outstanding as of December 31, 2004.

| Date of grant | Number of | Exercise | Expiration |
|-------------------|--------------------|----------|----------------------|
| | warrants | price | date |
| | outstanding | US\$ | |
| April 15, 1998 | 1,679,000 | 5.75 | April 15, 2005 |
| April 15, 1998 | 146,000 | 8.25 | April 15, 2005 |
| March 22, 2000 | 52,500 | 6.94 | March 31, 2005 |
| September 1, 2004 | 484,221 | 2.98 | September 3, 2009 |
| | 2,361,721 | | |

(i) On September 1, 2004, the Company issued Warrants for the investors of a private placement to purchase 484,221 shares of the Company's common stock at an exercise price of US\$2.98 per share with an expiration date of September 3, 2009. (See also note 13(a)(ii))

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LJ INTERNATIONAL INC.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

14. EMPLOYEE RETIREMENT BENEFIT PLANS

Prior to December 1, 2000, the Company operated a defined contribution retirement plan (Retirement Plan) which is optional for all qualified employees in Hong Kong. The assets of the Retirement Plan are held separately from those of the Company in a provident fund managed by an independent trustee. The pension cost charge represents contributions payable to the fund by the Company at rates specified in the rules of the Retirement Plan. Where employees leave the Retirement Plan prior to vesting fully in the contributions, the contributions payable by the Company are reduced by the amount of forfeited contributions.

Following the introduction of the Mandatory Provident Fund (MPF) legislation in Hong Kong, the Company has also participated in the defined contribution mandatory provident fund since December 1, 2000. Both the Company and its employees in Hong Kong make monthly contributions to the fund at 5% of the employees earnings as defined under Mandatory Provident Fund legislation. The 5% monthly contribution of the Company and the employees are subject to a cap of US\$0.128 per month and thereafter contributions are voluntary. When employees leave the MPF scheme prior to vesting fully in voluntary contributions, the contributions payable by the Company are reduced by the amount of forfeited contributions.

No amount was forfeited in respect of Retirement Plan and MPF scheme for the year ended December 31, 2004. The amounts of forfeitures for the year ended December 31, 2003, for the eight-month period ended December 31, 2002, for the year ended April 30, 2002 were US\$11, US\$17 and US\$46 respectively which was available to reduce the Company's contribution payable.

The full-time employees of the PRC subsidiaries are entitled to staff welfare benefits, including medical care, welfare subsidies, unemployment insurance and pension benefits. These companies are required to accrue for these benefits based on certain percentages of the employees' salaries in accordance with the relevant regulations, and to make contributions to the state-sponsored pension and medical plans out of the amounts accrued for medical and pension benefits. The state-sponsored retirement plan was responsible for the entire pension obligations for the actual pension payments or post-retirement benefits beyond the annual contributions.

The Company has adopted Profit Sharing Plan and Trust (Profit Sharing Plan) for the benefit of substantially all employees in the US that satisfied the age and service requirements. The Company's contributions are determined according to a discretionary formula in an amount determined each year by the management and will be allocated to each Qualifying Participant's Individual account using the pro rata formula. No profit sharing expense made during all financial periods since its adoption.

Contributions paid and payable by the Company in respect of the employee retirement benefit plans charged to the consolidated statement of operations were US\$616, US\$543, US\$290 and US\$481 for the years ended December 31, 2004 and 2003, for the eight-month period ended December 31, 2002 and for the year ended April 30, 2002 respectively.

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LJ INTERNATIONAL INC.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

15. STOCK-BASED COMPENSATION

(a) Stock incentive plan

On June 1, 1998, the Company adopted a stock option plan (The 1998 Plan) which was approved by the shareholders on December 9, 1998. The 1998 Plan allows the Board of Directors, or a committee thereof at the Board's discretion, to provide for a total of 2,000,000 stock options to officers, directors, key employees and advisors of the Company. Out of the stock options provided, 1,285,000 stock options were issued in accordance with the terms of the 1998 Plan on April 12, 1999 to certain officers, directors, key employees and advisors of the Company at an exercise price of US\$5.0 per share (the fair market value of the common stock as of April 12, 1999) and are exercisable during the period from April 12, 1999 to April 11, 2009.

Pursuant to the 1999 Annual Meeting of the Shareholders on December 15, 1999, the authorized number of stock options was increased from 2,000,000 to 4,000,000. The purchase price of the shares of the Common Stock covered by the 1998 Plan shall be at least 100% of the fair market value per share of such shares on the date of grant, with a term of ten years.

On July 1, 2003, the Company adopted the second stock plan (The 2003 Plan) which was approved by the shareholders on December 5, 2003. The 2003 Plan allows the Board of Directors, or a committee thereof at the Board's discretion, to provide for a total of 4,000,000 stock options to officers, directors, key employees and advisors of the Company. The purchase price of the shares of the Common Stock covered by The 2003 Plan could be less than, equal to or greater than 100% of the fair market value of the Common Stock at the time of grant, with a term of ten years.

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Table of Contents**LJ INTERNATIONAL INC.****NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS**

(Amounts in thousands, except share and per share data)

15. STOCK-BASED COMPENSATION (CONTINUED)*(a) Stock incentive plan (Continued)*

The stock options activities and related information are summarized as follows:

| | Year ended December 31, 2004 | | Year ended December 31, 2003 | | 8 months ended December 31, 2002 | | Year ended April 30, 2002 | |
|--|---|---|---------------------------------|--|-------------------------------------|--|------------------------------|--|
| | Options | Weighted average exercise price US\$ | Options | Weighted average exercise price US\$ | Options | Weighted average exercise Price US\$ | Options | Weighted average exercise price US\$ |
| Outstanding, beginning of year/period | 3,814,000 | 2.00 | 3,025,500 | 2.00 | 2,918,000 | 2.00 | 3,376,000 | 2.00 |
| Granted | 350,000 | 2.20 | 2,000,000 | 2.00 | 300,000 | 2.00 | | |
| Exercised (note 13) | (405,000) | 2.00 | (1,122,500) | 2.00 | | | | |
| Cancelled | | | (89,000) | 2.00 | (192,500) | 2.00 | (458,000) | 2.00 |
| Outstanding, end of year/period | 3,759,000 | 2.02 | 3,814,000 | 2.00 | 3,025,500 | 2.00 | 2,918,000 | 2.00 |
| Exercise price less than the market price on date of grant | 150,000 | 2.00 | | | | | | |
| Exercise price equals to market price on date of grant | 1,369,000 | 2.00 | 1,739,000 | 2.00 | 2,838,000 | 2.00 | 2,918,000 | 2.00 |
| Exercise price exceeds to market price on date of grant | 2,240,000 | 2.03 | 2,075,000 | 2.00 | 187,500 | 2.00 | | |
| | 3,759,000 | 2.02 | 3,814,000 | 2.00 | 3,025,500 | 2.00 | 2,918,000 | 2.00 |
| Range of exercise price | | | | | | | | |
| - US\$2.00 | 3,559,000 | 2.00 | 3,814,000 | 2.00 | 3,025,500 | 2.00 | 2,918,000 | 2.00 |
| - US\$2.35 | 200,000 | 2.35 | | | | | | |
| | 3,759,000 | 2.02 | 3,814,000 | 2.00 | 3,025,500 | 2.00 | 2,918,000 | 2.00 |

| | | | | | | | | |
|---|-------------------|-------------|------------|------|------------|------|------------|------|
| Exercisable, end of year/period | | | | | | | | |
| - exercise price at US\$2.00 | 2,489,500 | 2.00 | 2,557,000 | 2.00 | 2,913,000 | 2.00 | 2,918,000 | 2.00 |
| - exercise price at US\$2.35 | | | | | | | | |
| | 2,489,500 | | 2,557,000 | | 2,913,000 | | 2,918,000 | |
| Weighted average remaining contractual life | | | | | | | | |
| - exercise price at US\$2.00 | 6.42 years | | 7.04 years | | 5.33 years | | 6.06 years | |
| - exercise price at US\$2.35 | 8.50 years | | | | | | | |

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LJ INTERNATIONAL INC.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS

(Amounts in thousands, except share and per share data)

15. STOCK-BASED COMPENSATION (CONTINUED)

(a) Stock incentive plan (Continued)

All options issued, other than 1,269,500 options, are immediately exercisable as of December 31, 2004. The 1,269,500 options are issued and outstanding but only vest in additional increments of 415,625, 387,500, 369,500 and 96,875 upon 2005, 2006, 2007 and 2008 respectively.

(b) Warrants

(i) On March 22, 2000, the Company issued Warrants to a placement agent to purchase 35,000 shares of the Company's common stock at an exercise price of US\$6.94 per share with an expiration date of March 31, 2005, as partial compensation for its services.

(ii) On July 31, 1999 the Company entered into a consulting agreement with a consultant which providing investor relationship services to the Company, and the Company agreed to issue a 5-year common stock purchase warrant, with the expiry date on July 30, 2004. A warrant to purchase 35,000 shares of common stock of the Company at an exercise price of US\$5.00 was issued. The consulting agreement was subsequently terminated on January 31, 2000.

(iii) On May 26, 2001, the Company entered into a consulting agreement with a consultant for a period of 24 months commencing on June 1, 2001. Pursuant to the agreement, the Company issued to the consultant warrants to purchase 260,000 shares of common stock of the Company on June 1, 2001. Of the warrants issued on June 1, 2001, the warrant holder is entitled to:

purchase 100,000 shares at US\$2.29 per share exercisable through May 31, 2003 (expired, as of December 31, 2004);

purchase 80,000 shares at US\$3.43 per share exercisable through May 31, 2004 (expired, as of December 31, 2004);

purchase 80,000 shares at US\$4.57 per share exercisable through May 31, 2005.

(iv) On August 16, 2001, the Company issued to an agent warrants to purchase 200,000 shares of common stock of the Company in consideration for consultancy services at US\$3.00 per share exercisable through August 15, 2006.

Table of Contents**LJ INTERNATIONAL INC.****NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS**

(Amounts in thousands, except share and per share data)

15. STOCK-BASED COMPENSATION (CONTINUED)*(b) Warrants (Continued)*

- (v) On April 15, 2002, in accordance with a common stock purchase agreement, the Company issued to an investor warrants to purchase 150,000 shares of common stock of the Company at US\$1.79 per share exercisable through April 14, 2005. The warrants were exercised in July 2003 and 95,891 shares of common stock were issued accordingly pursuant to the cashless exercise (see note 13(a)(i)).
- (vi) Pursuant to a strategic advisory services agreement dated July 1, 2003, the Company issued to a consultant warrants to purchase 600,000 shares of common stock of the Company at US\$2 per share exercisable through March 31, 2004. The warrants were exercised in January 2004 and 395,570 shares of common stock were issued accordingly pursuant to the cashless exercise (see note 13 (a)(iii)).

Save as disclosed above, none of the warrants as aforesaid was exercised for the two years ended December 31, 2004 and 2003 for the eight-month period ended December 31, 2002 and for the year period ended April 30, 2002. The costs associated with these transactions are accounted for based on fair value of the warrants on the date of issue.

In addition, incentive stock options were issued to consultants/advisers under The 1998 Plan (see note 15(a)) to purchase the common stock of the Company as part of their fees during the year ended April 30, 2001. The costs associated with these transactions are also accounted for based on the fair value of these options at the date of issue.

Using the Black-Scholes option pricing model with the following weighted-average assumptions:

| | December 31, 2003 | Year ended April 30, 2002 |
|---------------------------------|-------------------------|---------------------------------|
| Expected dividend yield | | |
| Expected stock price volatility | 9% | 23% |
| Risk-free interest rate | 1.07% | 4.23% |
| | 0.75 | |
| Expected life of warrants | years | 3.21 years |

The fair value of these warrants and options was estimated as US\$9 and US\$297, respectively for the years ended December 31, 2003 and April 30, 2002. There were no incentive stock options and warrants granted and issued to consultants/advisers during the year ended December 31, 2004 and the eight-month period ended December 31, 2002, and accordingly no related costs arose. The additional expense was recognized in the consolidated statement of operations and the same amount was recorded in the Company's additional paid-in capital.

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(Amounts in thousands, except share and per share data)

16. RELATED PARTY TRANSACTIONS

(a) Names and relationship of related parties:

| | <u>Existing relationships with the Company</u> |
|---|--|
| Yih Yu Chuan | Director and major shareholder of the Company |
| Gemological Institute of America, Hong Kong Limited | Common director |
| iBBC Inc. | Common director (Became a subsidiary in March 2002) |
| Gemriver Jewelry Limited | Common directors (Became a subsidiary in March 2002) |
| Tanzanite (H.K.) Limited | Common directors |

(b) Summary of balances with related parties:

| | | As of December 31, | | |
|--|-------------|---------------------------|-------|-------|
| | <i>Note</i> | 2004 | 2003 | 2002 |
| | | US\$ | US\$ | US\$ |
| Due from related parties: | | | | |
| Gemological Institute of America, Hong Kong Limited | | 464 | 464 | 464 |
| Tanzanite (H.K.) Limited | | 27 | 44 | 47 |
| | <i>(i)</i> | 491 | 508 | 511 |
| Certain banking facilities granted to the Company collateralized by properties owned by Yih Yu Chuan and his personal guarantee to the extent of | | 12,971 | 9,147 | 8,311 |

Table of Contents**LJ INTERNATIONAL INC.****NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS**

(Amounts in thousands, except share and per share data)

16. RELATED PARTY TRANSACTIONS (CONTINUED)

(c) Summary of related party transactions:

| | | Year ended December 31, 2004 US\$ | Year ended December 31, 2003 US\$ | 8 months ended December 31, 2002 US\$ | Year ended April 30, 2002 US\$ |
|--|--------------|--|---|--|--|
| Purchase of equity interest in iBBC Inc., an entity controlled by Yih Yu Chuan | <i>Notes</i> | | | | 2,460 |
| Advances to: | | | | | |
| Gemriver Jewelry Limited | <i>(ii)</i> | | | | 679 |
| iBBC Inc. | | | | | 4,763 |
| | | | | | 5,442 |
| Repayment from: | | | | | |
| Gemriver Jewelry Limited | | | | | 1,360 |
| iBBC Inc. | | | | | 4,951 |
| | | | | | 6,311 |
| Rental expense to Tanzanite (H.K.) Limited | | 77 | 23 | 15 | 19 |

(i) The amounts due from related parties represent unsecured advances which are interest-free and repayable on demand.

(ii) The advances were expenses paid on behalf of related parties with terms set out in note 16(c)(i) above. The related party transactions with Gemriver Jewelry Limited and iBBC Inc. as aforesaid relate to transactions made before they became subsidiaries of the Company.

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(Amounts in thousands, except share and per share data)

17. SEGMENT INFORMATION

As over 90% of the Company's turnover and contribution to operating results are derived from the business segment of manufacture and sales of jewelry, the Company considered that it has only one business segment. In respect of geographical areas, revenues are based on the country in which the customer is located. Long-lived assets are where the assets are located.

(a) Geographical areas:

| | Year ended December 31, 2004 US\$ | Year ended December 31, 2003 US\$ | 8 months ended December 31, 2002 US\$ | Year ended April 30, 2002 US\$ |
|--|---|---|--|--|
| Revenue from external customers: | | | | |
| US & Canada | 56,186 | 42,851 | 24,545 | 28,810 |
| Hong Kong | 3,765 | 1,961 | 1,451 | 4,897 |
| Europe and other countries | 13,062 | 8,017 | 3,469 | 5,518 |
| PRC | 208 | | | 6 |
| Japan | 4,158 | 5,338 | 2,344 | 9 |
| | 77,379 | 58,167 | 31,809 | 39,240 |
| | | | As of December 31, | |
| | | | 2004 | 2003 |
| | | | US\$ | US\$ |
| Carrying amount of long-lived assets: | | | | 2002 |
| Hong Kong | | | 5,385 | 5,744 |
| PRC | | | 2,922 | 3,027 |
| US | | | 278 | 403 |
| Total long-lived assets (excluding goodwill) | | | 8,585 | 9,174 |
| Reconciling items: | | | | |
| Others | | | 66,454 | 39,714 |
| Total consolidated assets | | | 75,039 | 48,888 |

Table of Contents**LJ INTERNATIONAL INC.****NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS**

(Amounts in thousands, except share and per share data)

17. SEGMENT INFORMATION (CONTINUED)

- (b) The Company derived operating revenue from the following major customers, which accounted for over 10% of operating revenue.

| | Year ended | | Year ended | | 8 months | | Year ended | |
|------------|---------------------|-----------|---------------------|----------|---------------------|----------|-------------------|----------|
| | December 31, | | December 31, | | December 31, | | April 30, | |
| | 2004 | | 2003 | | 2002 | | 2002 | |
| | US\$ | % | US\$ | % | US\$ | % | US\$ | % |
| Customer A | 8,482 | 11 | 5,164 | 9 | 1,916 | 6 | 2,706 | 7 |
| Customer B | 7,234 | 9 | 5,870 | 10 | 2,709 | 9 | 3,121 | 8 |
| Customer C | 6,454 | 8 | 5,869 | 10 | 8,021 | 25 | 10,963 | 28 |

Trade receivables related to these major customers were US\$1,347, US\$2,711 and US\$1,655, as of December 31, 2004, 2003 and 2002 respectively.

18. SUBSEQUENT EVENTS

Pursuant to the purchase agreement dated January 1, 2005, the Company would pay US\$2,828 to Goldleaves International Limited (GIL), in which the Company had 20% equity interests and is classified as investment security (see note 9) as of December 31, 2004, for the issuance of 3,900 new shares in GIL (Acquisition). The Acquisition was completed on January 1, 2005. The Company then became the major stockholder holding 98% equity interests in GIL, which became a subsidiary of the Company.

This investment is currently accounted for using the cost method. As appropriate for a step- acquisition, in the 2005 financial statements, the investment as of December 31, 2004 and 2003 will be restated to account for under the equity method.

19. RECLASSIFICATIONS

Certain prior year amounts have been reclassified to conform to the current year presentation.

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ITEM 19. EXHIBITS

The following exhibits are being filed as part of this Annual Report on Form 20-F:

- 1.1 Memorandum of Association of the Company*
- 1.2 Articles of Association of the Company*
- 1.3 Amendment to Articles of Association of the Company*
- 4.1 Employment Agreement of Yu Chuan Yih with the Registrant**
- 8.1 List of Significant Subsidiaries of the Company
- 11.1 Code of Ethics**
- 12.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)
- 12.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)
- 13.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350
- 13.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350

* Incorporated by reference to the Exhibits to our Registration Statement on Form F-1 and pre-effective and post-effective amendments thereto, SEC File No. 333-7912, declared effective on April 15, 1998.

** Incorporated by reference to the Exhibits to our Annual Report on Form 20-F for the fiscal year ended December 31, 2004.

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SIGNATURES

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

LJ INTERNATIONAL INC.
(Registrant)

Date: March 31, 2005

By: /s/ YU CHUAN YIH

Yu Chuan Yih
Chairman

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| Exhibit Number | Description of Exhibit | Page Number |
|---------------------------|--|------------------------|
| 1.1 | Memorandum of Association of the Company | * |
| 1.2 | Articles of Association of the Company | * |
| 1.3 | Amendment to Articles of Association of the Company | * |
| 4.1 | Employment Agreement of Yu Chuan Yih with the Registrant | ** |
| 8.1 | List of Significant Subsidiaries of the Company | |
| 11.1 | Code of Ethics | ** |
| 12.1 | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) | |
| 12.2 | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) | |
| 13.1 | Certification of Chief Executive Officer Pursuant to Rule 13a-14(b)and 18 U.S.C. Section 1350 | |
| 13.2 | Certification of Chief Financial Officer Pursuant to Rule 13a-14(b)and 18 U.S.C. Section 1350 | |

* Incorporated by reference to the Exhibits to our Registration Statement on Form F-1 and pre-effective and post-effective amendments thereto, SEC File No. 333-7912, declared effective on April 15, 1998.

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