

BONSO ELECTRONICS INTERNATIONAL INC
Form 20-F
August 13, 2004

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 20-F

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

OR

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

For the fiscal year ended March 31, 2004

OR

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

Commission File Number: 0-17601

BONSO ELECTRONICS INTERNATIONAL INC.

(Exact name of Registrant as specified in its charter)

British Virgin Islands

(Jurisdiction of incorporation or organization)

Unit 1106 - 1110

11/F, Star House

3 Salisbury Road

Tsimshatsui

Kowloon, Hong Kong

(Address of principal executive offices)

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

NONE

Securities registered pursuant to Section 12(g) of the Act:

COMMON STOCK, PAR VALUE \$.003

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

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

5,708,365 shares of common stock, \$.003 par value, at March 31, 2004 (including 180,726 shares that are disputed and which the Company may have to repurchase).

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

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

Item 17 []

Item 18 [X]

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FORWARD-LOOKING STATEMENTS

This Annual Report on Form 20-F contains forward-looking statements. A forward-looking statement is a projection about a future event or result, and whether the statement comes true is subject to many risks and uncertainties. These statements often can be identified by the use of terms such as "may," "will," "expect," "believe," "anticipate," "estimate," "approximate" or "continue," or the negative thereof. The actual results or activities of the Company will likely differ from projected results or activities of the Company as described in this Memorandum, and such differences could be material.

Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause the actual results and performance of the

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Company to be different from any future results, performance and achievements expressed or implied by these statements. In other words, our performance might be quite different from what the forward-looking statements imply. You should review carefully all information included in this Annual Report.

You should rely only on the forward-looking statements that reflect management's view as of the date of this Annual Report. We undertake no obligation to publicly revise or update these forward-looking statements to reflect subsequent events or circumstances. You should also carefully review the risk factors described in other documents we file from time to time with the Securities and Exchange Commission (the "SEC"). The Private Securities Reform Act of 1995 contains a safe harbor for forward-looking statements on which the Company relies in making such disclosures. In connection with the "safe harbor," we are hereby identifying important factors that could cause actual results to differ materially from those contained in any forward-looking statements made by us or on our behalf. Factors that might cause such a difference include, but are not limited to, those discussed in the section entitled "Risk Factors" under Item 3. - Key Information.

FINANCIAL STATEMENTS AND CURRENCY PRESENTATION

We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the United States of America and publish our financial statements in United States Dollars.

REFERENCES

In this Annual Report, "China" refers to all parts of the People's Republic of China other than the Special Administrative Region of Hong Kong. The terms "Bonso," "we," "our," "us," and the "Company" refer to Bonso Electronics International Inc. and, where the context so requires or suggests, our direct and indirect subsidiaries. References to "dollars" or "\$" are to United States Dollars. "HK\$" are to Hong Kong Dollars, "Euros" or "(euro)" are to the European Monetary Union's Currency, "GPB" are to British Pounds, "RMB" are to Chinese Renminbi and "CDN" are to Canadian Dollars.

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PART I

Item 1. Identity of Directors, Senior Management and Advisors

Not Applicable.

Item 2. Offer Statistics and Expected Timetable

Not Applicable.

Item 3. Key Information

Selected Financial Data.

The selected consolidated financial data as of March 31, 2003 and 2004 and for each of the three fiscal years ended March 31, 2004 are derived from the audited Consolidated Financial Statements and notes which appear elsewhere in this Annual Report. The Financial Statements are prepared in accordance with generally accepted accounting principles in the United States of America in United States Dollars. The selected consolidated financial data set forth below as of March 31, 2000, 2001 and 2002, and for each of the two fiscal years in the

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period ended March 31, 2001 have been derived from our audited consolidated financial statements that are not included in this Annual Report. The selected consolidated financial data is qualified in their entirety by reference to, and should be read in conjunction with, the Consolidated Financial Statements and related notes and Item 5 - "Operating and Financial Review and Prospects" included in this Annual Report. The consolidated financial data as of March 31, 2003 and 2004 reflects the acquisition of a 51% interest in Gram Precision Scales, Inc. ("Gram Precision"), which was effective as of August 1, 2002. Data for the fiscal years ended prior to March 31, 2003 does not include information relating to Gram Precision. The consolidated financial data as of March 31, 2002, March 31, 2003 and March 31, 2004 reflects the acquisition of KORONA Haushaltswaren GmbH & Co. KG ("Korona"), which was effective as of May 1, 2001. Data for the fiscal years ending prior to March 31, 2002 does not include information relating to Korona.

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SELECTED CONSOLIDATED FINANCIAL DATA

Income Statement Data

	Year Ended March 31,			
	2000 ----	2001 ----	2002 (2) -----	2003 (1) -----
Net Sales	\$ 15,380	\$ 29,567	\$ 53,303	\$ 46,330
Cost of Sales	(11,118)	(22,400)	(40,192)	(35,528)
Gross Margin	4,262	7,167	13,111	10,802
Selling Expenses	(261)	(382)	(2,476)	(2,467)
Salaries and related costs	(1,899)	(2,334)	(3,880)	(4,563)
Research and Development expenses	(186)	(298)	(427)	(393)
Administration and general expenses	(1,646)	(2,411)	(3,411)	(3,957)
Amortization of brand name	--	--	(203)	(200)
Income (loss) from operations	270	1,742	2,714	(777)
Interest income	130	458	167	85
Interest expense	(261)	(338)	(645)	(533)
Foreign Exchange gain/(loss)	14	43	(40)	(96)
Other Income	192	205	181	169
Consultancy Fee	--	(381)	(381)	(381)
Income/(loss) before income taxes and minority interest	345	1,729	1,996	(1,534)
Income tax benefit/(expense)	3	(125)	(190)	(37)
Net income/(loss) before minority interest	\$ 348	\$ 1,604	\$ 1,806	(1,571)
Minority interest	--	--	--	(72)
Net income/(loss)	\$ 348	\$ 1,604	\$ 1,806	(\$ 1,643)

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Earning per share								
-- Basic	\$	0.0989	\$	0.2882	\$	0.3232	(\$	0.2936)
-- Diluted	\$	0.0874	\$	0.2824	\$	0.3194	(\$	0.2936)

Weighted average shares		3,515,690		5,564,536		5,586,920		5,599,238

Diluted weighted average shares		3,978,079		5,679,911		5,652,852		5,599,238

(1) Includes financial results of the acquisition of Gram Precision Scales that was effective as of August 1, 2002.

(2) Includes financial results of the acquisition of Korona that was effective as of May 1, 2001.

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Balance Sheet Data

Fiscal Year Ended March 31,									

		2000		2001		2002 (2)		2003 (1)	
		----		----		-----		----	
Cash and cash equivalents	\$	7,959	\$	5,322	\$	1,878	\$	3,633	\$
Working capital	\$	12,765	\$	9,323	\$	9,599	\$	9,777	\$
Total assets	\$	33,793	\$	37,497	\$	44,451	\$	48,911	\$
Current Liabilities	\$	5,905	\$	9,420	\$	13,488	\$	18,424	\$
Long-term debt and capital lease	\$	865	\$	404	\$	317	\$	606	\$
Deferred income tax assets	\$	126	\$	97	\$	112	\$	167	\$
Common Stock	\$	17	\$	16	\$	16	\$	17	\$
Shareholders' Equity	\$	27,022	\$	27,673	\$	29,200	\$	28,379	\$
Dividends declared per share		--	\$	0.10	\$	0.10		--	\$

(1) Includes financial results of the acquisition of Gram Precision Scales that was effective as of August 1, 2002.

(2) Includes financial results of the acquisition of Korona that was effective as of May 1, 2001.

Exchange Rate Information

The Hong Kong Dollar and the United States Dollar have been fixed at approximately 7.80 Hong Kong Dollars to 1.00 U.S. Dollars since 1983. The Chinese government expressed its intention in the Basic Law to maintain the stability of the Hong Kong currency after the sovereignty of Hong Kong (the "Basic Law") was transferred to China.

The noon buying rates in New York City for cable transfers as certified for customs purposes by the Federal Reserve Bank of New York were U.S. \$1.00 = CDN \$ 1.3687, U.S. \$1.00 = RMB 8.2767, U.S. \$1.00 = HK \$7.7970, U.S. \$1.00 = Euro 1.2210, U.S \$1 = 1.8359 GBP, respectively, on June 1, 2004. The following table sets forth the high and low noon buying rates between Chinese Renminbi and U.S. Dollars, Hong Kong Dollars and U.S. Dollars, and Euros and U.S. Dollars for each month during the six month period ended May 31, 2004.

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NOON BUYING RATE

	CDN\$ Per U.S. \$1		RMB Per U.S. \$1		HK\$ PER U.S. \$1		U.S. \$1 PER EURO	
	High	Low	High	Low	High	Low	High	Low
Jan. 2004	1.3340	1.2690	8.2772	8.2767	7.7775	7.7632	1.2853	1.238
Feb. 2004	1.3442	1.3108	8.2773	8.2768	7.7845	7.7686	1.2848	1.242
Mar. 2004	1.3480	1.3080	8.2774	8.2767	7.7980	7.7842	1.2431	1.208
Apr. 2004	1.3711	1.3080	8.2772	8.2768	7.8000	7.7870	1.2358	1.180
May 2004	1.3970	1.3580	8.2773	8.2768	7.8010	7.7895	1.2274	1.180
June 2004	1.3772	1.3407	8.2768	8.2766	7.800	7.7947	1.2320	1.200

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The following table sets forth the average noon buying rates between Canadian Dollars and U.S. Dollars, between Chinese Renminbi and U.S. Dollars, between Hong Kong Dollars and U.S. Dollars, between Euros and U.S. Dollars and between British Pounds and U.S. Dollars for each of the calendar years 1999, 2000, 2001, 2002 and 2003 based on daily noon buying rates for cable transfer in New York City certified for customs purposes by the Federal Reserve Bank of New York.

AVERAGE NOON BUYING RATE

	CDN\$ Per U.S. \$1	RMB PER U.S. \$1	HK\$ PER U.S. \$1	U.S. \$1 PER EURO
1999	1.4858	8.2785	7.7599	Not Applicable
2000	1.4855	8.2784	7.7924	Not Applicable
2001	1.5487	8.2770	7.7997	0.8952
2002	1.5704	8.2770	7.7997	0.9454
2003	1.4013	8.2772	7.7876	1.1315

Risk Factors

You should carefully consider the following risks, together with all other information included in this Annual Report. The realization of any of the risks described below could have a material adverse effect on our business, results of operations and future prospects.

Political, Legal, Economic and Other Uncertainties of Operations in China and Hong Kong

We Could Face Increased Currency Risks If China Does Not Maintain The Stability Of The Hong Kong Dollar. The Hong Kong Dollar and the United States Dollar have been fixed at approximately 7.80 Hong Kong Dollars to 1.00 U.S. Dollars since 1983. The Chinese government expressed its intention in the Basic Law to maintain the stability of the Hong Kong currency after the sovereignty of Hong Kong was transferred to China. If the current exchange rate mechanism is changed, we face increased currency risks, which could have a material adverse effect upon the Company.

We Face Significant Risks If The Chinese Government Changes Its Policies,

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Laws, Regulations, Tax Structure, Or Its Current Interpretations Of Its Laws, Rules And Regulations Relating To Our Operations In China. Our manufacturing facility is located in China. As a result, our operations and assets are subject to significant political, economic, legal and other uncertainties. Changes in policies by the Chinese government resulting in changes in laws or regulations or the interpretation of laws or regulations, confiscatory taxation, changes in employment restrictions, restrictions on imports and sources of supply, import duties, corruption, currency revaluation or the expropriation of private enterprise could materially and adversely affect us. Over the past several years, the Chinese government has pursued economic reform policies including the encouragement of private economic activity and greater economic decentralization. If the Chinese government does not continue to pursue its present policies that encourage foreign investment and operations in China, or if these policies are either not successful or are significantly altered, then our business operations in China could be adversely affected. We could even be subject to the risk of nationalization, which could result in the total loss of

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investment in that country. Following the Chinese government's policy of privatizing many state-owned enterprises, the Chinese government has attempted to augment its revenues through increased tax collection. Continued efforts to increase tax revenues could result in increased taxation expenses being incurred by us. Economic development may be limited as well by the imposition of austerity measures intended to reduce inflation, the inadequate development of infrastructure and the potential unavailability of adequate power and water supplies, transportation and communications. If for any reason we were required to move our manufacturing operations outside of China, our profitability would be substantially impaired, our competitiveness and market position would be materially jeopardized and we might have to discontinue our operations.

We Face Risks By Operating In China, Because The Chinese Legal System Relating To Foreign Investment And Foreign Operations Like Bonso's Is Evolving And The Application Of Chinese Laws Is Uncertain. The legal system of China relating to foreign investments is continually evolving, and currently there can be no certainty as to the application of its laws and regulations in particular instances. The Chinese legal system is a civil law system based on written statutes. Unlike common law systems, it is a system in which decided legal cases have little precedential value. In 1979, the Chinese government began to promulgate a comprehensive system of laws and regulations governing economic matters in general. Legislation over the past 20 years has significantly enhanced the protections afforded to various forms of foreign investment in China. Enforcement of existing laws or agreements may be sporadic and implementation and interpretation of laws inconsistent. The Chinese judiciary is relatively inexperienced in enforcing the laws that exist, leading to a higher than usual degree of uncertainty as to the outcome of any litigation. Even where adequate law exists in China, it may not be possible to obtain swift and equitable enforcement of that law. Continued uncertainty relating to the laws in China could have a material adverse effect upon us and our operations in China.

We Could Be Adversely Affected If China Changes Its Economic Policies In The Shenzhen Special Economic Zone Where We Operate. In August 1980, the Chinese government passed "Regulations for The Special Economy Zone of Guang Dong Province" and officially designated a portion of Shenzhen as The Shenzhen Special Economy Zone. Foreign enterprises in these areas benefit from greater economic autonomy and special tax incentives than enterprises in other parts of China. Changes in the policies or laws governing Special Economic Zones could have a material adverse effect on us. Moreover, economic reforms and growth in China have been more successful in certain provinces than others, and the

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continuation or increase of these disparities could affect the political or social stability of China, which could have a material adverse effect us and our operations near Shenzhen.

Controversies Affecting China's Trade With The United States Could Harm Our Results Of Operations Or Depress Our Stock Price. While China has been granted permanent most favored nation trade status in the United States through its entry into the World Trade Organization, controversies between the United States and China may arise that threaten the status quo involving trade between the United States and China. These controversies could materially and adversely affect our business by, among other things, causing our products in the United States to become more expensive resulting in a reduction in the demand for our products by customers in the United States, which would have a material adverse effect upon us and our results of operations. Further, political or trade friction between the United States and China, whether or not actually affecting our business, could also materially and adversely affect the prevailing market price of our common share.

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If Our Sole Factory Were Destroyed Or Significantly Damaged As A Result of Fire Or Some Other Natural Disaster, We Would Be Adversely Affected. All of our products are currently manufactured at our manufacturing facility located in Shenzhen, China. Fire fighting and disaster relief or assistance in China may not be as developed as in Western countries. We currently maintain property damage insurance aggregating approximately \$23,660,000 covering our stock in trade, goods and merchandise, furniture and equipment and buildings. We do not maintain business interruption insurance. Investors are cautioned that material damage to, or the loss of, our factory due to fire, severe weather, flood or other act of God or cause, even if insured, could have a material adverse effect on our financial condition, results of operations, business and prospects.

Our Results Could Be Harmed If We Have To Comply With New Environmental Regulations. Our operations create some environmentally sensitive waste that may increase in the future depending on the nature of our manufacturing operations. The general issue of the disposal of hazardous waste has received increasing attention from the PRC national and local governments and foreign governments and agencies and has been subject to increasing regulation. Our business and operating results could be materially and adversely affected if we were to increase expenditures to comply with environmental regulations affecting our operations.

Risk Factors Relating to Our Business

We Depend Upon Our Largest Customers For A Significant Portion Of Our Sales Revenue, And We Cannot Be Certain That Sales To These Customers Will Continue. If Sales To These Customers Do Not Continue, Then Our Sales Will Decline And Our Business Will Be Negatively Impacted. Traditionally, we have relied upon 3-4 customers for a significant portion of our sales during the fiscal year. One major customer accounted for approximately 22% of our sales in the fiscal year ended March 31, 2002, four customers accounted for approximately 37% in the fiscal year ended March 31, 2003, with one customer accounting for 25% of our sales and six customers accounted for approximately 65% of our sales during the fiscal year ended March 31, 2004. We do not enter into long-term contracts with our customers, but manufacture based upon purchase orders and therefore cannot be certain that sales to these customers will continue. The loss of any of our largest customers would likely have a material negative impact on our sales revenue and our business.

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Defects In Our Products Could Impair Our Ability To Sell Our Products Or Could Result In Litigation And Other Significant Costs. Detection of any significant defects in our products may result in, among other things, delay in time-to-market, loss of market acceptance and sales of our products, diversion of development resources, injury to our reputation, or increased warranty costs. Because our products are complex, they may contain defects that cannot be detected prior to shipment. These defects could harm our reputation, which could result in significant costs to us and could impair our ability to sell our products. The costs we may incur in correcting any product defects may be substantial and could decrease our profit margins.

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Since certain of our products are used in applications that are integral to our customers' businesses, errors, defects, or other performance problems could result in financial or other damages to our customers, which would likely result in adverse effect upon our business with these customers. If we were involved in any product liability litigation, even if it were unsuccessful, would be time consuming and costly to defend. Further, our product liability insurance may not be adequate to cover claims.

Our Sales Through Retail Merchants Result In Seasonality And Susceptibility To A Downturn In The Retail Economy And Sales Variances Resulting From Retail Promotional Programs. With the acquisition of Korona, a significant portion of our net sales involve sales of bathroom and kitchen scales to retail merchants in Europe. In addition, many of our other customers sell to retail merchants. Accordingly, these portions of our customer base are susceptible to a downturn in the retail economy. A greater number of our sales of scales and telecommunications products occur between the months of April and September for shipment in the summer in preparation of the Christmas holiday. Throughout the remainder of the year, our products do not appear to be subject to significant seasonal variation. However, past sales patterns may not be indicative of future performance. A significant portion of our sales in Europe are attributable to the promotional programs of our retail industry customers. These promotional programs result in significant orders by customers who do not carry our products on a regular basis. Promotional programs often involve special pricing terms or require us to spend funds to have our products promoted. We cannot assure you that promotional purchases by our retail industry customers will be repeated regularly, or at all. Further, our promotional sales could cause our quarterly results to vary significantly. The reduction in promotional purchases would likely have a material adverse effect upon our results of operations.

Our Customers Are Dependent On Shipping Companies For Delivery Of Our Products And Interruptions To Shipping Could Materially And Adversely Affect Our Business And Operating Results. Typically, we sell our products either F.O.B. Hong Kong or Yantian (Shenzhen) and our customers are responsible for the transportation of products from Hong Kong or Yantian (Shenzhen) to their final destinations. Our customers rely on a variety of carriers for product transportation through various world ports. A work stoppage, strike or shutdown of one or more major ports or airports could result in shipping delays materially and adversely affecting our customers, which in turn could have a material adverse effect on our business and operating results. Similarly, an increase in freight surcharges due to rising fuel costs or general price increases could materially and adversely affect our business and operating results.

Customer Order Estimates May Not Be Indicative Of Actual Future Sales. Some of our customers have provided us with forecasts of their requirements for our products over a period of time. We make many management decisions based on these

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customer estimates, including purchasing materials, hiring personnel, and other matters that may increase our production capacity and costs. If a customer reduces its orders from prior estimates after we have increased our production capabilities and costs, this reduction may decrease our net sales and we may not be able to reduce our costs to account for this reduction in customer orders. Many customers do not provide us with forecasts of their requirements for our products. If those customers place significant orders, we may not be able to increase our production quickly enough to fulfill the customers' orders. The inability to fulfill customer orders could damage our relationships with customers and reduce our net sales.

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Pressure By Our Customers To Reduce Prices And Agree To Long-Term Supply Arrangements May Cause Our Net Sales Or Profit Margins To Decline. Our customers are under pressure to reduce prices of their products. Therefore, we expect to experience pressure from our customers to reduce the prices of our products. Our customers frequently negotiate supply arrangements with us well in advance of delivery dates, thereby requiring us to commit to price reductions before we can determine if we can achieve the assumed cost reductions. We believe we must reduce our manufacturing costs and obtain higher volume orders to offset declining average sales prices. If we are unable to offset declining average sales prices, our gross profit margins will decline which would have a material adverse effect upon our results of operations.

We Depend Upon Our Key Personnel And The Loss Of Any Key Personnel, Or Our Failure To Attract And Retain Key Personnel, Could Adversely Affect Our Future Performance, Including Product Development, Strategic Plans, Marketing And Other Objectives. The loss or failure to attract and retain key personnel could significantly impede our performance, including product development, strategic plans, marketing and other objectives. Our success depends to a substantial extent not only on the ability and experience of our senior management, but particularly upon Anthony So our President, Secretary, Treasurer and Chairman of the Board. We do not have key man life insurance on Mr. So. To the extent that the services of Mr. So would be unavailable to us, we would be required to obtain another person to perform the duties Mr. So otherwise would perform. We may be unable to employ another qualified person with the appropriate background and expertise to replace Mr. So on terms suitable to us.

We Face The Pressures Of A Competitive Industry. Our business is in an industry that is highly competitive, and many of our competitors, both local and international, have substantially greater technical, financial and marketing resources than we have. We compete with scale manufacturers in the Far East, the United States, and Europe. We believe that our principal competitor in the scale market is Measurement Specialties, Inc. and principal competitors in the telecommunications market are other OEM manufacturers; however, as a contract and OEM and original design manufacturer, we compete with all companies engaged in the contract and OEM business. Further, subsequent to the acquisitions of Korona and Gram Precision, we compete with distributors of scales in Europe and Canada. Both the scale and the telecommunications markets are highly competitive and we face pressures on pricing and lower margins as evidenced by the decline in margins that we have experienced with our telecommunications products. Lower margins may affect our ability to cover our costs which could have a material negative impact on our operations and our business.

We Are Controlled By Our Management, Whose Interest May Differ From Those Of The Other Shareholders. At the present time, Mr. Anthony So, our founder and President, beneficially owns approximately 35.55% of the outstanding shares of common stock, including shares underlying his outstanding options, or 28.39%

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without including his outstanding options. Due to his stock ownership, Mr. So may be in a position to elect the board of directors and, therefore, to control our business and affairs including certain significant corporate actions such as acquisitions, the sale or purchase of assets and the issuance and sale of our

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securities. Mr. So may be able to prevent or cause a change in control. We also may be prevented from entering into transactions that could be beneficial to us without Mr. So's consent. The interest of our largest shareholder may differ from the interests of other shareholders.

Our Operating Results And Stock Price Are Subject To Wide Fluctuations. Our quarterly and annual operating results are affected by a wide variety of factors that could materially and adversely affect net sales, gross profit and profitability. This could result from any one or a combination of factors, many of which are beyond our control. Results of operations in any period should not be considered indicative of results to be expected in any future period, and fluctuations in operating results may also result in fluctuations in the market price of our common stock.

Our Results Could be Affected By Changes In Currency Exchange Rates. Changes in currency rates involving the Canadian Dollar, Hong Kong dollar, Chinese Renminbi, British Pounds or the Euro could increase our expenses.

During the fiscal year ended March 31, 2004 and 2003, our financial results were affected by currency fluctuations, resulting in a total foreign exchange gain of \$15,081 and a loss of \$96,592, respectively. Generally, our revenues are collected in United States Dollars, Euros and Canadian Dollars. Our costs and expenses are paid in United States Dollars, Canadian Dollars, Hong Kong Dollars, British Pound, Euros and Chinese Renminbi. We face a variety of risks associated with changes among the relative value of these currencies. An appreciation of the Canadian Dollar, Chinese Renminbi, Hong Kong Dollar British Pound, or the Euro against the U.S. Dollar would increase our expenses when translated into U.S. Dollars and could materially and adversely affect our margins and results of operations. In addition, a significant devaluation in the Canadian Dollar, Chinese Renminbi, Hong Kong Dollar, British Pound or Euro could have a material adverse effect upon our results of operations if it destabilizes the economy of Canada, China, Hong Kong, Great Britain or the European Union.

Protection And Infringement Of Intellectual Property. Except for one patent held by Gram Precision, the trademark for the KORONA and fifteen trademarks currently held by Gram Precision, we have no patents, licenses, franchises, concessions or royalty agreements that are material to our business. We have obtained a trademark registration in Hong Kong and China for the marks BONSO and MODUS in connection with certain electronic apparatus. Unauthorized parties may attempt to copy aspects of our products or trademarks or to obtain and use information that we regard as proprietary. Policing unauthorized use of our products is difficult. Our means of protecting our proprietary rights may not be adequate. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States. Our failure to adequately protect our proprietary rights may allow third parties to duplicate our products or develop functionally equivalent or superior technology. In addition, our competitors may independently develop similar technology or design around our proprietary intellectual property.

Further, we may be notified that we are infringing patents, trademarks, copyrights or other intellectual property rights owned by other parties. In the event of an infringement claim, we may be required to spend a significant amount

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of money to develop a non-infringing alternative or to obtain licenses. We may not be successful in developing such an alternative or obtaining a license on

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reasonable terms, if at all. Any litigation, even without merit, could result in substantial costs and diversion of resources and could have a material adverse affect on our business and results of operations.

Cancellations Or Delays In Orders Could Materially And Adversely Affect Our Gross Margins And Operating Income. Sales to our OEM customers are primarily based on purchase orders we receive from time to time rather than firm, long-term purchase commitments. Although it is our general practice to purchase raw materials only upon receiving a purchase order, for certain customers we will occasionally purchase raw materials based on such customers' rolling forecasts. Further, during times of potential component shortages we have purchased, and may continue to purchase, raw materials and component parts in the expectation of receiving purchase orders for products that use these components. In the event actual purchase orders are delayed, are not received or are cancelled, we would experience increased inventory levels or possible write-downs of raw material inventory that could materially and adversely affect our business and operating results.

We Generally Have No Written Agreements With Suppliers To Obtain Components And Our Margins And Operating Results Could Suffer From Increases In Component Prices. We are typically responsible for purchasing components used in manufacturing products for our customers. We generally do not have written agreements with our suppliers of components. This typically results in our bearing the risk of component price increases because we may be unable to procure the required materials at a price level necessary to generate anticipated margins from the orders of our customers. Further, prices of components have increased recently based upon the increase in oil prices and what management believes to be a high worldwide demand for components used in the manufacturing of our products. Accordingly, additional increases in component prices could materially and adversely affect our gross margins and results from operations.

Certain Legal Consequences of Foreign Incorporation and Operations

Judgments Against The Company And Management May Be Difficult To Obtain Or Enforce. We are a holding corporation organized as an International Business Company under the laws of the British Virgin Islands and our principal operating subsidiary is organized under the laws of Hong Kong. Our principal executive offices are located in Hong Kong, Korona is located in Germany and Gram Precision is located in Canada. Outside the United States, it may be difficult for investors to enforce judgments obtained against us in actions brought in the United States, including actions predicated upon the civil liability provisions of federal securities laws. In addition, most of our officers and directors reside outside the United States and the assets of these persons are located outside of the United States. As a result, it may not be possible for investors to effect service of process within the United States upon these persons, or to enforce against the Company or these persons judgments predicated upon the liability provisions of United States federal securities laws. Our Hong Kong counsel and our British Virgin Islands counsel have advised that there is substantial doubt as to the enforceability against us or any of our directors or officers in original actions or in actions for enforcement of judgments of United States courts in claims for liability based on the civil liability provisions of federal securities laws.

Because We Are Incorporated In The British Virgin Islands, You May Not Have The Same Protections As Shareholders Of U.S. Corporations. We are organized under the laws of the British Virgin Islands. Principles of law relating to matters affecting the validity of corporate procedures, the fiduciary duties of our management, directors and controlling shareholders and the rights of our shareholders differ from, and may not be as protective of shareholders as, those that would apply if we were incorporated in a jurisdiction within the United States. Our directors have the power to take certain actions without shareholder approval, including an amendment of our Memorandum or Articles of Association and certain fundamental corporate transactions, including reorganizations, certain mergers or consolidations and the sale or transfer of assets. In addition, there is doubt that the courts of the British Virgin Islands would enforce liabilities predicated upon United States federal securities laws.

Future issuances of preference shares could materially and adversely affect the holders of our common shares or delay or prevent a change of control. On October 10, 2001, our shareholders approved the amendment to our Memorandum and Articles of Association to create from time to time and issue an aggregate of 10,000,000 shares of preferred stock in four classes. While currently no preferred shares are issued or outstanding, we may issue preferred shares in the future. Future issuance of preferred shares could materially and adversely affect the rights of the holders of our common shares or delay or prevent a change of control.

Our Shareholders Do Not Have The Same Protections Or Information Generally Available To Shareholders Of U.S. Corporations Because The Reporting Requirements For Foreign Private Issuers Are More Limited Than Those Applicable To Public Corporations Organized In The United States. We are a foreign private issuer within the meaning of rules promulgated under the Exchange Act. We are not subject to certain provisions of the Exchange Act applicable to United States public companies including: the rules under the Exchange Act requiring the filing with the SEC of quarterly reports on Form 10-Q or current reports on Form 8-K, the sections of the Exchange Act regulating the solicitation of proxies, consents or authorizations in respect to 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 (i.e., a purchase and sale, or sale and purchase, of the issuer's equity securities within six months or less). Because we are not subject to these rules, our shareholders are not afforded the same protections or information generally available to investors in public companies organized in the United States.

Our Board's Ability To Amend Our Charter Without Shareholder Approval Could Have Anti-Takeover Effects That Could Prevent A Change In Control. As permitted by the law of the British Virgin Islands, our Memorandum and Articles of Association, which are the terms used in the British Virgin Islands for a corporation's charter and bylaws, may be amended by our board of directors without shareholder approval provided that a majority of our independent directors do not vote against the amendment. This includes amendments to increase or reduce our authorized capital stock. Our board's ability to amend our charter documents without shareholder approval could have the effect of delaying, deterring or preventing a change in control of Bonso, including a tender offer to purchase our common shares at a premium over the then current market price.

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We May Not Pay Dividends In The Future. Although we have declared dividends during the fiscal years ended March 31, 2001 and 2002 and on April 2, 2003 and July 13, 2004, we may not be able to declare dividends or may decide not to declare dividends in the future. We will determine the amounts of any dividends when and if they are declared, in the future at the time of declaration.

If there is an adverse outcome in litigation in Jefferson County Colorado that has been filed against us, our business could be seriously harmed. On or about August 20, 2003, Bonso and three of Bonso's directors were served with a copy of a Complaint filed on July 23, 2003 in District Court of Jefferson County, State of Colorado. For further information, see "Legal Proceedings." The Complaint alleges, among other claims, that certain of Bonso's officers and directors breached their fiduciary duties of care, loyalty, and good faith by causing Bonso, through its directors, to disseminate to the market materially misleading and inaccurate information and its failure to correct such information. The plaintiffs have filed an amended complaint alleging derivative claims for breaches of fiduciary duties for: (i) insider selling and misappropriation of information, (ii) dissemination of misleading and inaccurate information and (iii) waste of corporate assets against certain of our officers and directors. The ultimate outcome of this litigation cannot be presently determined. Any adverse determination in this litigation could also subject us to significant liabilities, any or all of which could materially and adversely affect our business and operating results.

Item 4. Information on the Company

History and Development of the Company

Bonso Electronics International Inc. was formed on August 8, 1988 as a limited liability International Business Company under the laws of the British Virgin Islands under the name "Golden Virtue Limited." On September 14, 1988, we changed our name to Bonso Electronics International, Inc. We operate under the International Business Companies Ordinance, 1984, of the British Virgin Islands.

As part of our ongoing expansion of the sensor-based product business, effective as of August 1, 2002, we acquired 51% of the equity of Gram Precision from a third party for approximately \$231,000 in cash, a promissory note in the gross amount of \$231,000, and the issuance of 125,000 shares of our common stock valued at approximately \$300,000. The purchase price was determined through arms-length negotiations between us and the third party, which negotiations took into consideration Gram Precision's business, financial position, operating history, products, and other factors relating to Gram Precision's business. Gram Precision is primarily engaged in the distribution and marketing of pocket scales in the United States, Canada, and Europe.

Effective as of May 1, 2001 we acquired 100% of the equity of Korona. We originally acquired Korona for approximately \$3,634,000. Augusta exercised its option to redeem the stock it received as part of the purchase price for a promissory note. While we disputed Augusta's exercise of the option, the Arbitration Panel has issued a Final Award holding Bonso liable to Augusta. For further information, see "Legal Proceedings."

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merchandisers and distributors. These products feature contemporary designs using the latest materials and attractive packaging. Since 2000, we have manufactured a portion of Korona's product line under an Original Design Manufacturers agreement and are familiar with Korona's stature in Europe and its potential for wider global distribution.

Our corporate administrative matters are conducted through our registered agent, HWR Services Limited, P.O. Box 71, Road Town, Tortola, British Virgin Islands. Our principal executive offices are located at Unit 1106 - 1110, 11/F, Star House, 3 Salisbury Road, Tsimshatsui, Kowloon, Hong Kong. Our telephone number is 852-2605-5822, our facsimile number is 852-2691-1724, our e-mail address is info@bonso.com and our website is www.bonso.com. Our registered agent in the United States is Henry F. Schlueter, Esq., 1050 Seventeenth Street, Suite 1700, Denver, Colorado 80265.

Capital Expenditures

Our principal capital expenditures and divestitures over the last three years include the following:

	2002	2003	2004
Property Plant & Equipment	\$3,100,610	\$1,754,713	\$3,089,656

Our capital expenditures in 2003 included the purchase of machinery used in the production of certain of our products.

All of the foregoing capital expenditures were financed principally from internally generated funds and our current plan is to continue to use internally generated funds principally to finance future capital expenditures. While we currently have no future plans for capital expenditures during the fiscal year ending March 31, 2005, our plans for capital expenditures are subject to change from time to time.

Business Overview

Bonso Electronics International Inc. designs, develops, produces and sells electronic sensor-based and wireless products for private label Original Equipment Manufacturers (individually "OEM" or collectively "OEMs"), Original Brand Manufacturers (individually "OBM" or collectively "OBMs") and Original Design Manufacturers (individually "ODM" or collectively "ODMs").

Since 1989, we have manufactured all of our products in China in order to take advantage of the lower overhead costs and competitive labor rates. Our factory is located in Shenzhen, China, about 50 miles from Hong Kong. The convenient location permits us to easily manage manufacturing operations from Hong Kong and facilitates transportation of our products out of China through the port of Hong Kong and Yantian (Shenzhen).

Products

Our sensor-based scale products are comprised of bathroom, kitchen, office, jewelry, laboratory, postal and industrial scales that are used in consumer, commercial and industrial applications. These products accounted for 63% of revenue for the fiscal year ended March 31, 2002, 59% for 2003 and 61% for 2004.

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Our wireless telecommunications products are primarily comprised of two-way radios and cordless telephones that are used in consumer and commercial applications. These products accounted for 33% of revenue for the fiscal year ended March 31, 2002, 34% for 2003 and 37% for 2004.

We also receive revenue from certain customers for the development and manufacture of tooling and moulding for scales and telecommunication products. Generally, these tools and moulds are used by us for the manufacture and sale of products. We also generate some sales of spare parts for repair work by our customers and from repair work performed by us for our customers. These revenues accounted for approximately 4% of net sales for the fiscal year ended March 31, 2002, 7% for 2003 and 2% for 2004.

The following table sets forth the percentage of net sales for each of the product lines mentioned above, for the fiscal years ended March 31, 2002, 2003, and 2004.

Product Line	Year ended March 31,		
	2002	2003	2004
Scales	63%	59%	61%
Telecommunications Products	33%	34%	37%
Other products and services	4%	7%	2%
Total	100%	100%	100%

Business Strategy

We believe that our continued growth depends upon our ability to strengthen our customer base by enhancing and diversifying our products, increasing the number of customers and expanding into additional markets, while maintaining or increasing sales of our products to existing customers. Our continued growth and profitability is also dependent upon our ability to control production costs and increase production capacity. Our strategy to achieve these goals is as follows:

Product Enhancement And Diversification. We continually seek to improve and enhance our existing products in order to provide a longer product life-cycle and to meet increasing customer demands for additional features. Our research and development staff are currently working on a variety of projects to enhance our existing scale products and for the telecommunications industry and in the postal scale/meter area. See "Products" below.

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Maintaining And Expanding Business Relations With Existing Customers. We promote relationships with our significant customers through regular communication, including visiting certain of our customers in their home countries and providing direct access to our manufacturing and quality control personnel. This access, together with our concern for quality, has resulted in a relatively low level of defective products. Moreover, we believe that our emphasis on timely delivery, good service and low cost has contributed and will continue to contribute to good relations with our customers and increased orders. Further, we solicit suggestions from our customers for product enhancement and when feasible, plan to develop and incorporate the enhancements suggested by our customers into our products.

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Market And Product Expansion. We have significantly expanded our marketing efforts in the United States, Canada and Europe. We have primarily done this through the acquisitions of Gram Precision and Korona, and through efforts to introduce the Korona brand name and products into the United States. Further, we have taken significant steps to expand the products that we sell and to position ourselves as both ODMs and OEMs for other companies that require a manufacturing partner with our capabilities. We intend to increase our marketing and sales efforts with both existing and potential customers.

Controlling Production Costs. In 1989, recognizing that labor cost is a major factor permitting effective competition in the consumer electronic products industry, we relocated all of our manufacturing operations to China to take advantage of the large available pool of lower cost manufacturing labor. We located our manufacturing facilities within 50 miles of Hong Kong in order to facilitate transportation of our products to markets outside of China, while benefiting from the advantages associated with manufacturing in China.

We are actively seeking to control production costs by such means as redesigning our existing products in order to decrease material and labor costs, controlling the number of our employees, increasing the efficiency of workers by providing regular training and tools and redesigning the flow of our production lines.

Increasing Production Capacity. We have significantly expanded our production capacity by leasing additional factory and dormitory buildings immediately adjacent to our factory in China. We have the opportunity to increase our capacity through the construction and/or leasing of additional factory and dormitory space near our factory in China. We intend to carefully monitor our capacity needs and to expand capacity as necessary.

Customers and Marketing

We sell our products primarily in the United States and Europe. Customers for our products are primarily OEMs, OBMs and ODMs, which market the products under their own brand names. We continue to market our products to OEM's, OBM's and ODM's at trade shows, via e-mail and facsimile. Gram Precision engages in the distribution and marketing of pocket scales in the United States, Canada, and Europe. Korona engages in the distribution and marketing of electronic and mechanical body and kitchen scales directly to the retail and catalogue markets in Europe.

Net export sales to customers by geographic area consisted of the following for each of the three years ended March 31, 2002, 2003 and 2004.

	Year ended March 31,					
	2002		2003		2004	
	-----	-----	-----	-----	-----	-----
North America	\$ 24,553,379	46%	\$22,017,956	48%	\$45,070,191	61%
Europe	\$ 25,641,446	48%	\$21,059,227	45%	\$27,791,392	37%
Asia	\$ 2,223,602	4%	\$ 2,661,535	6%	\$ 1,816,541	2%
Others	\$ 884,674	2%	\$ 591,336	1%	\$ 28,601	0%
Total	\$53,303,101	100%	\$46,330,054	100%	\$74,706,725	100%

We maintain a marketing and sales team of eleven people in China, a marketing team of two people in Canada and two people in Europe for Gram Precision and a sales team of six people at Korona in Germany (including two sales representative and four persons who are directly employed by Korona).

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Also, our experienced engineering teams work directly with our customers to develop and tailor our products to meet the customer's specific needs. We market our products primarily through a combination of direct contact by our experienced in-house technical sales staff and our sales representatives, and through the use of direct mail catalogues and product literature. Korona sells its products primarily through direct contact by sales agents/employees with customers. In addition, our marketing teams contact existing and potential customers by telephone, mail, facsimile, and in person.

A list of our major electronics sensor customers for each of the prior three fiscal years follows:

Percent of Sales - Year ended March 31,

Electronics Sensor Customers	2002 (1)	2003 (1)	2004 (1)
Sunbeam Products, Inc	0%	0	14%
Salter Housewares Ltd	5%	10%	6%
Kern & Sohn GmbH (Germany)	4%	4%	4%
Werner Dorsch GmbH & Co. (Germany)	4%	3%	2%
Media Markt und Saturn Verwaltungs GmbH	0%	0%	5%

A list of our major telecommunications customers for each of the prior three fiscal years follows:

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Percent of Sales - Year ended March 31,

Telecommunications Customer	2002	2003	2004
Trisquare Communications (HK) Company Ltd.	22%	14%	0%
TTI Tech Co., Ltd	4%	8%	25%
Global Link Corporation Ltd.	0%	5%	11%

Sales of our products to OEMs and ODM's accounted for approximately 65% of our total net sales in the year ended March 31, 2002, 34% for the year ended 2003 and 70% for the year ended 2004. Korona contributed \$15,459,585 of our total net sales or 21% of total net sales for the year ended March 31, 2004. Gram Precision contributed \$ 6,340,999 of our total net sales or 9% of total net sales for the year ended March 31, 2004.

Component Parts and Suppliers

We purchase over 1,000 different component parts from more than 100 major suppliers and are not dependent upon any single supplier for key components. We

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purchase components for our products primarily from suppliers in Japan, Taiwan, South Korea, Hong Kong and the PRC.

The costs of component parts has recently increased because of an increase in the price of oil that is used in the production of such components and what management believes to be an increase in worldwide demand for electronic components such as those used in the production of our products. Management has taken steps to reduce our exposure to any inability to obtain components by forecasting with an increased buffer rate and placing orders for components earlier and allowing for longer delivery lead times. Because of these actions, management does not expect to experience any difficulty in obtaining needed component parts for our products.

Quality Control

We have received ISO 9001: 2000 certification from Det Norske Veritas Certification B.V., the Netherlands. The ISO 9001: 2000 certification was awarded to our subsidiary, Bonso Electronics Limited and to Bonso Electronics Limited's subsidiary Bonso Electronics (Shenzhen) Company Limited, the manufacturing plant. Further, we have received TL 9000 certification for our telecommunications products.

ISO 9001 is one of the ISO 9000 series of quality system standards developed by the International Organization for Standardization, a worldwide federation of national standards bodies. ISO 9001 provides a model for quality assurance (and continuous improvement) in product development, manufacturing, installation and servicing that focuses on meeting customer requirements. The TL 9000 standard was developed by the Quality Excellence for Suppliers of Telecommunications (QuEST) Leadership Forum. The TL 9000 certification process was developed exclusively to address the quality of products and services provided by suppliers to the telecommunications industry.

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Patents, Licenses, Trademarks, Franchises, Concessions and Royalty Agreements

We have obtained a trademark registration in Hong Kong and China for the marks BONSO and MODUS in connection with certain electronic apparatus. Also, we have acquired the trademark registration rights to the KORONA mark for 16 European countries and in the United States. Gram Precision has one patent for a digital scale and fifteen trademarks.

We rely on a combination of patent, trademark and trade secret laws, employee and third party non-disclosure agreements and other intellectual property protection methods to protect our proprietary rights. There can be no assurance that third parties will not assert infringement or other claims against us with respect to any existing or future products. We cannot assure you that licenses would be available if any of our technology was successfully challenged by a third party, or if it became desirable to use any third-party technology to enhance the Company's products. Litigation to protect our proprietary information or to determine the validity of any third-party claims could result in a significant expense to us and divert the efforts of our technical and management personnel, whether or not such litigation is determined in our favor.

While we have no knowledge that we are infringing upon the proprietary rights of any third party, there can be no assurance that such claims will not be asserted in the future with respect to existing or future products. Any such

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assertion by a third party could require us to pay royalties, to participate in costly litigation and defend licensees in any such suit pursuant to indemnification agreements, or to refrain from selling an alleged infringing product or service.

Product Research and Development/Competition

The major responsibility of the product design, research and development personnel is to develop and produce designs to the satisfaction of and in accordance with the specifications provided by the OEMs, OBMs and ODMs. We believe our engineering and product development capabilities are important to the future success of our business. As an ODM, we take specifications that are provided to us by the customer and design a product to meet those specifications. Some of our product design, research, and development activities are customer funded and are under agreements with specific customers for specific products. We have successfully lowered the costs for our research and development team by moving most research and development activities to our facility in China. We principally employ Chinese engineers and technicians at costs that are substantially lower than that would be required in Hong Kong.

Both the electronic sensor-based and wireless products are highly competitive. Competition is primarily based upon unit price, product quality, reliability, product features and management's reputation for integrity. Accordingly, reliance is placed on research and development of new products, line extensions and technological, quality and other continuous product improvement. There can be no assurance that we will enjoy the same degree of

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success in these efforts in the future. Research and development expenses, aggregated approximately \$427,000 for 2002, \$393,000 for 2003 and \$740,000 for 2004.

Seasonality

Generally, the first calendar quarter of each year is typically the slowest sales period because our manufacturing facilities in China are closed for two weeks for the Chinese New Year holidays to permit employees to travel to their homes in China. In addition, sales during the first calendar quarter of both scales and telecommunications products usually dip following the increase in sales during the Christmas season. A greater number of our sales of scales and telecommunications products occur between the months of April and September for shipment in the summer in preparation of the Christmas holiday. Throughout the remainder of the year, our products do not appear to be subject to significant seasonal variation. However, past sales patterns may not be indicative of future performance. Throughout the remainder of the year, our products do not appear to be subject to significant seasonal variation. The summer months are generally the lowest sales point of the calendar year for Gram Precision and Korona; however, sales of telecommunication products are generally higher in the summer months off-setting Gram Precision's and Korona's decline in sales. However, the sales patterns may not be indicative of future performance.

Employee incentive compensation is conditioned on the employee's return to work following the Chinese New Year and is paid to employees following the reopening of the factory after the holidays. We believe that this method has resulted in lower employee turnover than might otherwise have occurred.

Transportation

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Typically, we sell products either F.O.B. Hong Kong Hong Kong or Yantian (Shenzhen), which means that our customers are responsible for the transportation of finished products from Hong Kong or Yantian (Shenzhen) to their final destination. Transportation of components and finished products to and from Shenzhen is by truck. To date, we have not been materially affected by any transportation problems. However, transportation difficulties affecting air cargo or shipping, such as an extended closure of ports that materially disrupts the flow of our customers' products into the United States, could materially and adversely affect our sales and margins if, as a result, our customers delay or cancel orders or seek concessions to offset expediting charges they incurred pending resolution of the problems causing the port closures.

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Government Regulation

We are subject to comprehensive and changing foreign, federal, state and local environmental requirements, including those governing discharges to the air and water, the handling and disposal of solid and hazardous waste, and the remediation of contamination associated with releases of hazardous substances. We believe that we are in compliance with current environmental requirements. Nevertheless, we use hazardous substances in our operations and as is the case with manufacturers in general, if a release of hazardous substances occurs on or from our properties we may be held liable and may be required to pay the cost of remediation. The amount of any resulting liability could be material.

Foreign Operations

A significant amount of our products are manufactured at our factory located in China. While China has been granted permanent most favored nation trade status in the United States through its entry into the World Trade Organization, controversies between the United States and China may arise that threaten the status quo involving trade between the United States and China. These controversies could materially and adversely affect our business by, among other things, causing our products in the United States to become more expensive resulting in a reduction in the demand for our products by customers in the United States.

Sovereignty over Hong Kong reverted to China on July 1, 1997. The 1984 Sino-British Joint Declaration, the 1990 Basic Law of Hong Kong, the 1992 United States-Hong Kong Policy Act and other agreements provide some indication of the business climate we believe will continue to exist in Hong Kong. Hong Kong remains a Special Administrative Region ("SAR") of China, with certain autonomies from the Chinese government. Hong Kong is a full member of the World Trade Organization. It has separate customs territory from China, with separate tariff rates and export control procedures. It has a separate intellectual property registration system. The Hong Kong Dollar is legal tender in the SAR, freely convertible and not subject to foreign currency exchange controls by China. The SAR government has sole responsibility for tax policies, though the Chinese government must approve the SAR's budgets. Notwithstanding the provisions of these international agreements, we cannot be assured of the continued stability of political, legal, economic or other conditions in Hong Kong. No treaty exists between Hong Kong and the United States providing for the reciprocal enforcement of foreign judgments. Accordingly, Hong Kong courts might not enforce judgments predicated on the federal securities laws of the United States, whether arising from actions brought in the United States or, if permitted, in Hong Kong.

Organizational Structure.

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We have one wholly-owned Hong Kong subsidiary - Bonso Electronics Limited ("BEL"). BEL was organized under the laws of Hong Kong and is responsible for the design, development, manufacture and sale of our products.

BEL has one active Hong Kong subsidiary - Bonso Investment Limited ("BIL"). BIL was organized under the laws of Hong Kong and has been used to acquire and hold our property investments in Hong Kong and China.

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BEL also has one active PRC subsidiary - Bonso Electronics (Shenzhen) Company Limited, which is organized under the laws of the PRC, and is used to manufacture all of our products.

We also have another wholly-owned British Virgin Islands subsidiary - Modus Enterprise International Inc., which owns 100% of Korona and 51% of Gram Precision. Korona is engaged in marketing, distributing and retailing of consumer bathroom and kitchen scale products throughout Europe. Gram Precision is primarily engaged in the distribution and marketing of pocket scales in the United States, Canada, and Europe.

Property, Plant and Equipment.

British Virgin Islands

Our offices are located at Cragmuir Chambers, Road Town, Tortola, British Virgin Islands. Only corporate administrative matters are conducted at such offices, through our registered agent, HWR Services Limited.

Hong Kong

We own approximately 5,000 square feet of office space located at Unit 1106 - 1110, 11/F, Star House, 3 Salisbury Road, Tsimshatsui, Kowloon, Hong Kong as our principal executive office.

We own approximately 4,593 square feet on the 8th floor of the Universal Industrial Centre, 23-25 Shan Mei Street, Fo Tan, Shatin, New Territories, Hong Kong. This facility now is used exclusively as warehouse space.

We own a residential property in Hong Kong, which is located at Savanna Garden, House No. 27, Tai Po, New Territories, Hong Kong. House No. 27 consists of approximately 2,475 square feet plus a 177 square foot terrace and a 2,308 square foot garden area. The use of House No. 27 is provided to Mr. Anthony So as part of his compensation. See Item 6 - "Directors, Senior Management and Employees -- Compensation."

China

Our existing factory in China is located at Shenzhen in the DaYang Synthetical Development District, close to the border between Hong Kong and China. This factory consists of four factory buildings, which contain approximately 300,000 square feet, four workers' dormitories, containing approximately 200,000 square feet, a canteen and recreation center of approximately 25,500 square feet, an office building, consisting of approximately 25,500 square feet, and staff quarters for our supervisory employees, consisting of approximately 35,000 square feet, for a total of approximately 586,000 square feet. All of the facilities noted above are wholly-owned, except two factory buildings and two workers' dormitories, however

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we continue to pay a monthly management fee of \$2,750 pursuant to a Contract on the Use of Land and Supply of Workers with Shenzhen Baoan Fuan Industrial Company.

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We also own three residential properties described as follows:

- (o) Lijingge Court, Unit F, 15th Floor, Hai Li Building, Shenzhen, China, consisting of approximately 1,000 square feet.
- (o) Lakeview Mansion, B-20C, Hujinju Building No. 63, Xinan Road, Boacheng Baoan Shenzhen, China, consisting of approximately 1,591 square feet.
- (o) Lakeview Mansion, B-11B, Hujinju Building No. 63, Xinan Road, Boacheng Baoan Shenzhen, China, consisting of approximately 1,335 square feet.

The property for the Lakeview Mansion, B-11B is rented to an unaffiliated third party for RMB3,500 per month (approximately \$422). The Lakeview Mansion property B-20C is utilized by directors when they require accommodations in China. The Hai Li Building is vacant.

We also own two office units in Beijing, namely Units 12 and 13 on the 3rd floor, Block A of Sunshine Plaza in Beijing, China. Unit 12 consists of 1,102 square feet and Unit 13 consists of 1,860 square feet. Both Units are rented to unaffiliated third parties for an aggregate monthly rental of RMB 21,000, or approximately \$2,537.

Germany

Korona leases approximately 885 square meters of office space located at Auf den Huttenberg 1-3, 35428 Langgons-Niederkleen, Germany. This facility is used as Korona's principal executive offices and the monthly rent for this facility is E 6,427.12.

Poland

Korona leases approximately 86 square meters of office space located at ul. Podmiejska 18, 01-498 Warszawa. The facility is used as office space and the monthly rent for this facility is E 533.

United States

Vector Distribution Systems Inc. leases approximately 7,000 square feet of office and warehouse space located at located at 3515 Airway Drive, Suite 203, Reno, Nevada 89511. This facility is used as warehouse and the annual rent for this facility is \$41,440.

Canada

Gram Precision, through an affiliated entity, owns approximately 5,028 square feet of office space located at 31-5155 Spectrum Way, Mississauga, Ontario, L4W 5A1, Canada. This facility is used as Gram Precision's principal executive offices and the monthly payment to the affiliated entity for this facility is CDN 4,250 including Goods & Services Tax.

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United Kingdom

Vector Europe Limited, a subsidiary of Gram Precision, leases 3,319 square feet of office and warehouse space located at Swansea, Wales, United Kingdom. The monthly rent for this facility is GBP 833.33.

Adequacy of Facilities

We believe the manufacturing complex, including the newly leased space, will be adequate for our reasonably foreseeable needs.

Item 5. Operating and Financial Review and Prospects

The following discussion and analysis should be read in conjunction with Item 3 - "Key Information - Selected Financial Data" and the Consolidated Financial Statements and Notes to Consolidated Financial Statements attached elsewhere in this Annual Report.

Financial information as of and for the fiscal years ended March 31, 2004 and 2003 reflects the impact of the acquisition of a majority interest in Gram Precision and the acquisition of Korona. Financial information as of and for the year ended March 31, 2002 reflects the impact of the acquisition of Korona effected May 1, 2001 and therefore will not be comparable with the financial information as of or for any past dates or periods and will not be indicative of results of operations for future periods.

Overview

We derive our revenues principally from the sale of sensor-based and wireless products manufactured in China, which represent 61% and 37% of total sales for fiscal year ended March 31, 2004 respectively. In the fiscal year ended March 31, 2002, net sales increased to approximately \$53,303,000 and net income increased to approximately \$1,806,000. In the fiscal year ended March 31, 2003, net sales were \$46,330,000 and net loss was \$1,644,000. In the fiscal year ended March 31, 2004, net sales were \$74,707,000 and net income increased to approximately \$2,267,000.

Although labor costs are increasing in China, our labor costs continue to represent a relatively small percentage of our total production costs. We believe that increased labor costs in China will not have a significant effect on our total production costs or results of operations, and that we will be able to continue to increase our production at our manufacturing facility without substantially increasing our non-production salaries and related costs. In addition, we have not experienced significant difficulties in obtaining raw materials for our products and management does not anticipate any such difficulties in the foreseeable future.

Operating Results.

The following table sets forth selected income data as a percentage of net sales for the periods indicated.

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	Year ended March 31,		
	2002	2003	2004
Income Statement Data			

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	-----	-----	-----
Net sales	100.0%	100.0%	100%
Cost of sales	(75.4)	(76.7)	(77.0)
Gross margin	24.6	23.3	23.0
Selling expenses	(4.6)	(5.3)	(4.2)
Salaries and related costs	(7.3)	(9.8)	(6.9)
Research and development expenses	(0.8)	(0.8)	(1.0)
Administration and general expenses	(6.4)	(8.5)	(7.6)
Amortization of brand name	(0.4)	(0.4)	(0.3)
Income (loss) from operations	5.1	(1.7)	3.1
Interest income	0.3	0.2	0.1
Interest expense	(1.2)	(1.1)	(0.7)
Foreign exchange gains/(loss)	(0.1)	(0.2)	0.0
Other income	0.3	0.4	1.0
Consultancy fee	(0.7)	(0.8)	0.0
Income (loss) before income taxes and minority interest	3.7	(3.3)	3.5
Income tax expense	(0.4)	(0.1)	(0.5)
Minority interest	0	(0.2)	0.1
Net income (loss)	3.4	(3.4)	3.1
	===	====	===

Fiscal year ended March 31, 2004 compared to fiscal year ended March 31, 2003

Net Sales. Our sales increased 61.2% from \$46,330,054 for the fiscal year ended March 31, 2003, to \$74,706,725 for the fiscal year ended March 31, 2004, primarily as a result of strong demand from both our scales & telecommunications products. Sales of our scales business increased from approximately \$27,443,774 for the fiscal year ended March 31, 2003, to approximately \$46,211,039 for the fiscal year ended March 31, 2004, and sales for telecommunications products were up from approximately \$15,729,490 for the fiscal year ended March 31, 2003, to approximately \$27,450,322 for the fiscal year ended March 31, 2004. The increased sales mainly came from both new customers, such as Sunbeam Products, and previous customers, such as TTI Tech Co., Ltd., as indicated in the section "Customers and Marketing".

Gross Margin. Gross margin declined slightly from 23.3% for the fiscal year ended March 31, 2003, to 23.1% in the fiscal year ended March 31, 2004. The decreased gross margin was primarily the result of decreases in the selling price of both our scale and telecommunication products.

Selling Expenses. Total selling expenses increased approximately 26.5% from \$2,466,653 during the fiscal year ended March 31, 2003 to \$3,121,900 during the fiscal year ended March 31, 2004. This increase is primarily attributable to the increased sales volume experienced during the year ended March 31, 2004 when compared to the same period in the prior year. However, selling expense decreased as a percentage of net sales from approximately 5.3% for the fiscal year ended March 31, 2003, to approximately 4.2% for the fiscal year ended March 31, 2004 because of a tightened control in costs.

Salaries And Related Costs. Salaries and related costs increased by 12.8% from \$4,563,453 for the fiscal year ended March 31, 2003 to \$5,150,345 for the fiscal year ended March 31, 2004. This increase was primarily due to the

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strength of the Euro and Canadian Dollar against the U.S. Dollar in translating our overseas subsidiaries' expenses. Apart from foreign exchange effect, the increase was also caused by the inclusion of an additional four months of Gram Precision salaries, which was acquired by Bonso on August 1, 2002 (only 8 months of Gram Precision's results was included in 2002-2003).

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Research And Development. Research and development expenses increased approximately 88.3% from \$392,926 during the fiscal year ended March 31, 2003, to \$739,730 during the fiscal year ended March 31, 2004 due to increased research and development activities for both telecommunications products and new scale models. Salary of engineers composed the largest part of research and development expense.

Administration And General Expenses. Administration and general expenses increased by approximately 44.3% from \$3,956,858 during the fiscal year ended March 31, 2003 to \$5,709,653 during the fiscal year ended March 31, 2004. This increase was primarily the result of a provision of \$1.2 million to account for the accrued interest, attorney fees and expenses arising from the arbitration with Augusta; the increase in foreign currency exchange rate of the Euro and Canadian Dollar as compared the United States Dollar. During the fiscal year ended March 31, 2004, the exchange rate of Euros and Canadian Dollars against the United States Dollar increased approximately 12.1% and 12.8% respectively. Additionally, an addition four months of administration cost was included for Gram Precision for the fiscal year ended March 31, 2004.

Amortization Of Brand Name. During the fiscal years ended March 31, 2003 and 2004 we amortized \$200,000 relating to the brand name acquired upon the acquisition of Korona. The brand name is amortized using the straight line method over the related estimated useful life of 15 years.

Income From Operations. As a result of the above changes, income from operations increased by 396.2% from a loss of approximately \$777,779 during the fiscal year ended March 31, 2003 to income of \$2,303,994 during the fiscal year ended March 31, 2004.

Interest Income. Interest income decreased by approximately 32.9% from \$85,178 during the fiscal year ended March 31, 2003, to \$57,169 during the fiscal year ended March 31, 2004. The decrease was the result of lower interest rates in Hong Kong.

Interest Expense. Interest expense decreased by approximately 6.2% from \$532,624 during the fiscal year ended March 31, 2003 to \$499,512 during the fiscal year ended March 31, 2004. This decrease was the result of lower interest rates.

Foreign Exchange Losses/Gains. Foreign currency exchange rates produced a gain of \$15,081 during the fiscal year ended March 31, 2004, as compared to a loss of \$96,592 during the fiscal year ended March 31, 2003, an increased gain of 115.6%. The gain was primarily the result of increased strength of the Canadian Dollar against the United States Dollar

Other Income. Other income increased approximately 344% from \$169,456 during the fiscal year ended March 31, 2003 to \$752,310 during the fiscal year ended March 31, 2004. The increase was primarily the result of sales of scrap material and \$80,000 compensation from a customer on excessive materials caused by order cancellation. The scrap material consists primarily of the remnants of steel plate and plastic after the production process.

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Consultancy Fee. In 2000, we entered into an agreement with a third party to provide consulting/advisory services relating to our capital structure and fund-raising activities. The period of service was from July 2000 to January 2003. A total consultancy fee of \$1,144,260 was capitalized in 2000 and was

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amortized over the three years of the contract, resulting in a non-cash consultancy fee of \$381,420 for the fiscal year ended March 31, 2003, relating to warrants that were issued to the consultant. There was no consultancy fee during the fiscal year ended March 31, 2004.

Income Tax Expense. Income tax expense increased from \$37,314 during the fiscal year ended March 31, 2003 to \$401,504 during the fiscal year ended March 31, 2004, representing 0.08% and 0.5% of net sales respectively. This increase was primarily the result of the increase in our net profit tax for the fiscal year ended March 31 2004.

Net Income. As a result of the above changes, net income during the fiscal year ended March 31, 2004 was \$2,268,610, compared to a net loss of \$1,643,734 during the fiscal year ended March 31, 2003, an increase of \$3,912,344 or approximately 238%.

Fiscal year ended March 31, 2003 compared to fiscal year ended March 31, 2002

Net Sales. Our sales decreased 13% from approximately \$53,303,101 for the fiscal year ended March 31, 2002, to approximately \$46,330,054 for the fiscal year ended March 31, 2003, primarily as a result of the poor performance of one of our subsidiaries, Korona, and the decrease in sales of both our scales and telecommunications products due to the poor worldwide economy. Gram Precision had \$4,275,499 in sales consolidated since August 1, 2002 representing 9% of total sales of the group, and Korona had \$13,112,156 in sales for the year representing 28% of total sales for the group for the year ended March 31, 2003. Korona had \$16,039,000 in sales consolidated since May 1, 2001 representing 30% of total sales of the group for the year ended March 31, 2002.

Gross Margin. Gross margin declined slightly from 24.6% for the fiscal year ended March 31, 2002, as compared with 23.3% in the current fiscal year. This is mainly caused by the decrease in selling price of both our scales and telecommunications products.

Selling Expenses. Total selling expenses declined only slightly; however, these expenses increased as a percentage of total sales from 4.7% to 5.3%. This increase was attributable primarily to \$302,153 in selling expenses from the acquisition and consolidation of Gram Precision in 2003.

Salaries And Related Costs. Salaries and related costs increased by 17.6% from approximately \$3,880,274 for the fiscal year ended March 31, 2002 to approximately \$4,563,453 for the fiscal year ended March 31, 2003. This increase was primarily due to the inclusion of a full year of Korona salaries of \$1,421,174 versus \$1,287,000, in 2002 and the inclusion of eight months of salaries from Gram Precision of \$495,648.

Research And Development. Research and development expenses decreased slightly from \$426,364 for the fiscal year ended March 31, 2002, to \$392,926 for the fiscal year ended March 31, 2003 due to less cost, such as testing fees, involved in the research and development of both our scales and

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telecommunication projects.

Administration And General Expenses. Administration and general expenses increased by 16% from approximately \$3,411,336 for the fiscal year ended March

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31, 2002 to approximately \$3,956,858 for the fiscal year ended March 31, 2003. This increase was primarily due to the inclusion of \$394,950 from Gram Precision's general and administrative expenses.

Amortization Of Brand Name. We amortized approximately \$200,000 and \$202,000 relating to the brand name acquired upon the acquisition of Korona during the fiscal year ended March 31, 2003 and March 31, 2002, respectively. The brand name is amortized using the straight line method over the related estimated useful life of 15 years.

Income From Operations. As a result of the above changes, income from operations declined by 128.7% from approximately \$2,713,992 for the fiscal year ended March 31, 2002 to a loss of \$777,779 for the fiscal year ended March 31, 2003.

Interest Income. Interest income decreased by 48.9% from approximately \$166,723 in the fiscal year ended March 31, 2002, to approximately \$85,178 for the fiscal year ended March 31, 2003. This decrease was primarily the result of the reduction of interest rates in Hong Kong.

Interest Expense. Interest expense declined 17.4% from approximately \$645,045 for the fiscal year ended March 31, 2002 to approximately \$532,624 for the fiscal year ended March 31, 2003. This decrease was primarily the result of lower interest rates.

Foreign Exchange Losses/Gains. Foreign exchange rates produced a loss of approximately \$96,592 for the fiscal year ended March 31, 2003, as compared to a loss of \$39,954 for the fiscal year ended March 31, 2002, an increased loss of 141.7%. The loss was primarily attributable to translating U.S. Dollars to H.K. Dollars, RMB, EURO or Canadian Dollars for the purchase of raw materials and payments of salaries and wages .

Other Income. Other income fell slightly from \$181,272 for the fiscal year ended March 31, 2002 to \$169,456 for the fiscal year ended March 31, 2003. This decrease primarily resulted from the production of less scrap material. The scrap we sell consists primarily of the remains of steel plate and plastics after the production process.

Consultancy Fee. We entered into an agreement with a third party to provide consulting/advisory services relating to our capital structure and fund-raising activities. The period of service was from July 2000 to January 2003. A total consultancy fee of \$1,144,260 was capitalized in 2000 and was amortized over three years of the contract, resulting in a non-cash consultancy fee of \$381,420 for the fiscal years ended March 31, 2003 and 2002, relating to warrants that were issued to the consultant.

Income Tax Expense. Income tax expense decreased from approximately \$189,962 for the fiscal year ended March 31, 2002 to \$37,314 for the fiscal year ended March 31, 2003, representing 0.36% and 0.08% of net sales respectively. This decrease was primarily attributed to the benefit arising from the net loss during this fiscal year of \$245,405, offset by an increase in the deferred tax asset valuation allowance of \$153,496. The increase in the valuation allowance

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is due to the portion of the increased net operating losses that more likely than not may not be realized through future taxable earnings of one of our subsidiaries.

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Net Loss. As a result of the above changes, we incurred a net loss of \$1,643,734 for the fiscal year ended March 31, 2003, compared to net income of \$1,805,606 for the fiscal year ended March 31, 2002, a decrease of approximately \$3,449,340, or 191%.

Fiscal year ended March 31, 2002 compared to fiscal year ended March 31, 2001

Net Sales. Our sales increased 80% from approximately \$29,567,000 for the fiscal year ended March 31, 2001, to approximately \$53,303,000 for the fiscal year ended March 31, 2002, primarily as a result of the contribution from our newly acquired subsidiary Korona and more sales of telecommunications products. Korona had \$16,039,000 in sales consolidated since May 1, 2001 representing 30% of total sales of the group. Another source of contribution was originated from additional telecommunications products sales of \$9,016,000 as a result of increased marketing efforts.

Gross Margin. Gross margin remained fairly stable at 24.6% for the fiscal year ended March 31, 2002, as compared with 24.2% in the prior year. The gain from higher gross margin of Korona products is offset by the loss from lower gross margin of telecom products.

Selling Expenses. Selling expenses increased by 548% from approximately \$382,000 for the fiscal year ended March 31, 2001 to approximately \$2,476,000 for the fiscal year ended March 31, 2002. This increase was attributable primarily to the addition of Korona's selling expenses such as sales commissions and advertising, which amounted to approximately \$1,904,000 during the year.

Salaries And Related Costs. Salaries and related costs increased by 66% from approximately \$2,334,000 for the fiscal year ended March 31, 2001 to approximately \$3,880,000 for the fiscal year ended March 31, 2002. This increase was primarily due to the inclusion of Korona's salaries of \$1,287,000, which constituted 55% of the increase. Further, there was an increase of three people in the production management team.

Research And Development. Research and development expenses increased 43% from approximately \$298,000 for the fiscal year ended March 31, 2001 to approximately \$427,000 for the fiscal year ended March 31, 2002 due to the increased research and development activities for telecommunications products.

Administration And General Expenses. Administration and general expenses increased by 41% from approximately \$2,411,000 for the fiscal year ended March 31, 2001 to approximately \$3,411,000 for the fiscal year ended March 31, 2002. This increase was primarily due to inclusion of Korona's general and administrative expenses. Further, there was an increase in the allowance for doubtful trade receivables provision of approximately \$221,000 in the fiscal year ended March 31, 2002, compared to a nil provision in the fiscal year ended March 31, 2001.

Amortization Of Brand Name. We amortized approximately \$203,000 relating to the brand name acquired upon the acquisition of Korona during the fiscal year ended March 31, 2002. The brand name is amortized using the straight line method over the related estimated useful life of 15 years.

Income From Operations. As a result of the above changes, income from operations increased by 56% from approximately \$1,742,000 for the fiscal year ended March 31, 2001 to \$2,714,000 for the fiscal year ended March 31, 2002.

Interest Income. Interest income decreased by 95% from approximately \$458,000 in the fiscal year ended March 31, 2001, to approximately \$167,000 for the fiscal year ended March 31, 2002. This decrease was primarily the result of a reduction of cash balances with our banks and the reduction of interest rates in Hong Kong.

Interest Expenses. Interest expenses increased 91% from approximately \$338,000 for the fiscal year ended March 31, 2001 to approximately \$645,000 for the fiscal year ended March 31, 2002. This increase was primarily the result of increased borrowings by Korona (i.e., short term loan and overdraft of approximately \$2,847,000 at March 31, 2002). These borrowings incurred an interest expense of approximately \$241,000 representing 79% of the increase.

Foreign Exchange Losses/Gains. Foreign exchange rates produced a gain of approximately \$43,000 for the fiscal year ended March 31, 2001 and a loss of approximately \$40,000 for the fiscal year ended March 31, 2002. The loss was primarily attributable to the increased strength of the RMB in the People's Republic of China against the U.S. Dollar, which arose when translating U.S. Dollars or H.K. Dollars to RMB for the purchase of raw materials and payments of salaries and wages in the People's Republic of China.

Other Income. Other income increased 59% from approximately \$205,000 for the fiscal year ended March 31, 2001 to approximately \$181,000 for the fiscal year ended March 31, 2002. This increase was primarily a result of increased scrap sales. The increase of scrap sales was mainly due to the increase in production volume as the scrap mainly represented the remains of steel plate and plastics after the production process.

Consultancy Fee. We entered into an agreement with a third party to provide consulting/advisory services relating to our capital structure and fund-raising activities. The period of service is from July 2000 to January 2003. A total consultancy fee of \$1,144,260 was capitalized in 2000 and is being amortized over three years of the contract, resulting in a non-cash consultancy fee of approximately \$381,000 for the fiscal year ended March 31, 2002, relating to warrants that were issued to the consultant.

Income Tax Expense. Income tax expense increased from approximately \$125,000 for the fiscal year ended March 31, 2001 to \$190,000 for the fiscal year ended March 31, 2002, representing 7% and 10% of net income respectively. This increase was primarily attributed to an under provision of income tax for fiscal year ended March 31, 2001 of approximately \$19,000 charged in the fiscal year ended March 31, 2002.

Net Income. As a result of the above changes, net income increased from approximately \$1,604,000 for the fiscal year ended March 31, 2001 to t\$1,806,000 for the fiscal year ended March 31, 2002, an increase of approximately \$202,000, or 13%.

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Impact of Inflation

We believe that inflation has not had a material affect on our business during the fiscal year ended March 31, 2004. During the financial year ended March 31, 2002, Hong Kong experienced a period of deflation and Germany sustained a low inflation rate. We have generally been able to modify and improve our product designs so that we could either increase the prices of our products or lower the production cost in order to keep pace with inflation. Although our costs of components used in the manufacture of our products have been relatively stable, we believe that any possible significant increase in material costs would affect the entire electronics industry. Thus, it would not have a negative material impact on our competitive position in the industry. We believe any increases in labor costs will not materially impact our operations because of the lower labor costs of operating in China.

Taxation

Under current British Virgin Islands law, we are not subject to tax on our income. The basic corporate tax rate for Foreign Investment Enterprises in China, is currently 33% (30% state tax and 3% local tax). However, because we are located in Shenzhen and are involved in production operations, they qualify for a special reduced state tax rate of 15%. In addition, the local tax authorities in the regions in which our subsidiaries operate in Shenzhen are not currently assessing any local tax.

Most of our subsidiaries' profits accrue in Hong Kong, Canada and Germany where the corporate tax rates are currently 17.5%, 38% and 26.375%, respectively. However, as Korona is a partnership, it is only subject to a local statutory tax rate in Germany of 14.17%. There is no tax payable in Hong Kong on offshore profit or on dividends paid to Bonso Electronics Limited by its subsidiaries or to us by Bonso Electronics Limited. Therefore, our overall effective tax rate may be lower than that of most United States corporations; however, this advantage could be materially and adversely affected by changes in the tax laws of the British Virgin Islands, Germany, Hong Kong or China.

Efforts by the Chinese government to increase tax revenues could result in decisions or interpretations of the tax laws by the Chinese tax authorities that are unfavorable to us and which increase our future tax liabilities, or deny us expected refunds. Changes in Chinese tax laws or their interpretation or application may subject us to additional Chinese taxation in the future.

No reciprocal tax treaty regarding withholding taxes exists between the United States and the British Virgin Islands. Under current British Virgin Islands law, dividends, interest or royalties paid by us to individuals are not subject to tax as long as the recipient is not a resident of the British Virgin Islands. If we were to pay a dividend, we would not be liable to withhold any tax, but shareholders would receive gross dividends, if any, irrespective of their residential or national status.

Dividends, if any, paid to any United States resident or citizen shareholder are treated as dividend income for United States federal income tax purposes. Such dividends are not eligible for the 70% dividends-received deduction allowed to United States corporations on dividends from a domestic corporation under Section 243 of the United States Internal Revenue Code of 1986 (the "Internal Revenue Code"). Various Internal Revenue Code provisions impose

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their shareholders. You are urged to consult your tax advisor with regard to such possibilities and your own tax situation.

In addition to United States federal income taxation, shareholders may be subject to state and local taxes upon their receipt of dividends.

Foreign Currency Exchange Rates

We sell most of our products to international customers. Our principal export markets are North America (mainly the United States), Europe (mainly Germany) and Asia. Other markets are other European countries (such as the United Kingdom), Australia and Africa. Sales to international customers are made directly by us to our customers. We sell all of our products in United States Dollars and pay for our material components principally in United States Dollars and Hong Kong Dollars. A very small portion of the components used are paid for in Japanese Yen. Most factory expenses incurred are paid in Chinese Renminbi. Because the Hong Kong Dollar is pegged to the United States Dollar, in the past our only material foreign exchange risk previously arose from potential fluctuations in the Chinese Renminbi; however, the Chinese Renminbi was very stable in the past fiscal year and management believes that it is unlikely that there will be material fluctuation in the coming year.

Gram Precision principally pays for its products in United States Dollars and Canadian dollars and sells its products in Canadian, United States Dollars, and United Kingdom Pound Sterling. Korona primarily pays for its products in United States Dollars and Euros and sells its products in Euros. As a result of our increased use of foreign currencies resulting from our acquisitions of Gram Precision and Korona, we experience greater foreign exchange risk than we have in the past; However, during the fiscal year ended March 31, 2004, we experienced a foreign currency gain of \$19,036. We don't currently engage in hedging transactions, however we may undertake hedging activities in the future.

A summary of our debts as at March 31, 2004 which were subjected to foreign currency risk is as below:

Currencies: -----	March 31, 2004 -----
Euro	\$4,599,651
Hong Kong Dollars	\$1,496,533
Japanese Yen	\$38,578
United States Dollars	\$2,040,655
Canadian Dollars	\$533,917

	\$8,709,334

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All the balances above, except \$613,209, are due within one year.

Fluctuations in the value of the Hong Kong Dollar have not been significant since October 17, 1983, when the Hong Kong government tied the value of the Hong Kong Dollar to that of the United States Dollar. However, there can be no assurance that the value of the Hong Kong Dollar will continue to be tied to

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that of the United States Dollar. China adopted a floating currency system on January 1, 1994, unifying the market and official rates of foreign exchange. China approved current account convertibility of the Chinese Renminbi on July 1, 1996, followed by formal acceptance of the International Monetary Fund's Articles of Agreement on December 1, 1996. These regulations eliminated the requirement for prior government approval to buy foreign exchange for ordinary trade transactions, though approval is still required to repatriate equity or debt, including interest thereon. There can be no assurance that these currencies will remain stable or will fluctuate to our benefit.

To manage our exposure to foreign currency and translation risks, we may purchase currency exchange forward contracts, currency options, or other derivative instruments, provided such instruments may be obtained at suitable prices. Management intends to take corrective action in an effort to attempt to minimize any negative impact foreign currency fluctuations may have upon us. However, to date we have not done so. If we are unsuccessful in hedging against currency fluctuations, it may have a material adverse effect on us.

Liquidity and Capital Resources.

We have financed our growth and cash needs to date primarily from internally generated funds and bank debt. We do not use off-balance sheet financing arrangements, such as securitization of receivables or obtaining access to assets through special purpose entities, as sources of liquidity. Our primary uses of cash have been to fund expansions and upgrades of our manufacturing facilities, to make strategic acquisitions and to fund increases in inventory and accounts receivable resulting from increased sales.

We believe that our cash flows from operations, our current cash balance and funds available under our working capital and credit facilities will be sufficient to meet our working capital needs and planned capital expenditures for the next 12 months. However, a decrease in the demand for our products may affect our internally generated funds, and we would further look to our banking facilities to meet our working capital demands.

A Final Award has been issued in favor of Augusta in the arbitration with Augusta. Under the terms of the Final Award, we are required to pay Augusta an aggregate of \$2,382,704, including: (i) monetary damages in the amount of \$1,802,029.07 (including principal and interest), (ii) costs arising out of the arbitration in the amount of (euro)418,956.42 (approximately \$504,675 based upon the noon buying rate in New York City for cable transfers as certified for customs purposes by the Federal Reserve Bank of New York on July 28, 2004 of 1.2046 dollars per Euro); and (iii) \$76,000 in reimbursement of the fees and expenses of the Tribunal. Management is currently evaluating the response it intends to make to the Final Award. A provision of \$1,200,000 was made in the Consolidated Financial Statements of Income (Loss) and Comprehensive Income and (Loss) for the year ended March 31, 2004 to account for the accrued interest, attorney fees and expenses arising from the arbitration. For additional information on the Augusta arbitration. See "Legal Proceedings."

The following tables set forth information with respect to our commitments as of March 31, 2004.

Commitments

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	Payments due by Period				
	Total	Within 1 year	Within 1 to 3 years	Within 3 to 5 years	More
Letters of credit	3,340,044	3,340,044	0	0	
Short-term loans	4,599,652	4,599,652	0	0	
Long-term loans	857,737	244,528	310,538	66,650	
Operating Leases	1,646,660	521,819	697,531	199,969	
Capital Leases	978,741	433,869	544,872	0	
Acquisitions of Plant & Machineries	143,404	143,404	0	0	
Total	11,566,238	9,283,316	1,552,941	266,619	

As of March 31, 2004 we had in place general banking facilities with 10 financial institutions with amounts available aggregating \$28,639,502. Such facilities include the ability to obtain overdrafts, letters of credit, short-term notes payable, short-term loans and long-term loans. As of March 31, 2004, we had utilized \$8,709,334 from these general banking facilities. Interest on this indebtedness fluctuates with the prime rate and HIBOR as set by the Hong Kong Bankers Association. The bank credit facilities are collateralized by certain of our bank deposits, real property located at Savanna Garden in Tai Po, the warehouse space in Fo Tan, office space in Tsimshatsui, and bank guarantees. Our bank credit facilities are due for renewal annually. We anticipate that the banking facilities will be renewed on substantially the same terms and our utilization in the next year will remain at a similar level as that in the current year. Excluding the current portion of long-term debt and capital lease obligations, the amounts of total short-term bank borrowings outstanding as of March 31, 2004 and 2003 were \$8,000,275 and \$9,763,369, respectively. During the fiscal year ended March 31, 2004 and 2003, we paid a total of \$499,512 and \$532,624, respectively, in interest on indebtedness.

Operating activities provided \$7,182,821 of net cash for the fiscal year ended March 31, 2004 compared to \$1,708,044 of net cash for the fiscal year ended March 31, 2003. This decrease in the use of cash can be primarily attributed to cash generated from our normal operation. Our investing activities included the purchase of fixed assets for the year ended March 31, 2004 of \$2,543,734 compared to the purchase of fixed assets in the prior year of \$1,912,056, or an increase of \$631,678, due to the expansion of the manufacturing facilities.

As of March 31, 2004, we had \$10,815,279 in cash and cash equivalents as compared to \$3,633,528 as of March 31, 2003. Working capital at March 31, 2004, was \$12,900,000 compared to \$9,777,000 at March 31, 2003. There are no other

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material unused sources of liquid assets. We believe there are no material restrictions (including foreign exchange controls) on the ability of our subsidiaries to transfer funds to us in the form of cash dividends, loans, advances or product/material purchases. We do not anticipate incurring any significant capital expenditures during this fiscal year. We believe our working capital is sufficient for our present requirements.

Our current ratio (current assets divided by current liabilities) increased from 1.53 as of March 31, 2003 to 1.64 as of March 31, 2004. Our quick ratio (cash and cash equivalents, restricted cash deposits and receivables divided by current liabilities) increased from 0.84 as of March 31, 2003 to 1.10 as of March 31, 2004.

Critical Accounting Policies

The methods, estimates and judgments we use in applying our most critical accounting policies have a significant impact on the results we report in our financial statements. The SEC has defined the most critical accounting policies as the ones that are most important to the portrayal of our financial condition and results, and require us to make our most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Based on this definition, our most critical policies include inventories, impairment, brand name, trade receivables, and deferred income taxes.

Below, we discuss these policies further, as well as the estimates and judgments involved. We also have other key accounting policies, such as revenue recognition. We believe that these other policies either do not generally require us to make estimates and judgments that are as difficult or as subjective, or it is less likely that they would have a material impact on our reported results of operations for a given period. See discussion of all our significant accounting policies in footnote 1 to the Consolidated Financial Statements included elsewhere in this Annual Report.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries (hereinafter collectively referred to as the "Group"). All significant intercompany accounts and transactions are eliminated in consolidation.

The companies acquired during the financial period have been consolidated from the date on which control of the net assets and operations was transferred to the Group.

Acquisitions of companies are accounted for using the purchase method of accounting. Goodwill represents the excess of the purchase cost over the fair value of assets less liabilities of acquired companies.

During the financial year ending March 31, 2003, the Group adopted Statement of Financial Accounting Standard ("SFAS") No. 142 "Goodwill and Other Intangible Assets," which requires discontinuance of goodwill amortization and an annual impairment review. Where an indication of impairment exists, the carrying amount of goodwill is assessed and written down to its recoverable amount.

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Inventories are stated at the lower of cost or net realizable value with cost determined on a first-in, first-out basis. Net realizable value is the price at which inventories can be sold in the normal course of business after allowing for the costs of completion and disposal. Inventories are reduced by the write-off of obsolete and slow moving parts, which are determined based on management's assessment of their current status.

This provision requires judgment regarding the marketability of certain inventories as certain inventories may be identified as in good condition that are subsequently obsolete and which could result in a subsequent write-off of the related inventories to the statement of operations. Any change in the marketability of inventories that were not previously provided for could significantly change the calculation of reserves and the results of our operations.

Revenue recognition

No revenue is recognized unless there is persuasive evidence of an arrangement, the price to the buyer is fixed or determinable, delivery has occurred and collectibility of the sales price is reasonably assured. Revenue is recognized when title and risk of loss transfers to the customer, which is generally when the product is shipped to the customer from our facility. Shipping costs billed to our customers are included within revenue. Associated costs are classified in cost of goods sold.

In addition, the products sold by the company are subject to a limited product quality warranty. The company accrues for estimated incurred but unidentified quality issues based upon historical activity and known quality issues if a loss is probable and can be reasonably estimated. The standard limited warranty period is one to three years. Quality returns are accounted for as a reduction of revenue. Historically, we have not experienced material differences between our estimated sales reserves and actual results.

Long-Lived Assets Including Goodwill and Other Acquired Intangible Assets

Long-lived assets held and used by the Group and intangible assets, excluding goodwill, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. The Group evaluates recoverability of assets to be held and used by comparing the carrying amount of an asset to future net undiscounted cash flows to be generated by the asset. If such assets are considered to be impaired, the impairment loss is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets calculated using a discounted future cash flows analysis. For the year ended March 31, 2004, the Group made a provision for impairment of approximately \$161,000, included in administration and general expenses, on leasehold land and buildings due to the decline in market value.

Goodwill is subject to an annual impairment review. The evaluation of goodwill for impairment involves two steps: (1) the identification of potential impairment by comparing the fair value of a reporting unit with its carrying amount, including goodwill and (2) the measurement of the amount of goodwill loss by comparing the implied fair value of the reporting unit goodwill with the carrying amount of that goodwill and recognizing a loss by the excess of the latter over the former.

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Brand Name

Brand name acquired as part of the purchase of a business is capitalized based on the estimated fair value as at the date of acquisition and amortized using the straight-line method over the related estimated useful life of 15 years.

Expected useful lives are reviewed at each balance sheet date and, where these differ significantly from previous estimates, amortization periods are changed accordingly. Where an indication of impairment exists, such as the downturn of economic inflow from the brand name, changes in business plan and so on, the carrying amounts of brand name is assessed and written down to their recoverable amounts. The measurement of the fair value of brand name is subject to management's assumptions regarding future estimated cash flows, discount rates, etc. Changes in these assumptions could significantly affect the recording of an impairment charge related to this asset.

Trade Receivables

Provision is made against trade receivables to the extent that collection is considered to be doubtful. This provision requires judgment regarding the collectibility of certain receivables as certain receivables may be identified as collectible that are subsequently uncollectible and which could result in a subsequent write-off of the related receivable to the statement of operations. Any change in the collectibility of accounts receivable that were not previously provided for could significantly change the calculation of such provision and the results of our operations.

Deferred Income Taxes

Amounts in the consolidated financial statements related to income taxes are calculated using the principles of SFAS No. 109, "Accounting for Income Taxes". SFAS No. 109 requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the temporary differences between the financial reporting basis and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. As part of this process we are required to estimate our income taxes and tax bases of assets and liabilities in each of the jurisdictions in which we operate. This process involves us estimating our current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. We must then assess the likelihood of the recoverability of future tax benefits, such as net operating loss carry forwards, based on estimated future taxable income and recognize such benefits to the extent that realization is more likely than not to occur. To the extent

37

we establish a valuation allowance or increase this allowance in a period, we must include an expense within the tax provision in the statement of operations. Any change in the recoverability of the deferred tax assets could significantly affect the results of our operations or cash flows.

Research and Development, Patents and Licenses, etc.

We believe that our engineering and product development capabilities are important to the future success of our business. We have successfully lowered

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the costs of our research and development team by moving most research and development activities to our facility in China and principottom">

Interest-earning assets:

Loans and leases (*b*):

Commercial loans

\$
22,345

\$
420

7.45
%

\$
20,879

\$
389

7.39
%

\$
28

\$
3

\$
31

Commercial mortgage

11,117

205

7.31

9,833

181

7.31

24

24

Commercial construction

5,499

105

7.55

5,913

118

7.90

(8)

)

(5

)

(13

)

Commercial leases

3,700

39

4.23

3,740

46

4.85

(1

)

(6

)

(7

)

Subtotal commercial

42,661

769

7.15

40,365

734

7.21

43

(8
)

35

Residential mortgage loans

10,396

160

6.12

9,699

146

5.96

10

4

14

Home equity

11,752

226

7.63

12,174

235

7.67

(8
)

(1
)

(9
)

Automobile loans

10,865

174

6.34

9,522

140

5.84

21

13

34

Credit card

1,366

34

10.03

870

26

12.06

13

(5)

)

8

Other consumer loans/leases

1,204

16

5.23

1,308

16

4.77

(1

)

1

Subtotal consumer

35,583

610

6.80

33,573

563

6.66

35

12

47

Total loans and leases

78,244

1,379

6.99

73,938

1,297

6.96

78

4

82

Securities:

Taxable

11,180

141

5.00

20,836

231

4.39

(118
)

28

(90
)

Exempt from income taxes (b)

490

9

7.17

587

10

7.29

(1
)

(1
)

Other short-term investments

459

6

5.35

159

2

5.69

4

4

Total interest-earning assets

90,373

1,535

6.74

95,520

1,540

6.40

(37
)

32

(5
)

Cash and due from banks

2,228

2,355

Other assets

10,330

8,745

Allowance for loan and lease losses

(800)
)

(752
)

Total assets

**\$
102,131**

**\$
105,868**

Liabilities

Interest-bearing liabilities:

Interest checking

\$
14,334

\$
77

2.14
%

\$
16,251

\$
102

2.49
%

\$
(11
)

\$
(14
)

\$
(25
)

Savings

15,390

122

3.15

12,279

95

3.08

25

2

27

Money market

6,247

69

4.35

6,371

69

4.30

(1
)

1

Foreign office deposits

1,808

20

4.33

770

8

4.11

11

1

12

Other time deposits

10,290

119

4.61

10,794

116

4.24

(7
)

10

3

Certificates \$100,000 and over

6,062

78

5.11

6,415

81

5.03

(4
)

1

(3
)

Other foreign office deposits

1,981

26

5.12

2,898

39

5.30

(12
)

(1
)

(13
)

Federal funds purchased

4,322

56

5.15

4,546

61

5.33

(3
)

(2
)

(5
)

Other short-term borrowings

3,285

37

4.50

4,056

45

4.42

(9
)

1

(8
)

Long-term debt

12,351

171

5.47

14,355

205

5.66

(27
)

(7
)

(34
)

Total interest-bearing liabilities

76,070

775

4.04

78,735

821

4.14

(38
)

(8
)

(46
)

Demand deposits

13,143

13,642

Other liabilities

3,593

3,613

Total liabilities

92,806

95,990

Shareholders' equity

9,325

9,878

Total liabilities and shareholders' equity

\$
102,131

\$
105,868

Net interest income

\$
760

\$
719

\$
1

\$
40

\$
41

Net interest margin

3.34
%

2.99
%

Net interest rate spread

2.70

2.26

Interest-bearing liabilities to interest-earning assets

84.17

82.43

-
- (a) *Changes in interest not solely due to volume or yield/rate are allocated in proportion to the absolute dollar amount of change in volume and yield/rate.*
- (b) *The net taxable equivalent adjustment amounts included in the above table are \$6 million for the three months ended September 30, 2007 and 2006, respectively.*

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

TABLE 3: Consolidated Average Balance Sheets and Analysis of Net Interest Income (FTE)

For the nine months ended	September 30, 2007			September 30, 2006			Attribution of Change in Net Interest Income (a)		
	Average Balance	Revenue/Cost	Average Yield/Rate	Average Balance	Revenue/Cost	Average Yield/Rate	Volume	Rate	Total
(\$ in millions)									
Assets									
Interest-earning assets:									
Loans and leases (b):									
Commercial loans	\$ 21,619	\$ 1,207	7.47%	\$ 20,260	\$ 1,079	7.12%	\$ 75	\$ 53	\$ 128
Commercial mortgage	10,906	596	7.31	9,753	516	7.08	63	17	80
Commercial construction	5,701	327	7.67	5,987	340	7.58	(17)	4	(13)
Commercial leases	3,680	118	4.29	3,719	139	5.00	(2)	(19)	(21)
Subtotal commercial	41,906	2,248	7.17	39,719	2,074	6.98	119	55	174
Residential mortgage loans	10,255	471	6.13	9,418	416	5.90	38	17	55
Home equity	11,902	682	7.66	12,018	662	7.36	(6)	26	20
Automobile loans	10,551	494	6.26	9,481	401	5.65	48	45	93
Credit card	1,213	98	10.82	812	71	11.68	32	(5)	27
Other consumer loans/leases	1,233	48	5.22	1,448	53	4.92	(8)	3	(5)
Subtotal consumer	35,154	1,793	6.82	33,177	1,603	6.46	104	86	190
Total loans and leases	77,060	4,041	7.01	72,896	3,677	6.74	223	141	364
Securities:									
Taxable	11,054	414	5.01	21,527	712	4.42	(382)	84	(298)
Exempt from income taxes (b)	511	28	7.32	616	34	7.41	(6)		(6)
Other short-term investments	274	12	5.84	166	7	5.44	5		5
Total interest-earning assets	88,899	4,495	6.76	95,205	4,430	6.22	(160)	225	65
Cash and due from banks	2,260			2,528					
Other assets	10,332			8,467					
Allowance for loan and lease losses	(784)			(748)					
Total assets	\$ 100,707			\$ 105,452					
Liabilities									
Interest-bearing liabilities:									
Interest checking	\$ 14,964	\$ 248	2.22%	\$ 16,955	\$ 303	2.39%	\$ (34)	\$ (21)	\$ (55)
Savings	14,573	350	3.21	11,979	259	2.89	60	31	91
Money market	6,289	208	4.42	6,296	188	3.99		20	20
Foreign office deposits	1,598	52	4.35	626	18	3.77	31	3	34
Other time deposits	10,700	369	4.61	10,334	308	4.00	12	49	61
Certificates \$100,000 and over	6,416	247	5.14	5,473	191	4.66	35	21	56
Other foreign office deposits	1,032	40	5.19	3,406	125	4.91	(92)	7	(85)
Federal funds purchased	3,462	135	5.24	4,328	160	4.93	(34)	9	(25)
Other short-term borrowings	2,689	89	4.41	4,540	142	4.18	(61)	8	(53)
Long-term debt	12,276	510	5.55	14,649	582	5.31	(97)	25	(72)
Total interest-bearing liabilities	73,999	2,248	4.06	78,586	2,276	3.87	(180)	152	(28)

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Demand deposits	13,233	13,693			
Other liabilities	3,846	3,477			
Total liabilities	91,078	95,756			
Shareholders' equity	9,629	9,696			
Total liabilities and shareholders' equity	\$ 100,707	\$ 105,452			
Net interest income	\$ 2,247	\$ 2,154	\$ 20	\$ 73	\$ 93
Net interest margin	3.38%	3.03%			
Net interest rate spread	2.70	2.35			
Interest-bearing liabilities to interest-earning assets	83.24	82.54			

-
- (a) Changes in interest not solely due to volume or yield/rate are allocated in proportion to the absolute dollar amount of change in volume and yield/rate.
- (b) The net taxable equivalent adjustment amounts included in the above table are \$18 million and \$20 million for the nine months ended September 30, 2007 and 2006, respectively.

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

The cost of interest-bearing core deposits was 3.36% in the third quarter of 2007, which was an increase of 3 bp from 3.33% in the third quarter of 2006 and a decrease of 6 bp from 3.42% in the second quarter of 2007. The increase in the cost of interest-bearing core deposits from the prior year was due to the mix shift from interest checking to savings as well as an increase in foreign office deposits. The decrease from the second quarter of 2007 was the result of modest decreases in consumer deposit rates. The interest on core deposits increased \$17 million, or four percent, in the third quarter of 2007 over the comparable period in 2006 due to the mix shift between interest checking accounts and savings accounts and the increase of \$1.6 billion in average balances. The Bancorp continues to focus on growing its core deposit balances in order to improve the funding mix and improve net interest margins.

The interest on wholesale funding decreased \$63 million to \$368 million, or 15%, compared to the prior year quarter primarily due to the decrease of \$4.3 billion in average balances. Average short-term wholesale funding decreased \$2.3 billion, or 13%, while average long-term debt decreased \$2.0 billion, or 14%, in the third quarter of 2007 over the comparable period in 2006. The decline in wholesale funding balances is a result of the sale of investment securities in the fourth quarter 2006.

Provision for Loan and Lease Losses

The Bancorp provides as an expense an amount for probable loan and lease losses within the loan portfolio that is based on the factors discussed in the Critical Accounting Policies section. The provision is recorded to bring the allowance for loan and lease losses to a level deemed appropriate by management. Actual credit losses on loans and leases are charged against the allowance for loan and lease losses. The amount of loans and leases actually removed from the Condensed Consolidated Balance Sheets are referred to as charge-offs. Net charge-offs include current period charge-offs less current period recoveries. Current period recoveries relate to loans and leases charged-off in previous periods.

The provision for loan and lease losses increased to \$139 million in the third quarter of 2007 compared to \$87 million in the same period last year. The \$52 million increase is related to loan growth during the past year, increases in delinquencies and increases in severity of loss from the decline in the real estate market. The allowance for loan and lease losses as a percentage of loans and leases increased to 1.08% at September 30, 2007 from 1.06% at June 30, 2007 and 1.04% at September 30, 2006. The increase in allowance percentage from third quarter of 2006 is primarily due to an increase in nonperforming assets and net charge-off trends from \$411 million at September 30, 2006 to \$706 million at September 30, 2007.

Refer to the Credit Risk Management section for further information on the provision for loan and lease losses, net charge-offs and other factors considered by the Bancorp in assessing the credit quality of the loan portfolio and the allowance for loan and lease losses.

Noninterest Income

For the three and nine months ended September 30, 2007, noninterest income increased by nine percent and seven percent, respectively. The components of noninterest income for these periods are as follows:

TABLE 4: Noninterest Income

(\$ in millions)	For the three months ended September 30,			For the nine months ended September 30,		
	2007	2006	Percent Change	2007	2006	Percent Change
Electronic payment processing revenue	\$ 253	218	16	\$ 721	626	15
Service charges on deposits	151	134	13	419	395	6
Investment advisory revenue	95	89	7	288	276	4
Corporate banking revenue	91	79	15	261	236	11
Mortgage banking net revenue	26	36	(28)	107	125	(14)
Other noninterest income	93	87	6	267	242	10
Securities gains, net	13	19	(32)	14	34	(59)
Total noninterest income	\$ 722	662	9	\$ 2,077	1,934	7

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Electronic payment processing revenue increased \$35 million, or 16%, in the third quarter of 2007, compared to the same period last year as FTPS realized growth in each of its three main product lines: merchant processing, financial institutions and card issuer interchange. Merchant processing revenue increased 23%, to \$122 million, compared to the same period in 2006 due to the continued addition of new national merchant customers and resulting increases in merchant sales volumes. The Bancorp recently signed large national merchant contracts with Walgreen Co., which converted during the quarter, and the U.S. Department of Treasury, which is in the process of conversion. Financial institutions revenue increased seven percent, to \$78 million, as a result of continued success in attracting financial institution customers and increased debit card volumes associated with these customers. Card issuer interchange increased 15%, to \$53 million, compared to the same period in 2006 due to continued growth in credit card volumes. Through the third quarter of 2007, the Bancorp processed over 19.6 billion transactions and handled electronic processing for over 2,400 financial institutions and approximately 155,000 merchant locations worldwide.

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Service charges on deposits increased 13% and six percent for the three and nine months ended September 30, 2007, respectively, compared to the same period last year. The increase was driven by consumer deposit service charges, which increased 19% and 11% for the three and nine months ended September 30, 2007, respectively. Commercial deposit service charges increased five percent and one percent for the three and nine months ended September 30, 2007, respectively, compared to the same periods last year. Growth in the number of customer deposit account relationships and deposit generation continues to be a primary focus of the Bancorp.

Investment advisory revenues increased seven percent from the third quarter of 2006 primarily due to success in cross-sell initiatives within the private banking group and improved retail brokerage performance. Private banking revenue and securities and brokerage revenue increased ten percent and seven percent, respectively, in the third quarter of 2007, compared to the same period last year. Additionally, mutual fund revenue and institutional revenue increased three percent and two percent, respectively, in the third quarter of 2007, compared to the same period last year. The Bancorp continues to focus its sales efforts on improving execution in retail brokerage and retail mutual funds and on growing the institutional money management business by improving penetration and cross-selling in its large middle-market commercial customer base. The Bancorp is one of the largest money managers in the Midwest and, as of September 30, 2007, had approximately \$232 billion in assets under care and managed \$34 billion in assets for individuals, corporations and not-for-profit organizations.

Corporate banking revenue increased \$12 million, or 15%, in the third quarter of 2007, compared to the same period last year. The growth in corporate banking revenue was largely attributable to increased institutional sales revenue, customer derivatives income and syndication fees, as well as increased letter of credit fees as the Bancorp continues to fill out its suite of commercial products. The Bancorp is committed to providing a comprehensive range of financial services to large and middle-market businesses and continues to see opportunities to expand its product offering.

Mortgage banking net revenue decreased \$10 million and \$18 million for the three and nine months ended September 30, 2007, respectively, compared to the same periods last year. The components of mortgage banking net revenue for the three and nine months ended September 30, 2007 and 2006 are shown in Table 5. Originations in the third quarter of 2007 were \$3.0 billion compared to \$2.3 billion in the third quarter of 2006; however, origination fees and gains on loan sales decreased \$12 million compared to the same period last year as a result of lower margins on sales of mortgages affected by widening credit spreads in the residential mortgage market.

TABLE 5: Components of Mortgage Banking Net Revenue

(\$ in millions)	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Origination fees and gains (losses) on loan sales	\$ 9	21	61	69
Servicing revenue:				
Servicing fees	37	30	105	90
Servicing rights amortization	(23)	(18)	(66)	(49)
Net valuation adjustments on servicing rights and free-standing derivatives entered into to economically hedge MSR	3	3	7	15
Net servicing revenue	17	15	46	56
Mortgage banking net revenue	\$ 26	36	107	125

Mortgage net servicing revenue increased \$2 million and decreased \$10 million compared to the three and nine months ended September 30, 2006, respectively. Net servicing revenue is comprised of gross servicing fees and related amortization as well as valuation adjustments on mortgage servicing rights and mark-to-market adjustments on both settled and outstanding free-standing derivative financial instruments. The Bancorp's total residential mortgage loans serviced at September 30, 2007 and 2006 were \$43.1 billion and \$37.5 billion, respectively, with \$33.1 billion and \$27.8 billion, respectively, of residential mortgage loans serviced for others.

Temporary impairment on the MSR portfolio was \$9 million and \$3 million for the three months ended September 30, 2007 and 2006, respectively. Servicing rights are deemed impaired when a borrower's loan rate is distinctly higher than prevailing rates. Impairment on servicing rights is reversed when the prevailing rates return to a level commensurate with the borrower's loan rate. Further detail on the valuation of

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mortgage servicing rights can be found in Note 4 of the Notes to Condensed Consolidated Financial Statements. The Bancorp maintains a non-qualifying hedging strategy to manage a portion of the risk associated with changes in impairment on the MSR portfolio. The Bancorp recognized a net gain of \$12 million and \$6 million for the three months ended September 30, 2007 and 2006, respectively, related to changes in fair value and settlement of free-standing derivatives purchased to economically hedge the MSR portfolio. See Note 5 of the Notes to Condensed Consolidated Financial Statements for more information on the free-standing derivatives used to hedge the MSR portfolio. In addition to the derivative positions used to economically hedge the MSR portfolio, the Bancorp acquires various securities (primarily principal only strips) as a component of its non-qualifying hedging strategy. The Bancorp did not recognize any gain or loss on the sale of securities related to mortgage servicing rights during the third quarter of 2007 or 2006.

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Other noninterest income increased six percent in the third quarter of 2007 compared to the same period last year. This increase was primarily driven by a \$15 million gain recognized from the sale of FDIC deposit insurance credits. The Bancorp was allocated these one-time assessment credits based on historical deposit levels. Other noninterest income in the third quarter of 2006 included gains totaling \$10.5 million from the sale of three branches in rural Indiana and the sale of \$23 million of out-of footprint credit card receivables. Income from bank-owned life insurance declined to \$17 million in the third quarter of 2007 from \$21 million in the second quarter 2007 due to a lower crediting rate. The Bancorp expects a similar decline in the fourth quarter of 2007 subject to continuation of current market conditions. See Note 17 of the Notes to Condensed Consolidated Financial Statements for further information.

The major components of other noninterest income are as follows:

TABLE 6: Components of Other Noninterest Income

(\$ in millions)	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Bank owned life insurance income	\$ 17	21	59	65
Cardholder fees	14	13	40	36
Consumer loan and lease fees	13	13	33	37
Insurance income	8	7	24	21
Operating lease income	8	6	22	20
Banking center fees	7	5	20	16
Gain on loan sales		4	17	14
Gain on sale of FDIC deposit insurance credits	15		15	
Other	11	18	37	33
Total other noninterest income	\$ 93	87	267	242

Net securities gains totaled \$13 million in the third quarter 2007 compared with \$19 million in the third quarter 2006. The gains recognized during the current quarter were a result of the sale of securities from the Bancorp's available-for-sale securities portfolio.

Noninterest Expense

During the third quarter of 2007, the Bancorp continued its investment in the expansion of its retail distribution network and information technology infrastructure. The efficiency ratio (noninterest expense divided by the sum of net interest income (FTE) and noninterest income) was 60.3% and 55.5% for the third quarter of 2007 and 2006, respectively. The Bancorp continues to focus on efficiency initiatives, as part of its core emphasis on operating leverage, and on expense control, although cost savings initiatives will continue to be somewhat mitigated by investments in certain high opportunity markets as evidenced by the 14 additional banking centers added during the third quarter of 2007. The Bancorp views investments in information technology and de novo expansion as its platform for future growth and increasing expense efficiency.

The major components of noninterest expense are as follows:

TABLE 7: Noninterest Expense

(\$ in millions)	For the three months ended September 30,		Percent Change	For the nine months ended September 30,		Percent Change
	2007	2006		2007	2006	
Salaries, wages and incentives	\$ 310	288	8	\$ 912	875	4

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Employee benefits	67	74	(10)	222	230	(4)
Payment processing expense	105	84	25	294	236	25
Net occupancy expense	66	63	6	199	180	11
Technology and communications	41	36	15	122	102	20
Equipment expense	30	32	(7)	90	86	5
Other noninterest expense	275	190	44	650	548	19
Total noninterest expense	\$ 894	767	16	\$ 2,489	2,257	10

Total noninterest expense increased 16% and ten percent for the three and nine months ended September 30, 2007, respectively, primarily due to expense associated with the Visa/American Express anti-trust litigation settlement, investment in technology, higher de novo related expenses and increased volume-related processing expense. The eight percent increase in salaries, wages and incentives compared to the third quarter of 2006 was driven by revenue-based incentives expense. Employee benefits expense decreased ten percent compared to the third quarter of 2006. Benefits expense included \$6 million of pension settlement expense in the current quarter compared with \$8 million in the third quarter of 2006. Full time equivalent employees totaled 20,775 as of September 30, 2007 compared to 21,301 as of September 30, 2006.

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Payment processing expense includes third-party processing expenses, network membership charges, card management fees and other bankcard processing expenses. Payment processing expense increased 25% for the three and nine months ended 2007 compared to the same periods in 2006, as a result of these primarily volume-related processing expenses. Processing volumes increased 19% and 27% for the merchant processing and financial institutions businesses, respectively, for the three months ended September 30, 2007, compared to the same quarter last year. These businesses had similar growth in processing volumes for the nine months ended September 30, 2007 over the comparable period last year. Additionally, the increase in this caption reflects the conversion of national merchant contracts during the quarter.

Net occupancy expense increased six percent and 11% for the three and nine months ended September 30, 2007 due to the addition of 36 banking centers since September 30, 2006. The Bancorp remains focused on expanding its retail franchise through de novo growth.

The major components of other noninterest expense are as follows:

TABLE 8: Components of Other Noninterest Expense

(\$ in millions)	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Loan processing	\$ 29	27	84	67
Marketing	19	18	57	60
Travel	14	13	40	39
Postal and courier	13	12	38	37
Intangible amortization	10	11	31	33
Professional services fees	9	7	24	21
Supplies	8	7	22	21
Franchise and other taxes	7	7	16	25
Operating lease	5	4	15	14
Visa/American Express litigation settlement	78		78	
Other	83	84	245	231
Total other noninterest expense	\$ 275	190	650	548

Total other noninterest expense increased 44% and 19% for the three and nine months ended September 30, 2007, respectively, compared to the same periods in 2006 driven by the expense associated with the Visa/American Express anti-trust litigation settlement and increased loan processing costs associated with collection activities. This increase for the nine months ended September 30, 2007 was partially offset by a decline in franchise and other taxes that resulted from a favorable settlement related to the completion of certain tax audits during the second quarter of 2007. Other noninterest expense in the third quarter of 2006 included an \$11 million charge associated with the early extinguishment of debt.

Applicable Income Taxes

The Bancorp's income before income taxes, applicable income tax expense and effective tax rate for each of the periods are as follows:

TABLE 9: Applicable Income Taxes

(\$ in millions)	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Income before income taxes and cumulative effect	\$ 443	521	1,473	1,575
Applicable income taxes	118	144	414	456
Effective tax rate	26.7%	27.6	28.1	28.9

Applicable income tax expense for both periods includes the benefit from tax-exempt income, tax-advantaged investments and general business tax credits, partially offset by the effect of nondeductible expenses. Income tax expense for the third quarter of 2007 also included the expiration of statutes of limitations and state income tax law changes.

Cumulative Effect of Change in Accounting Principle

In the first quarter of 2006, the Bancorp recognized a benefit of approximately \$4 million, net of \$2 million of tax, related to the adoption of SFAS No. 123 (Revised 2004) Share-Based Payment. The benefit recognized relates to the Bancorp's estimate of forfeiture experience to be realized for all unvested stock-based awards outstanding.

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**BUSINESS SEGMENT REVIEW**

The Bancorp reports on five business segments: Commercial Banking, Branch Banking, Consumer Lending, Investment Advisors and Processing Solutions. Further detailed financial information on each business segment is included in Note 15 of the Notes to Condensed Consolidated Financial Statements.

Results of the Bancorp's business segments are presented based on its management structure and management accounting practices. The structure and accounting practices are specific to the Bancorp; therefore, the financial results of the Bancorp's business segments are not necessarily comparable with similar information for other financial institutions. The Bancorp refines its methodologies from time to time as management accounting practices are improved and businesses change. Revisions to the Bancorp's methodologies are applied on a retroactive basis. During the fourth quarter of 2006, the Bancorp changed the application of the provision for loan and lease losses to the segments to include only actual net charge-offs.

The Bancorp manages interest rate risk centrally at the corporate level by employing a funds transfer pricing (FTP) methodology. This methodology insulates the business segments from interest rate volatility, enabling them to focus on serving customers through loan originations and deposit taking. The FTP system assigns charge rates and credit rates to classes of assets and liabilities, respectively, based on expected duration and the Treasury swap curve. Matching duration, or the expected term until an instrument can be repriced, allocates interest income and interest expense to each segment so its resulting net interest income is insulated from interest rate risk. In a rising rate environment, the Bancorp benefits from the widening spread between deposit costs and wholesale funding costs. The net impact of the FTP methodology, including the benefit from the widening spread between deposit costs and wholesale funding, is captured in General Corporate and Other. During the fourth quarter of 2006, the Bancorp made certain changes to the average duration of indeterminate-lived deposits and corresponding changes to the FTP crediting rates assigned to those deposits. This change more closely aligns the crediting rates to the expected economic benefit while continuing to insulate the segments from interest rate volatility.

The financial results of the business segments include allocations for shared services and headquarters expenses. Even with these allocations, the financial results are not necessarily indicative of the business segments' financial condition and results of operations as if they were to exist as independent entities. Additionally, the business segments form synergies by taking advantage of cross-sell opportunities and when funding operations by accessing the capital markets as a collective unit. Net income by business segment is summarized as follows:

TABLE 10: Business Segment Results

(\$ in millions)	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Commercial Banking	\$ 161	162	481	462
Branch Banking	168	158	495	445
Consumer Lending	20	31	89	120
Investment Advisors	25	20	72	61
Processing Solutions	(17)	69	49	149
General Corporate and Other	(32)	(63)	(127)	(114)
Net income	\$ 325	377	1,059	1,123

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Commercial Banking

Commercial Banking provides a comprehensive range of financial services and products to large and middle-market businesses, governments and professional customers. In addition to the traditional lending and depository offerings, Commercial Banking products and services include, among others, cash management, foreign exchange and international trade finance, derivatives and capital markets services, asset-based lending, real estate finance, public finance, commercial leasing and syndicated finance. The table below contains selected financial data for the Commercial Banking segment.

TABLE 11: Commercial Banking

(\$ in millions)	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Income Statement Data				
Net interest income (FTE)	\$ 292	300	876	879
Provision for loan and lease losses	21	23	63	64
Noninterest income:				
Corporate banking revenue	82	73	238	216
Service charges on deposits	35	34	105	106
Other noninterest income	21	14	61	34
Noninterest expense:				
Salaries, incentives and benefits	63	58	194	180
Other noninterest expenses	128	118	379	352
Income before taxes	218	222	644	639
Applicable income taxes (a)	57	60	163	177
Net income	\$ 161	162	481	462
Average Balance Sheet Data				
Commercial loans	\$ 35,551	32,991	34,786	32,307
Demand deposits	5,397	5,862	5,485	5,804
Interest checking	4,049	3,857	3,997	3,828
Savings and money market	4,250	4,859	4,374	5,077
Certificates over \$100,000 and other time	1,673	1,985	1,858	1,659
Foreign office deposits	1,527	506	1,328	424

(a) Includes taxable-equivalent adjustments of \$4 million and \$3 million, respectively, for the three months ended September 30, 2007 and 2006 and \$10 million for the nine months ended September 30, 2007 and 2006.

Net income decreased \$1 million, or one percent, compared to the third quarter of 2006 as commercial loan growth and corporate banking revenue growth was offset by a decrease in commercial demand deposits and an increase in noninterest expense. Net interest income decreased \$8 million compared to the third quarter of 2006 as an increase in average loans and leases was offset by decreases in deposits, particularly commercial demand, which declined despite an increase in the number of commercial accounts due to lower average carrying balances by commercial customers. Average loans and leases increased eight percent to \$35.6 billion over the prior year third quarter, with double-digit growth occurring in commercial and industrial loans. Average core deposits increased one percent compared to the third quarter of 2006. Net charge-offs declined modestly from the third quarter of 2006 although delinquencies increased primarily due to construction lending concentrated in South Florida and Eastern Michigan. The Commercial Banking segment continues to focus on managing credit risk but expects to see charge-offs trend upward during the fourth quarter.

Noninterest income increased \$17 million, or 14%, compared to the same quarter last year due to a \$9 million increase in corporate banking revenue and a \$7 million increase in other noninterest income. Corporate banking revenue grew across all categories as the segment continues to see benefit related to the build out of its commercial product offerings. During 2007, the Commercial Banking segment introduced new treasury

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management products and remains focused on further penetration of middle-market customers and the healthcare industry throughout its affiliates. Other noninterest income improved due to increased volume of operating leases.

Noninterest expense increased \$15 million, or eight percent, compared to the third quarter of 2006 due to higher employee incentives and volume-related increases in operating lease expenses.

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Branch Banking

Branch Banking provides a full range of deposit and loan and lease products to individuals and small businesses through 1,181 banking centers. Branch Banking offers depository and loan products, such as checking and savings accounts, home equity lines of credit, credit cards and loans for automobile and other personal financing needs, as well as products designed to meet the specific needs of small businesses, including cash management services. The table below contains selected financial data for the Branch Banking segment.

TABLE 12: Branch Banking

(\$ in millions)	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Income Statement Data				
Net interest income	\$ 374	331	1,103	978
Provision for loan and lease losses	44	27	105	79
Noninterest income:				
Service charges on deposits	113	97	304	279
Card issuer interchange	48	43	140	122
Merchant and financial institutions processing	9	8	24	22
Investment advisory income	23	20	69	66
Other noninterest income	29	36	95	94
Noninterest expense:				
Salaries, incentives and benefits	119	112	357	341
Net occupancy and equipment expenses	43	38	128	114
Other noninterest expenses	130	114	380	339
Income before taxes	260	244	765	688
Applicable income taxes	92	86	270	243
Net income	\$ 168	158	495	445
Average Balance Sheet Data				
Consumer loans	\$ 11,872	11,503	11,731	11,387
Commercial loans	5,137	5,293	5,154	5,323
Demand deposits	5,734	5,786	5,760	5,856
Interest checking	8,310	10,194	8,909	10,867
Savings and money market	15,291	12,082	14,446	11,636
Certificates over \$100,000 and other time	13,073	13,649	13,626	12,691

Net income increased \$10 million, or six percent, compared to the third quarter of 2006 as retail banking benefited from the increase in interest rates and double digit growth in electronic payment processing revenue and consumer service charges. Average loans and leases increased modestly as growth from the introduction of a new mortgage product and increased credit card production was offset by a decrease in home equity line utilization. Average core deposits and average total deposits both increased two percent over the third quarter of 2006 with an increase in savings and money market accounts of \$3.2 billion, or 27%, mitigated by a \$1.9 billion, or 18%, decrease in interest checking deposits. As a result of the growth in core deposits and the related net FTP impact, net interest income increased \$43 million compared to the same period last year. Net charge-offs as a percent of average loan and leases increased to 103 bp from 64 bp in the third quarter of 2006.

Noninterest income increased \$18 million, or nine percent, compared to the third quarter of 2006. Service charges on deposits increased 17%, or \$16 million, compared to the third quarter of 2006 driven by new account openings and higher levels of customer activity. Electronic payment processing revenue increased \$6 million, or 11%, as card issuer interchange benefited from the organic growth of the Bancorp's credit card portfolio. Card issuer interchange fees, which comprise the majority of the Branch Banking's electronic payment processing revenues, increased from \$43 million in the third quarter of 2006 to \$48 million in the third quarter of 2007.

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Partially offsetting revenue growth was an increase in noninterest expense of 11% compared to the third quarter of 2006, related to the Bancorp's de novo growth strategy, which led to a 12% increase in net occupancy and equipment costs. Since the third quarter of 2006, 36 additional banking centers were opened. The Bancorp continues to position itself for sustained long-term growth through new banking center additions.

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)
Consumer Lending

Consumer Lending includes the Bancorp's mortgage and home equity lending activities and other indirect lending activities. Mortgage and home equity lending activities include the origination, retention and servicing of mortgage and home equity loans or lines of credit, sales and securitizations of those loans or pools of loans or lines of credit and all associated hedging activities. Other indirect lending activities include loans to consumers through dealers as well as federal and private student education loans. The table below contains selected financial data for the Consumer Lending segment.

TABLE 13: Consumer Lending

(\$ in millions)	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Income Statement Data				
Net interest income	\$ 85	90	264	275
Provision for loan and lease losses	40	24	93	64
Noninterest income:				
Mortgage banking net revenue	24	35	99	120
Other noninterest income	22	15	56	62
Noninterest expense:				
Salaries, incentives and benefits	19	23	63	77
Other noninterest expenses	41	45	126	131
Income before taxes	31	48	137	185
Applicable income taxes	11	17	48	65
Net income	\$ 20	31	89	120
Average Balance Sheet Data				
Residential mortgage loans	\$ 10,026	9,684	9,960	9,403
Home equity	1,324	1,348	1,354	1,295
Automobile loans	9,843	8,516	9,563	8,465
Consumer leases	872	1,254	952	1,392

Net income decreased \$11 million, or 36%, compared to the third quarter of 2006 due to decreased gain on sale margins and higher charge-offs. Net interest income decreased six percent from the prior year despite average loans and leases increasing six percent, due to a higher FTP charge resulting from higher noninterest-earning assets in comparison to the third quarter of 2006. Net charge-offs as a percent of average loan and leases increased from 48 bp in the third quarter of 2006 to 78 bp in the third quarter of 2007 due to greater severity of loss in the home equity portfolio related to declining real estate prices and increase of charge-offs in the automobile portfolio.

Consumer Lending had mortgage originations of \$2.9 billion and \$2.3 billion for the three months ended September 30, 2007 and 2006. Origination fees and gains on loan sales were \$7 million, a decrease of \$12 million, or 61%, compared to the third quarter of 2006. The overall decrease occurred despite the increase in mortgage originations as gains on sale were significantly affected by liquidity issues and increased credit spreads in secondary markets during the third quarter of 2007. Additionally, there was a higher mix of originations from the wholesale channel compared to the third quarter of 2006.

Noninterest expense decreased \$8 million, or 12%, primarily from lower salaries and related employee benefits expense due to a reduction in personnel compared to the prior year.

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)
Investment Advisors

Investment Advisors provides a full range of investment alternatives for individuals, companies and not-for-profit organizations. The Bancorp's primary services include trust, asset management, retirement plans, custody and private banking. Fifth Third Securities, Inc., an indirect wholly-owned subsidiary of the Bancorp, offers full service retail brokerage services to individual clients and broker dealer services to the institutional marketplace. Fifth Third Asset Management, Inc., an indirect wholly-owned subsidiary of the Bancorp, provides asset management services and also advises the Bancorp's proprietary family of mutual funds, Fifth Third Funds.* As of September 30, 2007, the Bancorp has \$232 billion in assets under care and \$34 billion in managed assets. The table below contains selected financial data for the Investment Advisors segment.

TABLE 14: Investment Advisors

(\$ in millions)	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Income Statement Data				
Net interest income	\$ 37	30	\$ 111	93
Provision for loan and lease losses	4	1	10	3
Noninterest income:				
Investment advisory income	96	89	291	277
Other noninterest income	6	5	17	14
Noninterest expense:				
Salaries, incentives and benefits	41	41	125	129
Other noninterest expenses	56	51	173	158
Income before taxes	38	31	111	94
Applicable income taxes	13	11	39	33
Net income	\$ 25	20	\$ 72	61
Average Balance Sheet Data				
Loans and leases	\$ 3,230	3,071	\$ 3,169	3,062
Core deposits	4,970	4,841	5,027	4,652

Net income increased \$5 million, or 25%, compared to the third quarter of 2006 as a result of increased deposits and fee growth. Net interest income increased to \$37 million, an increase of \$7 million as a result of average core deposit growth and the related increase in the FTP credit for these deposits. Investment advisors realized growth in most deposit categories offset by declines in interest checking.

Investment advisory income increased eight percent from the third quarter of 2006 as growth was realized in the majority of sub captions, including positive brokerage results. Increased brokerage staff contributed to the growth in brokerage income of \$3 million, or 11%, during the third quarter of 2007.

Noninterest expense grew five percent as compensation and incentives were flat and other noninterest expense grew nine percent in comparison to the same quarter last year.

*** FIFTH THIRD FUNDS® PERFORMANCE DISCLOSURE**

Fifth Third Funds investments are: NOT INSURED BY THE FDIC or any other government agency, are not deposits or obligations of, or guaranteed by, any bank, the distributor or of the Funds any of their respective affiliates, and involve investment risks, including the possible loss of the principal amount invested. An investor should consider the fund's investment objectives, risks and charges and expenses carefully before investing or sending money. The Funds' prospectus contains this and other important information about the Funds. To obtain a prospectus or any other information about Fifth Third Funds, please call 1-800-282-5706 or visit www.53.com. Please read the prospectus carefully before investing. **Fifth Third Funds are distributed by ALPS Distributors, Inc., member NASD, d/b/a FTAM Funds Distributor, Inc. ALPS Distributors, Inc. and FTAM Funds Distributor, Inc. are affiliated firms through direct ownership, although ALPS Distributors, Inc.**

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Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Processing Solutions

Fifth Third Processing Solutions provides electronic funds transfer, debit, credit and merchant transaction processing, operates the Jeanie® ATM network and provides other data processing services to affiliated and unaffiliated customers. The table below contains selected financial data for the Processing Solutions segment.

TABLE 15: Processing Solutions

(\$ in millions)	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Income Statement Data				
Net interest income	\$ 1	6	\$ 9	19
Provision for loan and lease losses	4	2	16	6
Noninterest income:				
Merchant processing	123	100	340	284
Financial institutions processing	84	76	249	221
Other noninterest income	3	6	21	12
Securities gains (losses), net		53		78
Noninterest expense:				
Salaries, incentives and benefits	19	17	56	52
Payment processing expense	104	81	290	222
Other noninterest expenses	110	35	179	103
Income before taxes	(26)	106	78	231
Applicable income taxes	(9)	37	29	82
Net income	\$ (17)	69	\$ 49	149

Net income decreased \$86 million compared to the third quarter of 2006 as the segment expensed \$78 million associated with the Visa/American Express anti-trust litigation settlement in the third quarter of 2007 and \$53 million gain from the sale of the Bancorp's MasterCard, Inc. shares in the third quarter of 2006. Excluding these transactions, pretax income declined by \$1 million, or two percent, compared to the third quarter of 2006 as revenue growth was offset by expense growth. Merchant and financial institution revenues increased by \$23 million, or 23%, and \$8 million, or 11%, respectively, primarily due to new national merchant customer additions and continued success in attracting financial institution customers, resulting in increased transaction volume. Strong merchant revenue growth is expected to continue as national contracts signed during the current year convert throughout the remainder of 2007.

Payment processing expense increased 29% due to higher association network charges resulting from increased transaction volume in addition to expenses related to the conversion of large national merchant contracts. Merchant transactions processed increased 19% and financial institution transactions processed increased 27% over the third quarter of 2006. Expenses are expected to moderate in future quarters to be more consistent with revenue growth while reflecting spread pressure during the renewal of current customer contracts. The Bancorp continues to see significant opportunities to attract new financial institution customers and retailers within this business segment.

General Corporate and Other

General Corporate and Other includes the unallocated portion of the investment securities portfolio, certain non-core deposit funding, unassigned equity and certain support activities and other items not attributed to the business segments.

Net income increased by \$31 million compared to the same quarter last year. The increase in net income is primarily due to \$13 million in net securities gains in the current quarter compared to \$34 million in net securities losses in the same quarter last year. This increase was offset by the growth in the provision for loan and leases losses, which was \$26 million in the third quarter of 2007 compared to \$10 million in the same quarter last year.

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

BALANCE SHEET ANALYSIS

Loans

The table below summarizes the end of period total loans and leases, which includes loans held for sale. The Bancorp classifies its loans and leases based upon the primary purpose of the loan.

TABLE 16: Components of Total Loans and Leases (includes held for sale)

(\$ in millions)	September 30, 2007		December 31, 2006		September 30, 2006	
	Balance	% of Total	Balance	% of Total	Balance	% of Total
Commercial:						
Commercial loans	\$ 23,317	29	\$ 20,831	28	\$ 21,260	29
Commercial mortgage loans	11,178	14	10,405	14	9,879	13
Commercial construction loans	5,463	7	6,168	8	5,879	8
Commercial leases	3,710	5	3,841	5	3,752	5
Total commercial loans and leases	43,668	55	41,245	55	40,770	55
Consumer:						
Residential mortgage loans	9,945	13	9,905	13	9,629	13
Home equity	11,737	15	12,154	16	12,235	16
Automobile loans	11,043	14	10,028	13	9,599	13
Credit card	1,460	2	1,004	1	876	1
Other consumer loans and leases	1,162	1	1,167	2	1,243	2
Total consumer loans and leases	35,347	45	34,258	45	33,582	45
Total loans and leases	\$ 79,015	100	\$ 75,503	100	\$ 74,352	100

Total loans and leases increased six percent over the third quarter of 2006. During the fourth quarter of 2006, the Bancorp reviewed its loan classifications, which resulted in a reclassification of approximately \$450 million of commercial loans to commercial mortgage loans. Prior period balances were not restated.

Total commercial loans and leases increased \$2.9 billion, or seven percent, compared to September 30, 2006. The increase was primarily due to strong growth in commercial loans, which increased ten percent compared to the third quarter of 2006. The increase in commercial loans is attributable to growth in balances related to the disruption in wholesale capital markets. Commercial mortgage loans increased 13% over the third quarter of 2006, while commercial construction loans decreased seven percent compared to the same period reflecting the conversion of construction loans to permanent financing. The overall mix of commercial loans is consistent with prior periods.

Total consumer loans and leases increased \$1.8 billion, or five percent, compared to September 30, 2006. Credit cards increased to \$1.5 billion, an increase of 67%, over the third quarter of 2006, as the Bancorp continues to place an emphasis on cross-selling credit cards to its existing retail customer base. Automobile loans increased by approximately \$1.4 billion, or 15%, due to more indirect financing relationships. Credit card and automobile loan growth was offset by the anticipated run-off in the consumer lease portfolio totaling \$346 million since the third quarter of 2006. Excluding this run-off, consumer loans and leases grew seven percent compared to the same quarter last year.

TABLE 17: Components of Average Total Loans and Leases (includes held for sale)

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(\$ in millions)	September 30, 2007		December 31, 2006		September 30, 2006	
	Balance	% of Total	Balance	% of Total	Balance	% of Total
Commercial:						
Commercial loans	\$ 22,345	29	\$ 21,228	28	\$ 20,879	28
Commercial mortgage loans	11,117	14	9,929	13	9,833	13
Commercial construction loans	5,499	7	6,099	8	5,913	8
Commercial leases	3,700	5	3,762	6	3,740	5
Total commercial loans and leases	42,661	55	41,018	55	40,365	54
Consumer:						
Residential mortgage loans	10,396	13	10,038	13	9,699	13
Home equity	11,752	15	12,225	16	12,174	17
Automobile loans	10,865	14	9,834	13	9,522	13
Credit card	1,366	2	915	1	870	1
Other consumer loans and leases	1,204	1	1,232	2	1,308	2
Total consumer loans and leases	35,583	45	34,244	45	33,573	46
Total average loans and leases	\$ 78,244	100	\$ 75,262	100	\$ 73,938	100
Total portfolio loans and leases (excludes held for sale)	\$ 76,295		\$ 74,032		\$ 72,903	

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Average commercial loans and leases increased \$2.3 billion, or six percent, compared to the third quarter of 2006. The increase in average commercial loans and leases was primarily driven by strong growth in commercial loans and commercial mortgage loans, which combined, increased nine percent over the third quarter of 2006. Growth in these products was realized in the majority of the Bancorp's markets, including the key growth market of Nashville, which experienced 26% growth.

Average consumer loans and leases increased \$2.0 billion, or six percent, compared to the third quarter of 2006 as a result of the growth in average credit card balances of \$496 million and an increase in average automobile loan balances of \$1.3 billion. The Bancorp experienced growth in the majority of its markets highlighted by 32% growth in Nashville, nine percent in Chicago and eight percent in Florida.

Investment Securities

Total investment securities were \$11.3 billion, \$11.6 billion and \$20.0 billion at September 30, 2007, December 31, 2006 and September 30, 2006, respectively. Securities are classified as available-for-sale when, in management's judgment, they may be sold in response to or in anticipation of changes in market conditions. The Bancorp's management has evaluated the securities in an unrealized loss position in the available-for-sale portfolio and maintains the intent and ability to hold these securities to the earlier of the recovery of the losses or maturity.

The following table provides a breakout of the components of investment securities.

TABLE 18: Components of Investment Securities (amortized cost basis)

(\$ in millions)	September 30,	December 31,	September 30,
	2007	2006	2006
Available-for-sale and other:			
U.S. Treasury and Government agencies	\$ 3	1,396	503
U.S. Government sponsored agencies	500	100	1,059
Obligations of states and political subdivisions	538	603	631
Agency mortgage-backed securities	8,290	7,999	14,778
Other bonds, notes and debentures	705	172	2,142
Other securities	971	966	990
Total available-for-sale and other securities	\$ 11,007	11,236	20,103
Held-to-maturity:			
Obligations of states and political subdivisions	\$ 344	345	348
Other bonds, notes and debentures	2	11	11
Total held-to-maturity	\$ 346	356	359

During the third quarter of 2007, net unrealized losses on the available-for-sale securities portfolio decreased from \$355 million at June 30, 2007 to \$230 million at September 30, 2007 due to decreasing interest rates across the Treasury yield curve. At September 30, 2007, 95% of the unrealized losses in the available-for-sale security portfolio were comprised of securities issued by U.S. Treasury and Government agencies, U.S. Government sponsored agencies and states and political subdivisions as well as agency mortgage-backed securities. The Bancorp believes the price movements in these securities were the result of the movement in market interest rates.

On an amortized cost basis, period end available-for-sale securities decreased \$229 million since December 31, 2006 and decreased \$9.1 billion since September 30, 2006. During the third quarter of 2007, the Bancorp purchased commercial paper from an unconsolidated qualified special purpose entity (QSPE) that is wholly owned by an independent third party. As of September 30, 2007, the Bancorp held approximately \$547 million of this commercial paper in its available-for-sale securities portfolio. See Note 6 of the Notes to Condensed Consolidated Financial Statements for further information on the unconsolidated QSPE. Approximately \$1.4 billion in U.S. Treasury and Government agency securities were reinvested into agency mortgage-backed securities throughout 2007. Additionally, the Bancorp sold approximately \$747 million of certain

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agency mortgage-backed securities during the third quarter of 2007 to reduce exposure to slowing prepayment speeds. The overall decrease from the third quarter of 2006 was a result of the balance sheet actions taken in the fourth quarter of 2006 to reduce the available-for-sale securities portfolio to a size that is more consistent with its liquidity, collateral and interest rate risk management requirements.

At September 30, 2007, available-for-sale securities were 12% of interest-earning assets, down from 13% at December 31, 2006 and 21% at September 30, 2006. The estimated weighted-average life of the debt securities in the available-for-sale portfolio was 5.7 years at September 30, 2007 compared to 4.3 years at December 31, 2006 and 4.1 years at September 30, 2006. The weighted-average yield of the debt securities in the available-for-sale portfolio was 5.51% at September 30, 2007 compared to 5.18% at December 31, 2006 and 4.66% at September 30, 2006.

Information presented in Table 19 is on a weighted-average life basis, anticipating future prepayments. Yield information is presented on an FTE basis and is computed utilizing historical cost balances. Maturity and yield calculations for the total available-for-sale portfolio exclude equity securities that have no stated yield or maturity.

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

TABLE 19: Characteristics of Available-for-Sale and Other Securities

As of September 30, 2007 (\$ in millions)	Amortized Cost	Fair Value	Weighted-Average Life (in years)	Weighted-Average Yield
U.S. Treasury and Government agencies:				
Average life of one year or less	\$	\$		%
Average life 1 - 5 years				
Average life 5 - 10 years				
Average life greater than 10 years	3	3	12.7	6.45
Total	3	3	12.3	6.48
U.S. Government sponsored agencies:				
Average life of one year or less	340	340	0.1	4.10
Average life 1 - 5 years	160	157	3.3	4.44
Average life 5 - 10 years				
Average life greater than 10 years				
Total	500	497	1.1	4.21
Obligations of states and political subdivisions (a):				
Average life of one year or less	96	96	0.5	7.64
Average life 1 - 5 years	339	344	2.8	7.15 (b)
Average life 5 - 10 years	67	69	6.5	7.22 (b)
Average life greater than 10 years	36	36	11.0	3.92 (b)
Total	538	545	3.4	7.25
Agency mortgage-backed securities:				
Average life of one year or less	152	152	0.1	5.78
Average life 1 - 5 years	1,708	1,682	3.5	4.89
Average life 5 - 10 years	6,334	6,137	7.3	5.65
Average life greater than 10 years	96	90	10.3	4.87
Total	8,290	8,061	6.4	5.48
Other bonds, notes and debentures (c):				
Average life of one year or less	550	550	0.1	5.46
Average life 1 - 5 years	85	84	3.3	4.63
Average life 5 - 10 years	31	31	5.2	5.63
Average life greater than 10 years	39	38	29.3	6.74
Total	705	703	2.2	5.44
Other securities (d)	971	968		
Total available-for-sale and other securities	\$ 11,007	\$ 10,777	5.7	5.51%

(a) Taxable-equivalent yield adjustments included in above table are 2.51%, 2.35%, 2.38%, 1.29% and 2.38% for securities with an average life of one year or less, 1-5 years, 5-10 years, greater than 10 years and in total, respectively.

(b) Weighted-average yield excludes \$1 million, \$17 million and \$35 million of securities with an average life of 1-5 years, 5-10 years and greater than 10 years, respectively, related to qualified zone academy bonds whose yields are realized through income tax credits. The weighted-average effective yield of these instruments is 6.77%.

(c)

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Other bonds, notes and debentures consist of commercial paper, non-agency mortgage backed securities, certain other asset backed securities (primarily automobile and commercial loan backed securities) and corporate bond securities.

(d) *Other securities consist of Federal Home Loan Bank (FHLB) and Federal Reserve Bank restricted stock holdings that are carried at cost, Federal Home Loan Mortgage Corporation (FHLMC) preferred stock holdings, certain mutual fund holdings and equity security holdings.*

Deposits

The table below summarizes the end of period total deposits by major category:

TABLE 20: Deposits

(\$ in millions)	September 30, 2007		December 31, 2006		September 30, 2006	
	Balance	% of Total	Balance	% of Total	Balance	% of Total
Demand	\$ 13,174	19	14,331	21	13,883	20
Interest checking	14,294	21	15,993	23	15,855	23
Savings	15,599	22	13,181	19	12,392	18
Money market	6,163	9	6,584	9	6,462	10
Foreign office	2,014	3	1,353	2	846	1
Transaction deposits	51,244	74	51,442	74	49,438	72
Other time	10,267	15	10,987	16	10,818	16
Core deposits	61,511	89	62,429	90	60,256	88
Certificates \$100,000 and over	5,973	8	6,628	9	6,871	10
Other foreign office	1,898	3	323	1	1,516	2
Total deposits	\$ 69,382	100	69,380	100	68,643	100

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Deposit balances represent an important source of funding and revenue growth opportunity. The Bancorp continues to focus on transaction account deposit growth in its retail and commercial franchises by expanding its retail franchise, enhancing its product offerings and providing competitive rates. During the first quarter of 2007, the Bancorp expanded its deposit product line by offering an equity-linked certificate of deposit and a new savings account to help customers identify and reach savings goals. At September 30, 2007, core deposits represented 59% of the Bancorp's asset funding base, compared to 57% at September 30, 2006.

During the third quarter of 2007, the Bancorp reclassified certain foreign office deposits as transaction deposits. Included in foreign office deposits are Eurodollar sweep accounts for the Bancorp's commercial customers. These accounts bear interest at rates slightly higher than money market accounts, but the Bancorp does not have to pay FDIC insurance nor hold collateral. The remaining foreign office balances are brokered deposits and the Bancorp uses these, as well as certificates of deposit \$100,000 and over, as a method to fund earning asset growth.

Overall, transaction and core deposit balances increased four percent and two percent, respectively, compared to September 30, 2006. Account balances continued to migrate from demand and interest checking accounts to savings. While the Bancorp continues to realize a mix shift as customers move from lower-yield transaction accounts to higher-yield savings and money market deposits, the pace of the shift decreased slightly compared to the prior year. Growth in foreign office deposits also contributed to the overall increase in core deposits.

The table below summarizes the average deposits by major category for the three months ended:

TABLE 21: Average Deposits

(\$ in millions)	September 30, 2007		December 31, 2006		September 30, 2006	
	Balance	% of Total	Balance	% of Total	Balance	% of Total
Demand	\$ 13,143	19	13,882	20	13,642	20
Interest checking	14,334	20	15,744	23	16,251	23
Savings	15,390	22	12,812	18	12,279	18
Money market	6,247	9	6,572	9	6,371	9
Foreign office	1,808	3	1,047	2	770	1
Transaction deposits	50,922	73	50,057	72	49,313	71
Other time	10,290	15	10,991	16	10,794	16
Core deposits	61,212	88	61,048	88	60,107	87
Certificates \$100,000 and over	6,062	9	6,750	10	6,415	9
Other foreign office	1,981	3	1,711	2	2,898	4
Total deposits	\$ 69,255	100	69,509	100	69,420	100

Average core deposits increased two percent compared to the third quarter of 2006 as increases in savings and foreign office deposits were offset by declines in interest checking, certificates of deposit and commercial demand deposits. Average core deposits increased in the majority of affiliates, including increases in the Nashville, Louisville and Lexington affiliates by 23%, 11% and 10%, respectively, compared to the third quarter of 2006.

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)**Borrowings**

Total short-term borrowings were \$8.9 billion at September 30, 2007 compared to \$4.2 billion at December 31, 2006 and \$9.3 billion at September 30, 2006. As of September 30, 2007, December 31, 2006 and September 30, 2006, total borrowings as a percentage of interest-bearing liabilities were 28%, 23% and 30%, respectively. The overall decrease in borrowings from the third quarter of 2006 is due to the balance sheet actions in the fourth quarter of 2006 offset by increases in federal funds purchased and other short-term borrowings during 2007.

The Bancorp continues to explore additional alternatives regarding the level and cost of various other sources of funding. Refer to the Liquidity Risk Management section for discussion on the Bancorp's liquidity management. In March and August 2007, Fifth Third Capital Trust IV and V, wholly-owned non-consolidated subsidiaries of the Bancorp, issued \$750 and \$575 million, respectively, of Tier I-qualifying trust preferred securities to third party investors and invested the proceeds in junior subordinated notes issued by the Bancorp. See Note 8 of the Notes to Condensed Consolidated Financial Statements for further discussion. In October 2007, Fifth Third Capital Trust VI, a wholly-owned non-consolidated subsidiary of the Bancorp, issued \$863 million of Tier I-qualifying trust preferred securities to third party investors and invested the proceeds in junior subordinated notes issued by the Bancorp. See Note 19 of the Notes to Condensed Consolidated Financial Statements for further discussion.

TABLE 22: Borrowings

	September 30,	December 31,	September 30,
(\$ in millions)	2007	2006	2006
Federal funds purchased	\$ 5,130	1,421	5,434
Other short-term borrowings	3,796	2,796	3,833
Long-term debt	12,498	12,558	14,170
Total borrowings	\$ 21,424	16,775	23,437

Quantitative and Qualitative Disclosure about Market Risk (Item 3)

RISK MANAGEMENT OVERVIEW

Managing risk is an essential component of successfully operating a financial services company. The Bancorp's risk management function is responsible for the identification, measurement, monitoring, control and reporting of risk and mitigation of those risks that are inconsistent with the Bancorp's risk profile. The Enterprise Risk Management division (ERM), led by the Bancorp's Chief Risk Officer, ensures consistency in the Bancorp's approach to managing and monitoring risk within the structure of the Bancorp's affiliate operating model. In addition, the Internal Audit division provides an independent assessment of the Bancorp's internal control structure and related systems and processes. The risks faced by the Bancorp include, but are not limited to, credit, market, liquidity, operational and regulatory compliance. ERM includes the following key functions:

Risk Policy - ensures consistency in the approach to risk management as the Bancorp's clearinghouse for credit, market and operational risk policies, procedures and guidelines;

Credit Risk Review - responsible for evaluating the sufficiency of underwriting, documentation and approval processes for consumer and commercial credits, counter-party credit risk, the accuracy of risk grades assigned to commercial credit exposure, and appropriate accounting for charge-offs, non-accrual status and specific reserves and reports directly to the Risk and Compliance Committee of the Board of Directors;

Consumer Credit Risk Management - responsible for credit risk management in consumer lending;

Capital Markets Risk Management - responsible for establishing and monitoring proprietary trading limits, monitoring liquidity and interest rate risk and utilizing value at risk and earnings at risk models;

Compliance Risk Management - responsible for oversight of compliance with all banking regulations;

Operational Risk Management - responsible for the risk self-assessment process, the change control evaluation process, fraud prevention and detection, and root cause analysis and corrective action plans relating to identified operational losses;

Insurance Risk Management - responsible for all property, casualty and liability insurance policies including the claims administration process for the Bancorp;

Investment Advisors Risk Management - responsible for trust compliance, fiduciary risk and trading risk in the Investment Advisors line of business; and

Risk Strategies and Reporting - responsible for quantitative analytics and Board of Directors and senior management reporting on credit, market and operational risk metrics.

Designated risk managers have been assigned to all business lines. Affiliate risk management is handled by regional risk managers who are responsible for multiple affiliates and who report jointly to affiliate presidents and ERM.

Risk management oversight and governance is provided by the Risk and Compliance Committee of the Board of Directors and through multiple management committees whose membership includes a broad cross-section of line of business, affiliate and support representatives. The Risk and Compliance Committee of the Board of Directors consists of five outside directors and has the responsibility for the oversight of credit, market, operational, regulatory compliance and strategic risk management activities for the Bancorp, as well as for the Bancorp's overall aggregate risk profile. The Risk and Compliance Committee of the Board of Directors has approved the formation of key management

governance committees that are responsible for evaluating risks and controls. These committees include the Market Risk Committee, the Corporate Credit Committee, the Credit Policy Committee, the Operational Risk Committee and the Executive Asset Liability Committee. There are also new products and initiatives processes applicable to every line of business to ensure an appropriate standard readiness assessment is performed before launching a new product or initiative. Significant risk policies approved by the management governance committees are also reviewed and approved by the Risk and Compliance Committee of the Board of Directors.

CREDIT RISK MANAGEMENT

The objective of the Bancorp's credit risk management strategy is to quantify and manage credit risk on an aggregate portfolio basis, as well as to limit the risk of loss resulting from an individual customer default. The Bancorp's credit risk management strategy is based on three core principles: conservatism, diversification and monitoring. The Bancorp believes that effective credit risk management begins with conservative lending practices. These practices include conservative exposure, counterparty limits and conservative underwriting, documentation and collection standards. The Bancorp's credit risk management strategy also emphasizes diversification on a geographic, industry and customer level, regular credit examinations and monthly management reviews of large credit exposures and credits experiencing deterioration of credit quality. Lending officers with the authority to extend credit are delegated specific authority amounts, the utilization of which is closely monitored. Lending activities are largely centralized, while ERM manages the policy and authority delegation process directly. The Credit Risk Review function, within ERM, provides objective assessments of the quality of underwriting and documentation, the accuracy of risk grades and the charge-off and reserve analysis process.

The Bancorp's credit review process and overall assessment of required allowances is based on quarterly assessments of the probable estimated losses inherent in the loan and lease portfolio. The Bancorp uses these assessments to promptly identify potential problem loans or leases within the portfolio, maintain an adequate reserve and take any necessary charge-offs. In addition to the individual review of larger commercial loans that exhibit probable or observed credit weaknesses, the commercial credit review process includes the use of two risk grading systems. The risk grading system currently utilized for reserve analysis

Quantitative and Qualitative Disclosure about Market Risk (continued)

purposes encompasses ten categories. The Bancorp also maintains a dual risk rating system that provides for thirteen probabilities of default grade categories and an additional six grade categories for estimating actual losses given an event of default. The probability of default and loss given default evaluations are not separated in the ten-grade risk rating system. The Bancorp is in the process of completing significant validation and testing of the dual risk rating system prior to implementation for reserve analysis purposes. The dual risk rating system is expected to be consistent with Basel II expectations and allows for more precision in the analysis of commercial credit risk. Scoring systems, various analytical tools and delinquency monitoring are used to assess the credit risk in the Bancorp's homogenous consumer loan portfolios.

Commercial Portfolio

The Bancorp's credit risk management strategy includes minimizing concentrations of risk through diversification. The following table provides breakouts of the commercial loan and lease portfolio, including held for sale, by major industry classification, by loan size and by state, illustrating the diversity and granularity of the Bancorp's portfolio.

TABLE 23: Commercial Loan and Lease Portfolio (a)

As of September 30 (\$ in millions)	2007			2006		
	Outstanding	Exposure	Nonaccrual	Outstanding	Exposure	Nonaccrual
By industry:						
Real estate	\$ 11,003	13,708	97	10,312	12,770	46
Manufacturing	5,856	12,546	25	4,927	10,892	51
Construction	5,293	8,631	133	5,496	8,987	41
Retail trade	3,982	7,170	23	3,476	6,269	23
Transportation and warehousing	2,368	2,888	18	2,031	2,373	5
Healthcare	2,113	3,725	13	1,766	2,965	6
Business services	2,048	3,947	22	1,859	3,495	12
Wholesale trade	2,048	3,888	32	1,962	3,789	11
Financial services and insurance	1,695	5,915	6	1,556	4,520	4
Individuals	1,163	1,505	15	1,483	1,953	15
Other services	1,015	1,452	14	968	1,340	10
Accommodation and food	919	1,357	14	869	1,279	10
Communication and information	760	1,360	1	622	1,115	
Public administration	751	965		800	990	
Other	632	1,572	6	759	1,300	4
Agribusiness	622	816		622	816	8
Entertainment and recreation	590	857	5	568	852	
Mining	478	858	5	264	590	1
Utilities	332	1,141	2	320	1,221	
Total	\$ 43,668	74,301	431	40,660	67,516	247
By loan size:						
Less than \$200,000	4%	3	11	5	3	13
\$200,000 to \$1 million	15	11	27	17	13	26
\$1 million to \$5 million	29	24	41	32	27	42
\$5 million to \$10 million	16	15	16	17	16	19
\$10 million to \$25 million	22	24	5	20	24	
Greater than \$25 million	14	23		9	17	
Total	100%	100	100	100	100	100
By state:						
Ohio	25%	29	26	25	28	37

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Michigan	21	19	34	22	20	20
Illinois	10	10	11	10	10	6
Florida	10	8	9	10	9	8
Indiana	9	8	11	9	9	19
Kentucky	6	6	4	6	6	6
Tennessee	3	3	2	3	3	2
Pennsylvania	2	2		1	2	
Missouri	1	1		1	1	
West Virginia			1			
Out-of-footprint	13	14	2	13	12	2
Total	100%	100	100	100	100	100

(a) *Outstanding reflects total commercial customer loan and lease balances, including held for sale and net of unearned income, and exposure reflects total commercial customer lending commitments.*

Quantitative and Qualitative Disclosure about Market Risk (continued)

The commercial portfolio is characterized by 87% of outstanding balances and 86% of exposures concentrated within the Bancorp's primary market areas of Ohio, Kentucky, Indiana, Michigan, Illinois, Florida, Tennessee, West Virginia, Pennsylvania, and Missouri. Exclusive of the national large-ticket leasing business, the commercial portfolio is characterized by 93% of outstanding balances and 90% of exposures concentrated within these ten states. The mortgage and construction segments of the commercial portfolio are characterized by 97% of outstanding balances and exposures concentrated within these ten states.

Residential Mortgage Portfolio

The Bancorp manages credit risk in the mortgage portfolio through conservative underwriting and documentation standards and geographic and product diversification. The Bancorp may also package and sell loans in the portfolio without recourse or may purchase mortgage insurance for the loans sold in order to mitigate credit risk.

Certain mortgage products have contractual features that may increase credit exposure to the Bancorp in the event of a decline in housing prices. These types of mortgage products offered by the Bancorp include high loan-to-value (LTV) ratios, multiple loans on the same collateral that when combined result in a high LTV (80/20) and interest-only loans. Table 24 provides the amount of these loans as a percent of the residential mortgage loans in the Bancorp's portfolio and the delinquency rates of these loan products as of September 30, 2007 and 2006. Table 25 shows the Bancorp's originations of these products for the three months ended September 30, 2007 and 2006. The Bancorp does not currently originate mortgage loans that permit customers to defer principal payments or make payments that are less than the accruing interest.

TABLE 24: Residential Mortgage Outstandings

As of September 30 (\$ in millions)	2007			2006		
	Amount	Percent of total	Delinquency Ratio	Amount	Percent of total	Delinquency Ratio
Greater than 80% LTV with no mortgage insurance	\$ 1,855	21%	6.89%	\$ 1,949	22%	3.56%
Interest-only	1,567	18	1.44	1,216	14	.08
Greater than 80% LTV and interest-only	514	6	3.68	561	6	.38
80/20 loans				37		

The Bancorp also sells certain of these mortgage products in the secondary market with recourse. The outstanding balances and delinquency rates for these loans sold with recourse as of September 30, 2007 and 2006 were \$1.6 billion and 2.36% and \$1.1 billion and 1.66%, respectively.

TABLE 25: Residential Mortgage Originations

(\$ in millions)	2007		2006	
	Amount	Percent of total	Amount	Percent of total
For the three months ended September 30:				
Greater than 80% LTV with no mortgage insurance	\$ 45	2%	\$ 153	7%
Interest-only	438	16	310	14
Greater than 80% LTV and interest-only			19	1
80/20 loans	66	2	133	6
For the nine months ended September 30:				
Greater than 80% LTV with no mortgage insurance	243	3	545	8
Interest-only	1,496	17	924	13
Greater than 80% LTV and interest-only	19		172	2
80/20 loans	177	2	349	5
80/20 loans and interest-only	44	1		

The Bancorp originates certain non-conforming residential mortgage loans known as Alt-A. Borrower qualifications are comparable to other conforming residential mortgage products and the Bancorp has sold the majority of these loans into the secondary market without recourse. For

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the three and nine months ended September 30, 2007, the Bancorp originated \$71 million and \$644 million of Alt-A loans. During 2007, approximately \$150 million of Alt-A loans were moved from held for sale to held for investment, and an impairment charge of approximately \$3 million was recognized in mortgage banking net revenue. As of September 30, 2007, the Bancorp held \$163 million of Alt-A loans for investment with approximately \$2 million on nonaccrual status. As market conditions for these loans changed throughout 2007, management responded by making adjustments to underwriting standards and, as of September 30, 2007, all Alt-A loans are being underwritten and sold under an agency flow sale agreement.

Analysis of Nonperforming Assets

A summary of nonperforming assets is included in Table 26. Nonperforming assets include: (i) nonaccrual loans and leases for which ultimate collectibility of the full amount of the principal and/or interest is uncertain; (ii) loans and leases that have been renegotiated to provide for a reduction or deferral of interest or principal because of deterioration in the financial position of the borrower and (iii) other assets, including other real estate owned and repossessed equipment. Loans are placed on nonaccrual status

Quantitative and Qualitative Disclosure about Market Risk (continued)

when the principal or interest is past due 90 days or more (unless the loan is both well secured and in process of collection) and payment of the full principal and/or interest under the contractual terms of the loan are not expected. Additionally, loans are placed on nonaccrual status upon deterioration of the financial condition of the borrower. When a loan is placed on nonaccrual status, the accrual of interest, amortization of loan premium, accretion of loan discount and amortization or accretion of deferred net loan fees or costs are discontinued and previously accrued but unpaid interest is reversed. At least quarterly, commercial loans on nonaccrual status are reviewed for impairment and, if present, an allowance is recorded based on the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the underlying collateral. If the principal or a portion of principal is deemed a loss, the loss amount is charged off to the allowance for loan and lease losses.

As of September 30, 2007, nonaccrual credits as a percent of total loans and leases were .75%, compared to .43% as of September 30, 2006. As of September 30, 2007, 74% of total nonaccrual credits were secured by real estate compared to 57% as of September 30, 2006.

TABLE 26: Summary of Nonperforming Assets and Delinquent Loans

(\$ in millions)	September 30,	December 31,	September 30,
	2007	2006	2006
Commercial loans	\$ 175	127	157
Commercial mortgage	146	84	49
Commercial construction	105	54	31
Commercial leases	5	6	11
Residential mortgage	68	38	34
Consumer loans and leases (a)	48	43	38
Consumer restructured loans	22		
Total nonaccrual loans and leases	569	352	320
Other assets, including other real estate owned	137	103	91
Total nonperforming assets	\$ 706	455	411
Commercial loans	\$ 45	38	33
Commercial mortgage	41	17	19
Commercial construction loans	54	6	10
Commercial leases	3	2	3
Residential mortgage (b)	116	68	65
Credit card	24	16	13
Consumer loans and leases (a)	77	63	53
Total 90 days past due loans and leases	\$ 360	210	196
Nonperforming assets as a percent of total loans, leases and other assets, including other real estate owned	.92%	.61	.56
Allowance for loan and lease losses as a percent of total nonperforming assets	117	170	185

(a) Includes home equity, automobile and other consumer loans and leases.

(b) Information for all periods presented excludes advances made pursuant to servicing agreements to Government National Mortgage Association (GNMA) mortgage pools whose repayments are insured by the Federal Housing Administration or guaranteed by the Department of Veterans Affairs. As of September 30, 2007, December 31, 2006 and September 30, 2006, these advances were \$19 million, \$14 million and \$11 million, respectively.

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Commercial nonaccrual credits as a percent of commercial loans increased since the third quarter of 2006, from .61% to 1.00%. The majority of the increase continues to be driven by the real estate and construction industries in the Southern Florida, Northeastern Ohio and Eastern Michigan affiliates. As shown in Table 23, the real estate and construction industries contributed to more than two-thirds of the increase in nonaccrual credits. As of September 30, 2007, the Bancorp has outstanding loans to homebuilders of \$1.4 billion, exposure of \$2.4 billion and \$49 million of nonaccrual credits.

Consumer nonaccrual credits as a percent of consumer loans increased since the third quarter of 2006, from .22% to .41%. The increase in consumer nonaccrual credits is primarily attributable to the housing markets in the Michigan and Florida affiliates, the changes in policy for the repossession of automobiles and the restructuring of certain high risk loans. Michigan and Florida nonaccrual credits contributed to 57% of the increase in nonaccrual credits in the consumer loan portfolio. The Bancorp has devoted significant attention to loss mitigation activities and, during the past year, decreased the timing between delinquency and repossession of automobiles and proactively restructured certain real estate loans with borrowers located in high-risk areas. These changes contributed approximately \$30 million in additional nonaccrual loans as of September 30, 2007.

Total nonperforming assets were \$706 million at September 30, 2007, compared to \$455 million at December 31, 2006 and \$411 million at September 30, 2006. Nonperforming assets as percentage of total loans, leases and other assets, including other real estate owned increased to .92% as of September 30, 2007 compared to .61% as of December 31, 2006 and .56% as of September 30, 2006. Total loans and leases 90 days past due have increased from \$196 million as of September 30, 2006 to \$360 million as of

Quantitative and Qualitative Disclosure about Market Risk (continued)

September 30, 2007, with the majority of the increase in the real estate and construction industries in the Michigan and Florida affiliates.

Analysis of Net Loan Charge-offs

The table below provides a summary of credit loss experience and net charge-offs as a percentage of average loans and leases outstanding by loan category:

TABLE 27: Summary of Credit Loss Experience

(\$ in millions)	For the three months		For the nine months	
	ended September 30, 2007	2006	ended September 30, 2007	2006
Losses charged off:				
Commercial loans	\$ (24)	(29)	(71)	(95)
Commercial mortgage loans	(8)	(8)	(30)	(16)
Commercial construction loans	(5)	(1)	(17)	(4)
Commercial leases			(1)	(3)
Residential mortgage loans	(9)	(5)	(25)	(16)
Home equity	(29)	(16)	(70)	(49)
Automobile loans	(32)	(21)	(80)	(62)
Credit card	(14)	(9)	(37)	(25)
Other consumer loans and leases	(6)	(7)	(20)	(21)
Total losses	(127)	(96)	(351)	(291)
Recoveries of losses previously charged off:				
Commercial loans	1	4	10	16
Commercial mortgage loans		1	1	2
Commercial construction loans				
Commercial leases		1	1	5
Residential mortgage loans				
Home equity	2	2	6	8
Automobile loans	7	6	25	24
Credit card	1	1	6	4
Other consumer loans and leases	1	2	14	13
Total recoveries	12	17	63	72
Net losses charged off:				
Commercial loans	(23)	(25)	(61)	(79)
Commercial mortgage loans	(8)	(7)	(29)	(14)
Commercial construction loans	(5)	(1)	(17)	(4)
Commercial leases		1		2
Residential mortgage loans	(9)	(5)	(25)	(16)
Home equity	(27)	(14)	(64)	(41)
Automobile loans	(25)	(15)	(55)	(38)
Credit card	(13)	(8)	(31)	(21)
Other consumer loans and leases	(5)	(5)	(6)	(8)
Total net losses charged off	\$ (115)	(79)	(288)	(219)
Net charge-offs as a percent of average loans and leases (excluding held for sale):				
Commercial loans	.41%	.47	.38	.52

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Commercial mortgage loans	.26	.30	.36	.19
Commercial construction loans	.35	.07	.40	.08
Commercial leases	(.01)	(.12)	.01	(.07)
Total commercial loans	.33	.32	.35	.32
Residential mortgage loans	.41	.27	.39	.25
Home equity	.94	.46	.72	.46
Automobile loans	.91	.63	.70	.54
Credit card	3.59	3.82	3.40	3.49
Other consumer loans and leases	1.99	1.09	.49	.78
Total consumer loans	.93	.57	.72	.52
Total net losses charged off	.60%	.43	.51	.41

Net charge-offs as a percent of average loans and leases outstanding were 60 bp in the third quarter of 2007, an increase from 52 bp and 43 bp for the quarter ended December 31, 2006 and September 30, 2006, respectively. Commercial charge-offs were modestly higher than the prior year as the increase in commercial real estate charge-offs was offset by lower commercial loan charge-offs.

Quantitative and Qualitative Disclosure about Market Risk (continued)

Compared to the prior year, consumer charge-offs increased 36 bp and 20 bp for the three and nine months ended September 30, 2007, primarily due to the home equity and automobile portfolios. Home equity charge-offs increased due to the depressed housing markets in Michigan and Florida. Automobile charge-offs increased as a result of increased loss severity due to a market surplus of used automobiles.

Allowance for Credit Losses

The allowance for credit losses is comprised of the allowance for loan and lease losses and the reserve for unfunded commitments. The allowance for loan and lease losses provides coverage for probable and estimable losses in the loan and lease portfolio. The Bancorp evaluates the allowance each quarter to determine its adequacy to cover inherent losses. Several factors are taken into consideration in the determination of the overall allowance for loan and lease losses, including an unallocated component. These factors include, but are not limited to, the overall risk profile of the loan and lease portfolios, net charge-off experience, the extent of impaired loans and leases, the level of nonaccrual loans and leases, the level of 90 days past due loans and leases and the overall percentage level of the allowance for loan and lease losses. The Bancorp also considers overall asset quality trends, credit administration and portfolio management practices, risk identification practices, credit policy and underwriting practices, overall portfolio growth, portfolio concentrations and current national and local economic conditions that might impact the portfolio. The Bancorp continues to monitor recent developments in the credit markets.

In the current year, the Bancorp has not substantively changed any material aspect of its overall approach in the determination of the allowance for loan and lease losses and there have been no material changes in assumptions or estimation techniques as compared to prior periods that impacted the determination of the current period allowance. In addition to the allowance for loan and lease losses, the Bancorp maintains a reserve for unfunded commitments (recorded in other liabilities on the Condensed Consolidated Balance Sheet). The methodology used to determine the adequacy of this reserve is similar to the Bancorp's methodology for determining the allowance for loan and lease losses. The provision for unfunded commitments is included in other noninterest expense on the Condensed Consolidated Statements of Income.

TABLE 28: Changes in Allowance for Credit Losses

(\$ in millions)	For the three months		For the nine months	
	ended September 30, 2007	2006	ended September 30, 2007	2006
Allowance for loan and lease losses:				
Beginning balance	\$ 803	753	771	744
Net losses charged off	(115)	(79)	(288)	(219)
Provision for loan and lease losses	139	87	344	236
Ending balance	\$ 827	761	827	761
Reserve for unfunded commitments:				
Beginning balance	\$ 77	74	76	70
Provision for unfunded commitments	2	2	3	6
Ending balance	\$ 79	76	79	76

The allowance for loan and lease losses as a percent of the total loan and lease portfolio increased to 1.08% at September 30, 2007 from 1.04% at December 31, 2006 and September 30, 2006.

MARKET RISK MANAGEMENT

Market risk arises from the potential for fluctuations in interest rates, foreign exchange rates and equity prices that may result in potential reductions in net income. Interest rate risk, a component of market risk, is the exposure to adverse changes in net interest income or financial position due to changes in interest rates. Management considers interest rate risk a prominent market risk in terms of its potential impact on earnings. Interest rate risk can occur for any one or more of the following reasons:

Assets and liabilities may mature or reprice at different times;

Short-term and long-term market interest rates may change by different amounts; or

The remaining maturity of various assets or liabilities may shorten or lengthen as interest rates change.

In addition to the direct impact of interest rate changes on net interest income, interest rates can indirectly impact earnings through their effect on loan demand, credit losses, mortgage origination fees, the value of servicing rights and other sources of the Bancorp's earnings. Stability of the Bancorp's net interest income is largely dependent upon the effective management of interest rate risk. Management continually reviews the Bancorp's balance sheet composition and models the interest rate risk, and possible actions to reduce this risk, given numerous future interest rate scenarios.

Quantitative and Qualitative Disclosure about Market Risk (continued)

Net Interest Income Simulation Model

The Bancorp employs a variety of measurement techniques to identify and manage its interest rate risk, including the use of an earnings simulation model to analyze net interest income sensitivity to changing interest rates. The model is based on contractual and assumed cash flows and repricing characteristics for all of the Bancorp's financial instruments and incorporates market-based assumptions regarding the effect of changing interest rates on the prepayment rates of certain assets and liabilities. The model also includes senior management projections of the future volume and pricing of each of the product lines offered by the Bancorp as well as other pertinent assumptions on the balance sheet. Actual results will differ from these simulated results due to timing, magnitude and frequency of interest rate changes as well as changes in market conditions and management strategies.

The Bancorp's Executive Asset Liability Committee (ALCO), which includes senior management representatives and is accountable to the Risk and Compliance Committee of the Board of Directors, monitors and manages interest rate risk within Board approved policy limits. In addition to the risk management activities of ALCO, the Bancorp has a Market Risk Management function as part of ERM that provides independent oversight of market risk activities. The Bancorp's current interest rate risk exposure is determined by measuring the anticipated change in net interest income over 12-month and 24-month horizons assuming a 200 bp parallel ramped increase or decrease in market interest rates. In accordance with the current policy, the rate movements are assumed to occur over one year and are sustained thereafter.

The following table shows the Bancorp's estimated earnings sensitivity profile and the ALCO policy limits on the asset and liability positions as of September 30, 2007:

TABLE 29: Estimated Earnings Sensitivity Profile

Change in Interest Rates (bp)	Change in Net Interest Income (FTE)		ALCO Policy Limits	
	12 Months	13 to 24 Months	12 Months	13 to 24 Months
+200	(.02)%	2.96	(5.00)	(7.00)
+100	.09	1.57		
-100	.64	.79		
-200	1.52	.03	(5.00)	(7.00)

Economic Value of Equity

The Bancorp also employs economic value of equity (EVE) as a measurement tool in managing interest rate sensitivity. Whereas net interest income simulation highlights exposures over a relatively short time horizon, the EVE analysis incorporates all cash flows over the estimated remaining life of all balance sheet and derivative positions. The EVE of the balance sheet, at a point in time, is defined as the discounted present value of asset and derivative cash flows less the discounted value of liability cash flows. The sensitivity of EVE to changes in the level of interest rates is a measure of the longer-term interest rate risk. In contrast to the net interest income simulation, which assumes interest rates will change over a period of time, EVE uses instantaneous changes in rates. EVE values only the current balance sheet and does not incorporate the growth assumptions used in the net interest income simulation model. As with the net interest income simulation model, assumptions about the timing and variability of balance sheet cash flows are critical in the EVE analysis. Particularly important are the assumptions driving prepayments and the expected changes in balances and pricing of the transaction deposit portfolios.

The following table shows the Bancorp's EVE sensitivity profile and the ALCO policy limits as of September 30, 2007:

TABLE 30: Estimated EVE Sensitivity Profile

Change in Interest Rates (bp)	Change in EVE	ALCO Policy Limits
+200	(5.53)%	(20.0)
-200	3.02	(20.0)

While an instantaneous shift in interest rates is used in this analysis to provide an estimate of exposure, the Bancorp believes that a gradual shift in interest rates would have a much more modest impact. Since EVE measures the discounted present value of cash flows over the estimated lives of instruments, the change in EVE does not directly correlate to the degree that earnings would be impacted over a shorter time horizon

(i.e., the current fiscal year). Further, EVE does not take into account factors such as future balance sheet growth, changes in product mix, changes in yield curve relationships and changing product spreads that could mitigate the adverse impact of changes in interest rates. The net interest income simulation and EVE analyses do not necessarily include certain actions that management may undertake to manage this risk in response to anticipated changes in interest rates.

Use of Derivatives to Manage Interest Rate Risk

An integral component of the Bancorp's interest rate risk management strategy is its use of derivative instruments to minimize significant fluctuations in earnings and cash flows caused by changes in market interest rates. Examples of derivative instruments that the Bancorp may use as part of its interest rate risk management strategy include interest rate swaps, interest rate floors, interest rate caps, forward contracts, principal only swaps, options and swaptions.

Quantitative and Qualitative Disclosure about Market Risk (continued)

As part of its overall risk management strategy relative to its mortgage banking activity, the Bancorp enters into forward contracts accounted for as free-standing derivatives to economically hedge interest rate lock commitments that are also considered free-standing derivatives.

The Bancorp also establishes derivative contracts with reputable third parties to economically hedge significant exposures assumed in commercial customer accommodation derivative contracts. Generally, these contracts have similar terms in order to protect the Bancorp from market volatility. Credit risks arise from the possible inability of counterparties to meet the terms of their contracts, which the Bancorp minimizes through approvals, limits and monitoring procedures. The notional amount and fair values of these derivatives as of September 30, 2007 are included in Note 5 of the Notes to Condensed Consolidated Financial Statements.

Portfolio Loans and Leases and Interest Rate Risk

Although the Bancorp's portfolio loans and leases contain both fixed and floating/adjustable rate products, the rates of interest earned by the Bancorp on the outstanding balances are generally established for a period of time. The interest rate sensitivity of loans and leases is directly related to the length of time the rate earned is established. The following table summarizes the expected principal cash flows of the Bancorp's portfolio loans and leases as of September 30, 2007:

TABLE 31: Portfolio Loan and Lease Principal Cash Flows

(\$ in millions)	Greater than				Total
	Less than 1 year	1	5 years	5 years	
Commercial loans	\$ 12,410	8,816	1,423	22,649	
Commercial mortgage loans	4,899	4,614	1,577	11,090	
Commercial construction loans	3,876	1,311	276	5,463	
Commercial leases	589	1,483	1,638	3,710	
Subtotal - commercial loans	21,774	16,224	4,914	42,912	
Residential mortgage loans	2,498	3,851	2,708	9,057	
Home equity	2,182	4,843	4,712	11,737	
Automobile loans	3,567	5,816	623	10,006	
Credit card	201	1,259		1,460	
Other consumer loans and leases	491	552	39	1,082	
Subtotal - consumer loans	8,939	16,321	8,082	33,342	
Total	\$ 30,713	32,545	12,996	76,254	

Segregated by interest rate type, the following is a summary of expected principal cash flows occurring after one year as of September 30, 2007:

TABLE 32: Portfolio Loan and Lease Principal Cash Flows Occurring After One Year

(\$ in millions)	Interest Rate	
	Fixed	Floating or Adjustable
Commercial loans	\$ 2,517	7,722
Commercial mortgage loans	2,174	4,017
Commercial construction loans	322	1,265
Commercial leases	3,121	

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Subtotal - commercial loans	8,134	13,004
Residential mortgage loans	3,617	2,942
Home equity	1,656	7,899
Automobile loans	6,439	
Credit card	275	984
Other consumer loans and leases	528	63
Subtotal - consumer loans	12,515	11,888
Total	\$ 20,649	24,892

Mortgage Servicing Rights and Interest Rate Risk

The net carrying amount of the MSR portfolio was \$621 million and \$498 million as of September 30, 2007 and 2006, respectively. The Bancorp maintains a non-qualifying hedging strategy relative to its mortgage banking activity and consults with an independent third-party specialist in order to manage a portion of the risk associated with changes in the value of its MSR portfolio as a result of changing interest rates. The value of servicing rights can fluctuate sharply depending on changes in interest rates and other factors. Generally, as interest rates decline and loans are prepaid to take advantage of refinancing, the total value of existing servicing rights declines because no further servicing fees are collected on repaid loans.

Quantitative and Qualitative Disclosure about Market Risk (continued)

The decrease in spread between current interest rates charged and the earning interest rate of the serviced mortgage portfolio resulted in temporary impairment of \$9 million during the third quarter of 2007 compared to a temporary impairment charge of \$3 million in the third quarter of 2006. Servicing rights are deemed impaired when a borrower's loan rate is distinctly higher than prevailing rates. Impairment on servicing rights is reversed when the prevailing rates return to a level commensurate with the borrower's loan rate. The Bancorp recognized a net gain of \$12 million and \$6 million for the three months ended September 30, 2007 and 2006, respectively, related to changes in the fair value and settlement of free-standing derivatives purchased to economically hedge the MSR portfolio. See Note 4 of the Notes to Condensed Consolidated Financial Statements for further discussion on servicing rights.

Foreign Currency Risk

The Bancorp may enter into foreign exchange derivative contracts to economically hedge certain foreign denominated loans. The derivatives are classified as free-standing instruments with the revaluation gain or loss being recorded in other noninterest income on the Condensed Consolidated Statements of Income. The balance of the Bancorp's foreign denominated loans at September 30, 2007 and 2006 was approximately \$262 million and \$266 million, respectively. The Bancorp also enters into foreign exchange contracts for the benefit of commercial customers involved in international trade to hedge their exposure to foreign currency fluctuations. The Bancorp has internal controls in place to ensure excessive risk is not being taken in providing this service to customers. These controls include an independent determination of currency volatility and credit equivalent exposure on these contracts, counterparty credit approvals and country limits.

LIQUIDITY RISK MANAGEMENT

The goal of liquidity management is to provide adequate funds to meet changes in loan and lease demand or unexpected deposit withdrawals. This goal is accomplished by maintaining liquid assets in the form of investment securities, maintaining sufficient unused borrowing capacity in the national money markets and delivering consistent growth in core deposits. The estimated weighted-average life of the available-for-sale portfolio was 5.7 years at September 30, 2007, based on current prepayment expectations. Of the \$10.8 billion (fair value basis) of securities in the available-for-sale portfolio at September 30, 2007, \$2.5 billion in principal and interest is expected to be received in the next 12 months, and an additional \$1.5 billion is expected to be received in the next 13 to 24 months. In addition to the sale of available-for-sale securities, asset-driven liquidity is provided by the Bancorp's ability to sell or securitize loan and lease assets. In order to reduce the exposure to interest rate fluctuations and to manage liquidity, the Bancorp has developed securitization and sale procedures for several types of interest-sensitive assets. A majority of the long-term, fixed-rate single-family residential mortgage loans underwritten according to FHLMC or Federal National Mortgage Association (FNMA) guidelines are sold for cash upon origination. Additional assets such as jumbo fixed-rate residential mortgages, certain floating rate short-term commercial loans, certain floating-rate home equity loans and other consumer loans are also capable of being securitized, sold or transferred off-balance sheet. For the nine months ended September 30, 2007 and 2006, a total of \$9.4 billion and \$6.9 billion, respectively, were sold, securitized or transferred off-balance sheet.

During the third quarter of 2007, an indirect, wholly-owned special purpose subsidiary of the Bancorp established an effective shelf registration with the U.S. Securities and Exchange Commission (SEC) to issue up to \$5.0 billion in securities backed by automobile loans originated by the Bancorp's Ohio and Michigan subsidiary Banks. Additionally, during the third quarter the Bancorp reclassified approximately \$1.0 billion in automobile loans to loans held for sale and entered into an interest rate swap with a \$1.0 billion notional amount to hedge the forecasted sale and securitization of such loans in the fourth quarter. In the fourth quarter, the Bancorp increased the forecasted sale and securitization by \$1.0 billion and entered into an additional \$1.0 billion interest rate swap. The effect of the forecasted sale and securitization and related hedges on our financial results for the fourth quarter of 2007 will depend on future market developments and related management decisions. However, current estimates are that pretax income could be reduced by up to \$20 million.

Additionally, the Bancorp has a shelf registration in place with the SEC permitting ready access to the public debt markets and qualifies as a well-known seasoned issuer under SEC rules. As of September 30, 2007, \$1.7 billion of debt or other securities were available for issuance from this shelf registration under the current Bancorp's Board of Directors' authorizations and subsequently used to issue \$863 million of trust preferred securities in October 2007. See Note 19 of the Notes to Condensed Consolidated Financial Statements for further information on this issuance. The Bancorp also has \$16.1 billion of funding available for issuance through private offerings of debt securities pursuant to its bank note program. These sources, in addition to a 9.13% average equity capital base, provide the Bancorp with a stable funding base.

Core deposits have historically provided the Bancorp with a sizeable source of relatively stable and low cost funds. The Bancorp's average core deposits and shareholders' equity funded 69% of its average total assets during the third quarter of 2007. In addition to core deposit funding, the Bancorp also accesses a variety of other short-term and long-term funding sources, which include the use of various regional Federal Home Loan Banks as a funding source. Certificates carrying a balance of \$100,000 or more and deposits in the Bancorp's foreign branch located in the Cayman Islands are wholesale funding tools utilized to fund asset growth. Management does not rely on any one source of liquidity and

manages availability in response to changing balance sheet needs.

Quantitative and Qualitative Disclosure about Market Risk (continued)

CAPITAL MANAGEMENT

The Bancorp maintains a relatively high level of capital as a margin of safety for its depositors and shareholders. At September 30, 2007, shareholders' equity was \$9.3 billion, compared to \$10.0 billion at December 31, 2006 and September 30, 2006. Average shareholders' equity as a percentage of average assets for the third quarter of 2007 was 9.13% compared to 9.33% in the same quarter last year. Tangible equity as a percent of tangible assets was 6.83% and 7.40% at September 30, 2007 and 2006, respectively. The decline in shareholders' equity and the tangible equity ratio are a result of the \$1.1 billion in share repurchases during 2007.

During 2007, the Bancorp raised approximately \$2.2 billion in Tier I-qualifying funding through three separate issuances of trust preferred securities. In March 2007, Fifth Third Capital Trust IV, a wholly-owned non-consolidated subsidiary of the Bancorp, issued \$750 million of Tier I-qualifying trust preferred securities to third party investors and invested the proceeds in junior subordinated notes issued by the Bancorp. In August 2007, Fifth Third Capital Trust V, a wholly-owned non-consolidated subsidiary of the Bancorp, issued \$575 million of Tier I-qualifying trust preferred securities to third party investors and invested the proceeds in junior subordinated notes issued by the Bancorp. Additionally, in October 2007, Fifth Third Capital Trust VI, a wholly owned non-consolidated subsidiary of the Bancorp, issued \$863 million of Tier I-qualifying trust preferred securities to third party investors and invested the proceeds in junior subordinated notes issued by the Bancorp. See Note 8 and Note 19 of the Notes to Condensed Consolidated Financial Statements for further discussion of these issuances.

Regulatory capital ratios remain comparable with the prior year as the impact of the share repurchases and growth in risk weighted assets was offset by the March and August issuances of Tier I-qualifying trust preferred securities. In September 2007, the Bancorp entered into a material definitive agreement to repurchase all issued and outstanding shares of its Fifth Third REIT Series B Preferred Stock on December 27, 2007. The carrying value of the Series B Preferred Stock, which qualifies as Tier 1 capital, is expected to be approximately \$690 million at the purchase date. The negative impact to the regulatory ratios from the repurchase of the REIT shares will be offset by the \$863 million of trust preferred securities issued in October 2007.

The Bancorp completed its acquisition of R-G Crown Bank in the fourth quarter. The integration of Crown is expected to reduce tangible and regulatory capital levels by approximately 40 bp.

The Federal Reserve Board adopted quantitative measures that assign risk weightings to assets and off-balance sheet items and also define and set minimum regulatory capital requirements (risk-based capital ratios). The guidelines define "well-capitalized" ratios of Tier I, total risk-based capital and leverage as 6%, 10% and 5%, respectively. The Bancorp exceeded these "well-capitalized" ratios for all periods presented.

TABLE 33: Regulatory Capital

(\$ in millions)	September 30,	December 31,	September 30,
	2007	2006	2006
Tier I capital	\$ 9,201	8,625	8,810
Total risk-based capital	11,824	11,385	10,817
Risk-weighted assets	108,754	102,823	101,940
Regulatory capital ratios:			
Tier I capital	8.46%	8.39	8.64
Total risk-based capital	10.87	11.07	10.61
Tier I leverage	9.23	8.44	8.52

Dividend Policy

The Bancorp's common stock dividend policy reflects its earnings outlook, desired payout ratios, the need to maintain adequate capital levels and alternative investment opportunities. The Bancorp's quarterly dividend for the third quarter of 2007 was \$.42 per share, consistent with the second quarter of 2007 quarterly dividend and an increase of five percent over the \$.40 per share declared in the third quarter of 2006.

Stock Repurchase Program

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On January 18, 2005, the Bancorp announced that its Board of Directors had authorized management to purchase 20 million shares of the Bancorp's common stock through the open market or in any private transaction. The timing of the purchases and the exact number of shares to be purchased was dependent upon market conditions. The authorization did not include specific price targets or an expiration date. During 2007, the Bancorp repurchased the remaining 16 million shares under this authorization.

On May 21, 2007, the Bancorp announced that its Board of Directors had authorized management to purchase 30 million shares of the Bancorp's common stock through the open market or in any private transaction. The timing of the purchases and the exact number of shares to be purchased depends upon market conditions. The authorization does not include specific price targets or an

Quantitative and Qualitative Disclosure about Market Risk (continued)

expiration date. During the second and third quarter of 2007, the Bancorp repurchased approximately 8 million and 3 million shares, respectively, under this authorization. At September 30, 2007, the Bancorp had approximately 19 million shares remaining under the current Board of Directors' authorization.

The Bancorp's third quarter 2007 repurchases of common shares were as follows:

TABLE 34: Share Repurchases

Period	Total Number of Shares Purchased (a)	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 1, 2007 - July 31, 2007	400,818	\$ 38.67	395,900	21,711,518
August 1, 2007 - August 31, 2007	2,510,007	\$ 37.78	2,510,000	19,201,518
September 1, 2007 - September 30, 2007	1,455			19,201,518
Total	2,912,280	\$ 37.92	2,905,900	19,201,518

(a) The Bancorp repurchased 4,918, 7 and 1,455 shares during July, August and September of 2007, respectively, in connection with various employee compensation plans. These purchases are not included in the calculation for average price paid per share and do not count against the maximum number of shares that may yet be purchased under the Board of Directors' authorization.

OFF-BALANCE SHEET ARRANGEMENTS

The Bancorp consolidates all of its majority-owned subsidiaries for which the Bancorp is the primary beneficiary. Other entities, including certain joint ventures, in which there is greater than 20% ownership, but upon which the Bancorp does not possess, nor can exert, significant influence or control, are accounted for by equity method accounting and not consolidated. Those entities in which there is less than 20% ownership are generally carried at the lower of cost or fair value.

The Bancorp's derivative product policy and investment policies provide a framework within which the Bancorp and its affiliates may use certain authorized financial derivatives as a market risk management tool in meeting the Bancorp's ALCO capital planning directives and to hedge changes in fair value of its largely fixed-rate mortgage servicing rights portfolio. The Bancorp also provides qualifying commercial customers access to the derivative market, including foreign exchange, interest rate and commodity contracts. The Bancorp may economically hedge significant exposures related to these derivative contracts entered into for the benefit of customers by entering into offsetting contracts with approved, reputable, independent counterparties with matching terms that are generally settled daily. These policies are reviewed and approved annually by the Risk and Compliance Committee of the Board of Directors.

Through September 30, 2007 and 2006, the Bancorp had transferred, subject to credit recourse, certain primarily floating-rate, short-term, investment grade commercial loans to an unconsolidated QSPE that is wholly owned by an independent third-party. The outstanding balance of such loans at September 30, 2007 and 2006 was \$3.0 billion and \$3.4 billion, respectively. These loans may be transferred back to the Bancorp upon the occurrence of certain specified events. These events include borrower default on the loans transferred, bankruptcy preferences initiated against underlying borrowers and ineligible loans transferred by the Bancorp to the QSPE. The maximum amount of credit risk in the event of nonperformance by the underlying borrowers is approximately equivalent to the total outstanding balance. In addition, the Bancorp's agreement to provide liquidity support to the QSPE was \$4.0 billion and \$3.8 billion as of September 30, 2007 and 2006. At September 30, 2007 and 2006, the Bancorp's loss reserve related to the liquidity support and credit enhancement provided to the QSPE was \$13 million and \$14 million, respectively, and was recorded in other liabilities on the Condensed Consolidated Balance Sheets.

At the end of the third quarter of 2007, the Bancorp purchased asset-backed commercial paper from the QSPE due to widening credit spreads in the commercial paper market. As of September 30, 2007, the amount of commercial paper held was \$547 million. In October 2007, credit spreads narrowed and the Bancorp reduced its holdings to \$20 million as of October 31, 2007.

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The Bancorp utilizes securitization trusts formed by independent third parties to facilitate the securitization process of residential mortgage loans, certain floating-rate home equity lines of credit, certain automobile loans and other consumer loans. The cash flows to and from the securitization trusts are principally limited to the initial proceeds from the securitization trust at the time of sale with subsequent cash flows relating to interests that continue to held by the Bancorp. The Bancorp's securitization policy permits the retention of subordinated tranches, servicing rights, interest-only strips, residual interests, credit recourse and, in some cases, a cash reserve account. At September 30, 2007, the Bancorp had retained servicing assets totaling \$626 million, subordinated tranche security interests totaling \$4 million and residual interests totaling \$11 million. At September 30, 2006, the Bancorp had retained servicing assets totaling \$504 million, subordinated tranche security interests totaling \$19 million and residual interests totaling \$22 million. The Bancorp had the following cash flows with these unconsolidated QSPEs during the nine months ended September 30, 2007 and 2006:

Quantitative and Qualitative Disclosure about Market Risk (continued)

TABLE 35: Cash Flows with Unconsolidated QSPEs

For the nine months ended September 30 (\$ in millions)	2007	2006
Proceeds from transfers, including new securitizations	\$ 1,114	1,288
Proceeds from collections reinvested in revolving-period securitizations	55	76
Fees received	23	26

As of September 30, 2007 and 2006, the Bancorp had provided credit recourse on approximately \$1.6 billion and \$1.3 billion, respectively, of residential mortgage loans sold to unrelated third parties. In the event of any customer default, pursuant to the credit recourse provided, the Bancorp is required to reimburse the third party. The maximum amount of credit risk in the event of nonperformance by the underlying borrowers is equivalent to the total outstanding balance. In the event of nonperformance, the Bancorp has rights to the underlying collateral value attached to the loan. As of September 30, 2007 and 2006, the Bancorp maintained an estimated credit loss reserve recorded in other liabilities on the Condensed Consolidated Balance Sheets of approximately \$18 million relating to these residential mortgage loans sold. To determine the credit loss reserve, the Bancorp used an approach that is consistent with its overall approach in estimating credit losses for various categories of residential mortgage loans held in its loan portfolio.

CONTRACTUAL OBLIGATIONS AND COMMITMENTS

The Bancorp has certain obligations and commitments to make future payments under contracts. At September 30, 2007, the aggregate contractual obligations and commitments were:

TABLE 36: Contractual Obligations and Other Commitments

As of September 30, 2007 (\$ in millions)	Greater than				Total
	Less than 1 year	1-3 years	3-5 years	5 years	
Contractually obligated payments due by period:					
Total deposits	\$ 67,350	498	14	1,520	69,382
Long-term debt (a)	2,156	2,489	1,009	6,844	12,498
Short-term borrowings (b)	8,926				8,926
Noncancelable leases (c)	88	158	122	402	770
Partnership investment commitments (d)	302				302
Capital expenditures (e)	92				92
Purchase obligations	22	29	9		60
Total contractually obligated payments due by period	\$ 78,936	3,174	1,154	8,766	92,030
Other commitments by expiration period:					
Commitments to extend credit (f)	\$ 27,191	19,881			47,072
Letters of credit (g)	2,825	3,117	1,942	446	8,330
Total other commitments by expiration period	\$ 30,016	22,998	1,942	446	55,402

- (a) In the banking industry, interest-bearing obligations are principally used to fund interest-earning assets. As such, interest charges on contractual obligations were excluded from reported amounts, as the potential cash outflows would have corresponding cash inflows from interest-earning assets.
- (b) Includes federal funds purchased, bank notes, securities sold under repurchase agreements and borrowings with an original maturity of less than one year. For additional information, see the Borrowings discussion in the Balance Sheet Analysis section of Management Discussion and Analysis.

- (c) *Includes both operating and capital leases.*
- (d) *Includes low-income housing, historic and new market tax credit investments.*
- (e) *Includes commitments to various general contractors for work related to banking center construction.*
- (f) *Commitments to extend credit are agreements to lend, typically having fixed expiration dates or other termination clauses that may require payment of a fee. Many of the commitments to extend credit may expire without being drawn upon. The total commitment amounts do not necessarily represent future cash flow requirements.*
- (g) *Letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party.*

As of September 30, 2007, the Bancorp has unrecognized tax benefits that, if recognized, would impact the effective tax rate in future periods. Due to the uncertainty of the amounts to be ultimately paid as well as the timing of such payments, all uncertain tax liabilities that have not been paid have been excluded from the Contractual Obligations and Other Commitments table. Further detail on the impact of income taxes is located in Note 7 of the Notes to Condensed Consolidated Financial Statements.

Controls and Procedures (Item 4)

The Bancorp conducted an evaluation, under the supervision and with the participation of the Bancorp's management, including the Bancorp's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Bancorp's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act). Based on the foregoing, as of the end of the period covered by this report, the Bancorp's Chief Executive Officer and Chief Financial Officer concluded that the Bancorp's disclosure controls and procedures were effective, in all material respects, to ensure that information required to be disclosed in the reports the Bancorp files and submits under the Exchange Act is recorded, processed, summarized and reported as and when required and to provide reasonable assurance that information required to be disclosed by the Bancorp in such reports is accumulated and communicated to the Bancorp's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

On May 11, 2007, the Bancorp filed an amended 2006 Form 10-K to restate the Consolidated Statements of Cash Flows for the annual periods 2006, 2005 and 2004. The restatement did not affect the Bancorp's Consolidated Statements of Income, Consolidated Balance Sheet or Consolidated Statements of Changes in Shareholders' Equity for any of the affected periods. Accordingly, the Bancorp's historical revenues, net income, earnings per share, total assets and regulatory capital remained unchanged. The facts and circumstances surrounding this restatement had no impact on the Bancorp's assessment of disclosure controls and procedures as of the end of the period covered by this report.

The Bancorp's management also conducted an evaluation of internal control over financial reporting to determine whether any changes occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Bancorp's internal control over financial reporting. Based on this evaluation, there has been no such change during the period covered by this report.

Fifth Third Bancorp and Subsidiaries

Condensed Consolidated Financial Statements and Notes (Item 1)

CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)

	September 30,	As of December 31,	September 30,
(\$ in millions, except share data)	2007	2006	2006
Assets			
Cash and due from banks	\$ 2,540	2,737	2,399
Available-for-sale and other securities (a)	10,777	11,053	19,514
Held-to-maturity securities (b)	346	356	359
Trading securities	155	187	164
Other short-term investments	720	809	125
Loans held for sale	2,761	1,150	872
Portfolio loans and leases:			
Commercial loans	22,649	20,831	21,260
Commercial mortgage loans	11,090	10,405	9,879
Commercial construction loans	5,463	6,168	5,879
Commercial leases	3,710	3,841	3,751
Residential mortgage loans	9,057	8,830	8,811
Home equity	11,737	12,153	12,235
Automobile loans	10,006	10,028	9,599
Credit card	1,460	1,004	876
Other consumer loans and leases	1,082	1,093	1,190
Portfolio loans and leases	76,254	74,353	73,480
Allowance for loan and lease losses	(827)	(771)	(761)
Portfolio loans and leases, net	75,427	73,582	72,719
Bank premises and equipment	2,127	1,940	1,902
Operating lease equipment	283	202	142
Goodwill	2,192	2,193	2,193
Intangible assets	138	166	175
Servicing rights	626	524	504
Other assets	6,173	5,770	4,760
Total Assets	\$ 104,265	100,669	105,828
Liabilities			
Deposits:			
Demand	\$ 13,174	14,331	13,883
Interest checking	14,294	15,993	15,855
Savings	15,599	13,181	12,392
Money market	6,163	6,584	6,462
Other time	10,267	10,987	10,818
Certificates - \$100,000 and over	5,973	6,628	6,871
Foreign office	3,912	1,676	2,362
Total deposits	69,382	69,380	68,643
Federal funds purchased	5,130	1,421	5,434
Other short-term borrowings	3,796	2,796	3,833
Accrued taxes, interest and expenses	2,295	2,283	2,156
Other liabilities	1,871	2,209	1,570

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Long-term debt	12,498	12,558	14,170
Total Liabilities	94,972	90,647	95,806
Shareholders Equity			
Common stock (c)	1,295	1,295	1,295
Preferred stock (d)	9	9	9
Capital surplus	1,768	1,812	1,799
Retained earnings	8,593	8,317	8,473
Accumulated other comprehensive income	(198)	(179)	(392)
Treasury stock	(2,174)	(1,232)	(1,162)
Total Shareholders Equity	9,293	10,022	10,022
Total Liabilities and Shareholders Equity	\$ 104,265	100,669	105,828

(a) Amortized cost: **September 30, 2007 - \$11,007**, December 31, 2006 - \$11,236 and September 30, 2006 - \$20,103.

(b) Market values: **September 30, 2007 - \$346**, December 31, 2006 - \$356 and September 30, 2006 - \$359.

(c) Common shares: Stated value \$2.22 per share; authorized 1,300,000,000; outstanding at **September 30, 2007 - 532,626,990 (excludes 50,800,114 treasury shares)**, December 31, 2006 - 556,252,674 (excludes 27,174,430 treasury shares) and September 30, 2006 558,066,338 (excludes 25,360,766 treasury shares).

(d) 490,750 shares of undesignated no par value preferred stock are authorized of which none had been issued; 7,250 shares of 8.0% cumulative Series D convertible (at \$23.5399 per share) perpetual preferred stock with a stated value of \$1,000 per share were authorized, issued and outstanding; 2,000 shares of 8.0% cumulative Series E perpetual preferred stock with a stated value of \$1,000 per share were authorized, issued and outstanding.

See Notes to Condensed Consolidated Financial Statements.

Fifth Third Bancorp and Subsidiaries

Condensed Consolidated Financial Statements and Notes (continued)

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (unaudited)

(\$ in millions, except per share data)	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Interest Income				
Interest and fees on loans and leases	\$ 1,376	\$ 1,294	4,032	3,668
Interest on securities	147	238	433	735
Interest on other short-term investments	6	2	12	7
Total interest income	1,529	1,534	4,477	4,410
Interest Expense				
Interest on deposits	511	510	1,514	1,392
Interest on short-term borrowings	93	106	224	302
Interest on long-term debt	171	205	510	582
Total interest expense	775	821	2,248	2,276
Net Interest Income	754	713	2,229	2,134
Provision for loan and lease losses	139	87	344	236
Net Interest Income After Provision for Loan and Lease Losses	615	626	1,885	1,898
Noninterest Income				
Electronic payment processing revenue	253	218	721	626
Service charges on deposits	151	134	419	395
Investment advisory revenue	95	89	288	276
Corporate banking revenue	91	79	261	236
Mortgage banking net revenue	26	36	107	125
Other noninterest income	93	87	267	242
Securities gains, net	13	19	14	34
Total noninterest income	722	662	2,077	1,934
Noninterest Expense				
Salaries, wages and incentives	310	288	912	875
Employee benefits	67	74	222	230
Payment processing expense	105	84	294	236
Net occupancy expense	66	63	199	180
Technology and communications	41	36	122	102
Equipment expense	30	32	90	86
Other noninterest expense	275	190	650	548
Total noninterest expense	894	767	2,489	2,257
Income Before Income Taxes and Cumulative Effect	443	521	1,473	1,575
Applicable income taxes	118	144	414	456
Income Before Cumulative Effect	325	377	1,059	1,119
Cumulative effect of change in accounting principle, net (a)				4
Net Income	\$ 325	\$ 377	1,059	1,123

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Net Income Available to Common Shareholders (b)	\$ 325	\$ 377	1,059	1,122
Earnings Per Share	\$ 0.61	\$ 0.68	1.96	2.02
Earnings Per Diluted Share	\$ 0.61	\$ 0.68	1.95	2.01

(a) Reflects a benefit of \$4 million (net of \$2 million of tax) for the adoption of SFAS No. 123(R) as of January 1, 2006 due to the recognition of an estimate of forfeiture experience to be realized for all unvested stock-based awards.

(b) Dividends on preferred stock are \$.185 and \$.555 for the three and nine month periods ended September 30, 2007 and 2006, respectively. See Notes to Condensed Consolidated Financial Statements.

Fifth Third Bancorp and Subsidiaries

Condensed Consolidated Financial Statements and Notes (continued)

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY (unaudited)

	For the nine months	
(\$ in millions, except per share data)	ended September 30, 2007	2006
Total shareholders equity, beginning	\$ 10,022	9,446
Net income	1,059	1,123
Other comprehensive income, net of tax:		
Change in unrealized gains and (losses):		
Available-for-sale securities	(30)	13
Qualifying cash flow hedges	7	8
Change in accumulated other comprehensive income related to employee benefit plans	4	
Comprehensive income	1,040	1,144
Cash dividends declared:		
Common stock (2007 - \$1.26 per share and 2006 - \$1.18 per share)	(680)	(658)
Preferred stock (a)	(1)	(1)
Stock-based awards exercised, including treasury shares issued	46	30
Stock-based compensation expense	46	61
Loans repaid (issued) related to the exercise of stock-based awards, net	3	7
Change in corporate tax benefit related to stock-based compensation	4	(1)
Shares acquired for treasury	(1,084)	(1)
Diversification of nonqualified deferred compensation plan	(18)	
Impact of cumulative effect of change in accounting principle (b)	(98)	(6)
Other	13	1
Total shareholders equity, ending	\$ 9,293	10,022

(a) Dividends on preferred stock are \$.555 million for the nine months ended September 30, 2007 and 2006.

(b) 2007 includes \$96 million impact due to the adoption of FASB Staff Position (FSP) FAS 13-2, Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction on January 1, 2007 and \$2 million impact due to the adoption of FIN No. 48, Accounting for Uncertainty in Income Taxes-An Interpretation of FASB Statement No. 109 on January 1, 2007. 2006 impact is due to the adoption of SFAS No. 123(R) Share-Based Payment on January 1, 2006.

See Notes to Condensed Consolidated Financial Statements.

Fifth Third Bancorp and Subsidiaries

Condensed Consolidated Financial Statements and Notes (continued)

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

(\$ in millions)	For the nine months ended, September 30,	
	2007	2006 (Restated, See Note 16)
Operating Activities		
Net income	\$ 1,059	1,123
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan and lease losses	344	236
Depreciation, amortization and accretion	275	298
Cumulative effect of change in accounting principle		(4)
Stock-based compensation expense	46	61
Provision (benefit) for deferred income taxes	2	(91)
Realized securities gains	(15)	(80)
Realized securities losses	1	46
Net gains on sales of loans	(153)	(101)
Loans originated for sale, net of repayments	(9,347)	(6,255)
Proceeds from sales of loans held for sale	8,785	6,646
Decrease (increase) in trading securities	32	(47)
Increase in other assets	(183)	(472)
(Decrease) increase in accrued taxes, interest and expenses	(67)	103
Excess tax benefit related to stock-based compensation	(4)	(5)
(Decrease) increase in other liabilities	(565)	100
Net Cash Provided by Operating Activities	210	1,558
Investing Activities		
Proceeds from sales of available-for-sale securities	1,581	1,301
Proceeds from calls, paydowns and maturities of available-for-sale securities	4,927	2,453
Purchases of available-for-sale securities	(6,233)	(1,305)
Proceeds from calls, paydowns and maturities of held-to-maturity securities	10	35
Purchases of held-to-maturity securities	(1)	(5)
Decrease in other short-term investments	89	33
Net increase in loans and leases	(4,020)	(3,941)
Proceeds from sale of loans	783	305
Increase in operating lease equipment	(95)	(13)
Purchases of bank premises and equipment	(356)	(346)
Proceeds from disposal of bank premises and equipment	37	51
Cash acquired in business combination		(5)
Net Cash Used In Investing Activities	(3,278)	(1,437)
Financing Activities		
Decrease in core deposits	(918)	(200)
Increase in certificates - \$100,000 and over, including other foreign office	920	1,408
Increase in federal funds purchased	3,709	111
Increase (decrease) in short-term borrowings	1,000	(425)
Proceeds from issuance of long-term debt	3,946	1,844
Repayment of long-term debt	(4,090)	(2,930)
Payment of cash dividends	(676)	(644)
Exercise of stock-based awards, net	49	37
Purchases of treasury stock	(1,084)	(1)

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Excess tax benefit related to stock-based compensation	4	5
Other	11	(5)
Net Cash Provided by (Used In) Financing Activities	2,871	(800)
Decrease in Cash and Due from Banks	(197)	(679)
Cash and Due from Banks at Beginning of Period	2,737	3,078
Cash and Due from Banks at End of Period	\$ 2,540	2,399
Cash Payments		
Interest	\$ 2,260	2,260
Federal income taxes	427	481
Supplemental Cash Flow Information		
Business acquisitions:		
Fair value of tangible assets acquired (noncash)		6
Goodwill and identifiable intangible assets acquired		17
Liabilities assumed and note issued		(18)

See Notes to Condensed Consolidated Financial Statements.

Fifth Third Bancorp and Subsidiaries**Notes to Condensed Consolidated Financial Statements****1. Basis of Presentation**

In the opinion of management, the unaudited Condensed Consolidated Financial Statements include all adjustments, which consist of normal recurring accruals, necessary to present fairly the financial position as of September 30, 2007 and 2006, the results of operations for the three and nine months ended September 30, 2007 and 2006, the cash flows for the nine months ended September 30, 2007 and 2006 and the changes in shareholders' equity for the nine months ended September 30, 2007 and 2006. In accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the United States Securities and Exchange Commission for interim financial information, these statements do not include certain information and footnote disclosures required for complete annual financial statements and it is suggested that these condensed financial statements be read in conjunction with the latest annual financial statements. The results of operations for the three and nine months ended September 30, 2007 and 2006 and the cash flows for the nine months ended September 30, 2007 and 2006 are not necessarily indicative of the results to be expected for the full year. Financial information as of December 31, 2006 has been derived from the annual Consolidated Financial Statements of the Fifth Third Bancorp (Bancorp) and the amended Form 10-K/A. For further information on the amended Form 10-K/A, see Note 16.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Certain reclassifications have been made to prior periods' Condensed Consolidated Financial Statements and related notes to conform to the current period presentation.

2. New Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 123 (Revised 2004), Share-Based Payment. This Statement requires measurement of the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award with the cost to be recognized over the vesting period. This Statement was effective for financial statements as of the beginning of the first interim or annual reporting period of the first fiscal year beginning after September 15, 2005. On January 1, 2006, the Bancorp elected to adopt this Statement using the modified retrospective application. Adoption of this Statement had two impacts on the Bancorp's Condensed Consolidated Financial Statements: i) the recognition of a benefit for the cumulative effect of change in accounting principle of approximately \$4 million (net of \$2 million of tax) during the first quarter of 2006 due to the recognition of an estimate of forfeiture experience to be realized for all unvested stock-based awards outstanding and ii) the reclassification in the Condensed Consolidated Statements of Cash Flows of net cash provided related to the excess corporate tax benefit received on stock-based compensation, previously recorded in the operating activities section, to the financing activities section. The adoption of this Statement did not have an impact on basic or diluted earnings per share. For further information on stock-based compensation, see Note 12.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statement No. 133 and 140. This Statement amends FASB Statements No. 133, Accounting for Derivative Instruments and Hedging Activities, and No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - A Replacement of FASB Statement No. 125, as well as resolves issues addressed in Statement No. 133 Implementation Issue No. D1, Application of Statement No. 133 to Beneficial Interests in Securitized Financial Assets. Specifically, this Statement: i) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation; ii) clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement No. 133; iii) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are free-standing derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation; iv) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and v) amends Statement No. 140 to eliminate the prohibition on a QSPE from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This Statement was effective for all financial instruments acquired or issued after the beginning of the first fiscal year that begins after September 15, 2006. The adoption of this Statement on January 1, 2007 did not have a material effect on the Bancorp's Condensed Consolidated Financial Statements.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140. This Statement amends FASB Statement No. 140 and requires that all separately recognized servicing rights be initially measured at fair value, if practicable. For each class of separately recognized servicing assets and liabilities, this Statement permits the Bancorp to choose either to report servicing assets and liabilities at fair value or at amortized cost. Under the fair value approach, servicing assets and liabilities will be recorded at fair value at each reporting date with changes in fair value recorded in earnings in the period in which the changes occur. Under the amortized cost method, servicing assets and liabilities are amortized in proportion to and over the period of estimated net servicing income or net servicing loss and are assessed for impairment based on fair value at each reporting date. This Statement was effective as of the beginning of the first fiscal year that begins after September 15, 2006. Upon adoption of this Statement on January 1, 2007, the Bancorp elected to continue to report

all classes of servicing assets and liabilities at amortized cost subsequent to initial recognition at fair value. The adoption of this Statement did not have a material effect on the Bancorp's Condensed Consolidated Financial Statements.

Fifth Third Bancorp and Subsidiaries**Notes to Condensed Consolidated Financial Statements (continued)**

In July 2006, the FASB issued FSP FAS 13-2, *Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction*. This FSP addresses the accounting for a change or projected change in the timing of lessor cash flows, but not the total net income, relating to income taxes generated by a leveraged lease transaction. This FSP amends SFAS No. 13, *Accounting for Leases*, and applies to all transactions classified as leveraged leases. The timing of cash flows relating to income taxes generated by a leveraged lease is an important assumption that affects the periodic income recognized by the lessor. Under this FSP, the projected timing of income tax cash flows generated by a leveraged lease transaction are required to be reviewed annually or more frequently if events or circumstances indicate that a change in timing has occurred or is projected to occur. If during the lease term the expected timing of the income tax cash flows generated by a leveraged lease is revised, the rate of return and the allocation of income would be recalculated from the inception of the lease. In the year of adoption, the cumulative effect of the change in the net investment balance resulting from the recalculation will be recognized as an adjustment to the beginning balance of retained earnings. On an ongoing basis following the adoption, a change in the net investment balance resulting from a recalculation will be recognized as a gain or a loss in the period in which the assumption changed and included in income from continuing operations in the same line item used when leveraged lease income is recognized. These amounts would then be recognized back into income over the remaining terms of the affected leases. Additionally, upon adoption, only tax positions that meet the more-likely-than-not recognition threshold should be reflected in the financial statements and all recognized tax positions in a leveraged lease must be measured in accordance with FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109*, issued in July 2006. During May 2005, the Bancorp filed suit in the United States District Court for the Southern District of Ohio related to a dispute with the Internal Revenue Service concerning the timing of deductions associated with certain leveraged lease transactions in its 1997 tax return. The Internal Revenue Service has also proposed adjustments to the tax effects of certain leveraged lease transactions in subsequent tax return years. The proposed adjustments, including penalties, relate to the Bancorp's portfolio of lease-in lease-out transactions, service contract leases and qualified technology equipment leases with both domestic and foreign municipalities. The Bancorp is challenging the Internal Revenue Service's proposed treatment of all of these leasing transactions. The Bancorp's original net investment in these leases totaled approximately \$900 million. The Bancorp continues to believe that its treatment of these leveraged leases was appropriate and in compliance with applicable tax law and regulations. While management cannot predict with certainty the result of the suit, given the tax treatment of these transactions has been challenged by the Internal Revenue Service, the Bancorp believes a resolution may involve a projected change in the timing of these leveraged lease cash flows. This FSP was effective for fiscal years beginning after December 15, 2006. Upon adoption of this FSP on January 1, 2007, the Bancorp recognized an after-tax adjustment to beginning retained earnings of \$96 million representing the cumulative effect of applying the provisions of this FSP.

In July 2006, the FASB issued Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109*. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This Interpretation also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The evaluation of a tax position in accordance with this Interpretation is a two-step process. The first step is a recognition process to determine whether it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The second step is a measurement process whereby a tax position that meets the more-likely-than-not recognition threshold is calculated to determine the amount of benefit to be recognized in the financial statements. In May 2007, the FASB issued FSP FIN 48-1, *Definition of Settlement in FASB FIN No. 48*. FSP FIN 48-1 amends FIN No. 48 to provide guidance on determining whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. The concept of effectively settled replaces the concept of ultimately settled originally issued in FIN 48. The tax position can be considered effectively settled upon completion of an examination by the taxing authority if the entity does not plan to appeal or litigate any aspect of the tax position and it is remote that the taxing authority would examine any aspect of the tax position. For effectively settled tax positions, the full amount of the tax benefit can be recognized. The guidance in FSP FIN 48-1 was effective upon initial adoption of FIN No. 48. FIN No. 48 was effective for fiscal years beginning after December 15, 2006. Upon adoption of this Interpretation on January 1, 2007, the Bancorp recognized an after-tax adjustment to beginning retained earnings of \$2 million representing the cumulative effect of applying the provisions of this interpretation.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This Statement emphasizes that fair value is a market-based measurement and should be determined based on assumptions that a market participant would use when pricing an asset or liability. This Statement clarifies that market participant assumptions should include assumptions about risk as well as the effect of a restriction on the sale or use of an asset. Additionally, this Statement establishes a fair value hierarchy that provides the highest priority to quoted prices in active markets and the lowest priority to unobservable data. This Statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Bancorp is currently in the process of evaluating the impact of adopting this Statement on the Bancorp's Condensed Consolidated Financial Statements.

Fifth Third Bancorp and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) 108, Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. This SAB provides guidance on the consideration of prior year misstatements in determining whether the current year's financial statements are materially misstated. In providing this guidance, the SEC staff references both the iron curtain and rollover approaches to quantifying a current year misstatement for purposes of determining materiality. The iron curtain approach focuses on how the current year's balance sheet would be affected in correcting misstatements without considering the year in which the misstatement originated. The rollover approach focuses on the amount of the misstatements that originated in the current year's income statement. The SEC staff indicates that entities should quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. This SAB was effective for fiscal years ending after November 15, 2006. An entity may either restate their financials for any material misstatements arising from the application of this SAB or recognize a cumulative effect of applying SAB 108 within the current year opening balance in retained earnings. The adoption of this SAB did not have a material impact on the Bancorp's Condensed Consolidated Financial Statements.

In September 2006, the FASB issued SFAS No. 158, Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R). This Statement amends the current accounting for pensions and postretirement benefits by requiring an entity to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in the funded status in the year in which the changes occur through other comprehensive income. This Statement also requires recognition, as a component of other comprehensive income (net of tax), of the actuarial gains and losses and the prior service costs and credits that arise during the period, but are not recognized as components of net periodic benefit cost pursuant to SFAS No. 87 and No. 106. Additionally, this Statement requires an entity to measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position. The Bancorp adopted this Statement on December 31, 2006. The effect of this Statement was to recognize \$59 million, after-tax, of net actuarial losses and prior service cost as a reduction to accumulated other comprehensive income.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115. This Statement permits an entity to choose to measure certain financial instruments and certain other items at fair value, on an instrument-by-instrument basis. Once an entity has elected to record eligible items at fair value, the decision is irrevocable and the entity should report unrealized gains and losses on items for which the fair value option has been elected in earnings. This Statement is effective for fiscal years beginning after November 15, 2007. At the effective date, an entity may elect the fair value option for eligible items that exist at that date with the effect of the first remeasurement to fair value reported as a cumulative-effect adjustment to the opening balance of retained earnings. The Bancorp is currently in the process of evaluating the impact of adopting this Statement on the Bancorp's Condensed Consolidated Financial Statements.

Fifth Third Bancorp and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

3. Intangible Assets and Goodwill

Intangible assets consist of core deposits, servicing rights, customer lists and non-competition agreements. Intangibles, excluding servicing rights, are amortized on either a straight-line or an accelerated basis over their estimated useful lives and have an estimated weighted-average life at September 30, 2007 of 3.24 years. For further information on servicing rights, see Note 4. The Bancorp reviews intangible assets for possible impairment whenever events or changes in circumstances indicate that carrying amounts may not be recoverable. The details of the Bancorp's intangible assets are shown in the following table.

(\$ in millions)	Gross Carrying Amount	Accumulated Amortization	Valuation Allowance	Net Carrying Amount
As of September 30, 2007:				
Mortgage servicing rights	\$ 1,372	(730)	(21)	621
Other consumer and commercial servicing rights	24	(19)		5
Core deposits	410	(293)		117
Other	46	(25)		21
Total intangible assets	\$ 1,852	(1,067)	(21)	764
As of December 31, 2006:				
Mortgage servicing rights	\$ 1,210	(664)	(27)	519
Other consumer and commercial servicing rights	23	(18)		5
Core deposits	417	(276)		141
Other	43	(18)		25
Total intangible assets	\$ 1,693	(976)	(27)	690
As of September 30, 2006:				
Mortgage servicing rights	\$ 1,173	(644)	(31)	498
Other consumer and commercial servicing rights	23	(17)		6
Core deposits	417	(267)		150
Other	40	(15)		25
Total intangible assets	\$ 1,653	(943)	(31)	679

As of September 30, 2007, all of the Bancorp's intangible assets were being amortized. Amortization expense recognized on intangible assets, including servicing rights, for the three months ended September 30, 2007 and 2006 was \$33 million and \$30 million, respectively. For the nine months ended September 30, 2007 and 2006, amortization expense was \$99 million and \$85 million, respectively.

Estimated amortization expense, including servicing rights, for the years ending December 31, 2007 through 2011 is as follows:

(\$ in millions)	
2007 (a)	\$ 131
2008	124
2009	107
2010	91
2011	67

(a) Includes nine months actual and three months estimated.

Changes in the net carrying amount of goodwill by reporting segment for the nine months ended September 30, 2007 and 2006 were as follows:

(\$ in millions)	Commercial	Branch	Consumer	Investment	Processing	Total
	Banking	Banking	Lending	Advisors	Solutions	
Balance as of December 31, 2006	\$ 871	797	182	138	205	2,193
Acquisition activity		(1)				(1)
Balance as of September 30, 2007	\$ 871	796	182	138	205	2,192
Balance as of December 31, 2005	\$ 871	798	182	127	191	2,169
Acquisition activity		(1)			14	13
Reclassification				11		11
Balance as of September 30, 2006	\$ 871	797	182	138	205	2,193

The Bancorp completed its most recent annual goodwill impairment test during the fourth quarter of 2006 using a September 30, 2006 assessment date and determined that no impairment exists. In the table above, acquisition activity includes acquisitions in the respective period plus purchase accounting adjustments related to previous acquisitions. During the first quarter of 2006, the Bancorp acquired a credit card servicing company. The acquisition resulted in the recognition of \$14 million of goodwill and did

Fifth Third Bancorp and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

not have a material impact on the financial results of the Bancorp. Additionally, during the first quarter of 2006, \$11 million of goodwill was reclassified from other intangible assets.

4. Sales of Receivables

The Bancorp sold fixed and adjustable rate residential mortgage loans during the third quarter of 2007 and 2006. In those sales, the Bancorp obtained servicing responsibilities. The Bancorp receives annual servicing fees based on a percentage of the outstanding balance. The investors have no recourse to the Bancorp's other assets for failure of debtors to pay when due. The Bancorp identifies classes (i.e., fixed and adjustable rate residential mortgage loans) of servicing assets based on the availability of market inputs used in determining the fair value of servicing assets. For the three months ended September 30, 2007 and 2006, the Bancorp recognized pretax gains of \$9 million and \$21 million, respectively, on the sales of residential mortgage loans. Additionally, the Bancorp recognized \$37 million and \$30 million in servicing fees on residential mortgages for the three months ended September 30, 2007 and 2006. For the nine months ended September 30, 2007 and 2006, the Bancorp recognized pretax gains of \$61 million and \$69 million, respectively, on the sales of residential mortgage loans. Additionally, the Bancorp recognized \$105 million and \$90 million in servicing fees on residential mortgages for the nine months ended September 30, 2007 and 2006. The gains on sales of residential mortgages and servicing fees related to residential mortgages are included in mortgage banking net revenue.

During the third quarter of 2007 and 2006, the Bancorp sold student loans and certain commercial loans and obtained servicing responsibilities. The Bancorp also securitized and sold certain automobile loans in 2004 and securitized and sold certain home equity lines of credit in 2003, in which the Bancorp obtained servicing responsibilities and subordinated interests. The automobile loan securitization was terminated during the third quarter of 2007. For these sales and securitizations, the investors and the securitization trust have no recourse to the Bancorp's other assets for failure of debtors to pay when due. The interests that continue to be held by the Bancorp are subordinate to investor's interests. At September 30, 2007 and 2006, the value of the servicing asset and subordinated interest related to these sales were immaterial to the Bancorp's Condensed Consolidated Financial Statements.

As of September 30, 2007 and 2006, the key economic assumptions used in measuring the interests that continue to be held by the Bancorp were as follows:

	Rate	September 30, 2007			Weighted-Average Default Rate	Weighted-Average Life (in years)	September 30, 2006		
		Weighted-Average Life (in years)	Prepayment Speed (annual)	Discount Rate (annual)			Prepayment Speed (annual)	Discount Rate (annual)	Weighted-Average Default Rate
Residential mortgage loans:									
Servicing assets	Fixed	6.8	9.9%	9.7%	N/A	7.25	11.0%	10.3%	N/A
Servicing assets	Adjustable	3.3	26.2	12.5	N/A	3.6	26.2	10.9	N/A

Based on historical credit experience, expected credit losses for residential mortgage loan servicing assets have been deemed immaterial. At September 30, 2007 and 2006, the Bancorp serviced \$33.1 billion and \$27.8 billion of residential mortgage loans for other investors.

The value of servicing assets is subject to credit, prepayment and interest rate risks on the sold financial assets. At September 30, 2007, the sensitivity of the current fair value of residual cash flows to immediate 10% and 20% adverse changes in those assumptions were as follows:

Fair	Weighted-Average Life (in years)	Prepayment Assumption	Prepayment Speed		Residual Servicing Cash Flows	Weighted-Average Default
			Impact of Adverse Change on Fair	Impact of Adverse Change		
			Discount	Impact of Adverse Change		Impact of Adverse Change

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(\$ in millions)	Rate	Value			Value			on Fair Value		on Fair Value	
		Rate	10%	20%	Rate	10%	20%	Rate	10%	20%	
Residential mortgage loans:											
Servicing assets	Fixed	\$ 586	6.8	9.9%	\$ 23	44	9.7%	\$ 23	44	%	\$
Servicing assets	Adjustable	50	3.3	26.2	3	6	12.5	2	3		

These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in fair value based on a 10% variation in assumptions typically cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in the previous table, the effect of a variation in a particular assumption on the fair value of the interests that continue to be held by the Bancorp is calculated without changing any other assumption; in reality, changes in one factor may result in changes in another (for example, increases in market interest rates may result in lower prepayments and increased credit losses), which might magnify or counteract the sensitivities.

Fifth Third Bancorp and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

Changes in the servicing asset related to residential mortgage loans for the nine months ended September 30, 2007 and 2006 were as follows:

(\$ in millions)	2007	2006
Carrying amount as of the beginning of period	\$ 546	479
Servicing obligations that result from transfer of residential mortgage loans	162	98
Amortization	(66)	(48)
Carrying amount before valuation allowance	\$ 642	529
Valuation allowance for servicing assets:		
Beginning balance	(27)	(46)
Servicing valuation recovery	6	15
Ending balance	(21)	(31)
Carrying amount as of the end of the period	\$ 621	498

Temporary impairment or impairment recovery, effected through a change in the Mortgage Servicing Right (MSR) valuation reserve, is captured as a component of mortgage banking net revenue in the Condensed Consolidated Statements of Income.

The fair value of the servicing asset is based on the present value of expected future cash flows. The following table displays the beginning and ending fair value for the nine months ended September 30, 2007 and 2006:

(\$ in millions)	2007	2006
Fixed rate residential mortgage loans:		
Fair value at beginning of period (December 31, 2006 and 2005)	\$ 483	413
Fair value at end of period	586	458
Adjustable rate residential mortgage loans:		
Fair value at beginning of period (December 31, 2006 and 2005)	45	45
Fair value at end of period	50	45

The Bancorp maintains a non-qualifying hedging strategy to manage a portion of the risk associated with changes in value of the MSR portfolio. This strategy includes the purchase of free-standing derivatives (principal-only swaps, swaptions and interest rate swaps) and various available-for-sale securities (primarily principal-only strips). The interest income, mark-to-market adjustments and gain or loss from sale activities associated with these portfolios are expected to economically hedge a portion of the change in value of the MSR portfolio caused by fluctuating discount rates, earnings rates and prepayment speeds.

The Bancorp recognized a net gain of \$1 million and a net loss of \$1 million in the nine months ended September 30, 2007 and 2006, respectively, related to changes in fair value and settlement of free-standing derivatives purchased to economically hedge the MSR portfolio. As of September 30, 2007 and 2006, other assets included free-standing derivative instruments related to the MSR portfolio with a fair value of \$32 million and \$9 million, respectively, and other liabilities included free-standing derivative instruments with a fair value of \$8 million for both periods. The outstanding notional amounts on the free-standing derivative instruments related to the MSR portfolio totaled \$5.5 billion and \$1.9 billion as of September 30, 2007 and 2006, respectively. As of September 30, 2007, the available-for-sale securities portfolio included \$314 million of securities related to the non-qualifying hedging strategy.

5. Derivative Financial Instruments

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The Bancorp maintains an overall risk management strategy that incorporates the use of derivative instruments to reduce certain risks related to interest rate, prepayment and foreign currency volatility.

The Bancorp's interest rate risk management strategy involves modifying the repricing characteristics of certain financial instruments so that changes in interest rates do not adversely affect the net interest margin and cash flows. Derivative instruments that the Bancorp may use as part of its interest rate risk management strategy include interest rate swaps, interest rate floors, interest rate caps, forward contracts, options and swaptions. Interest rate swap contracts are exchanges of interest payments, such as fixed-rate payments for floating-rate payments, based on a common notional amount and maturity date. Interest rate floors protect against declining rates, while interest rate caps protect against rising interest rates. Forward contracts are contracts in which the buyer agrees to purchase, and the seller agrees to make delivery of, a specific financial instrument at a predetermined price or yield. Options provide the purchaser with the right, but not the obligation, to purchase or sell a contracted item during a specified period at an agreed upon price. Swaptions are financial instruments granting the owner the right, but not the obligation, to enter into or cancel a swap.

Prepayment volatility arises mostly from changes in fair value of the largely fixed-rate MSR portfolio, mortgage loans and mortgage-backed securities. The Bancorp may enter into various free-standing derivatives (principal-only swaps, swaptions, floors,

Fifth Third Bancorp and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

options and interest rate swaps) to economically hedge prepayment volatility. Principal-only swaps are total return swaps based on changes in the value of the underlying mortgage principal-only trust. Foreign currency volatility occurs as the Bancorp enters into certain foreign denominated loans. Derivative instruments that the Bancorp may use to economically hedge these foreign denominated loans include foreign exchange swaps and forward contracts.

The Bancorp also enters into derivative contracts (including foreign exchange contracts, commodity contracts and interest rate swaps, floors and caps) for the benefit of commercial customers. The Bancorp may economically hedge significant exposures related to these free-standing derivatives by entering into offsetting third-party contracts with approved, reputable counterparties with substantially matching terms and currencies. Credit risk arises from the possible inability of counterparties to meet the terms of their contracts. The Bancorp's exposure is limited to the replacement value of the contracts rather than the notional, principal or contract amounts. The Bancorp minimizes the credit risk through credit approvals, limits, counterparty collateral and monitoring procedures.

FAIR VALUE HEDGES - The Bancorp may enter into interest rate swaps to convert its fixed-rate, long-term debt to floating-rate debt. Decisions to convert fixed-rate debt to floating are made primarily by consideration of the asset/liability mix of the Bancorp, the desired asset/liability sensitivity and interest rate levels. For the three months ended September 30, 2007 and 2006, certain interest rate swaps met the criteria required to qualify for the shortcut method of accounting. Based on this shortcut method of accounting treatment, no ineffectiveness is assumed. For interest rate swaps that do not meet the shortcut requirements, an assessment of hedge effectiveness was performed and such swaps were accounted for using the long-haul method. The long-haul method requires periodic assessment of hedge effectiveness and measurement of ineffectiveness. Ineffectiveness results to the extent changes in the fair value of the recorded derivative do not offset changes in fair value of the debt due to changes in the hedged risk. For interest rate swaps accounted for as fair value hedges using the long-haul method, ineffectiveness is the difference between the changes in the fair value of the interest rate swap and changes in fair value of the long-term debt attributable to the risk being hedged. The ineffectiveness of interest rate swaps hedging long-term debt is reported within interest expense in the Condensed Consolidated Statements of Income. For the three months ended September 30, 2007 and 2006, changes in the fair value of any interest rate swaps attributed to hedge ineffectiveness were insignificant to the Bancorp's Condensed Consolidated Statements of Income.

The Bancorp also enters into forward contracts to hedge its residential mortgage loans held for sale. The hedged mortgage loans held for sale are grouped into portfolios of loans with similar risk exposure. For the three months ended September 30, 2007 and 2006, the Bancorp recognized net losses of \$9 million and \$2 million, respectively, attributable to the ineffectiveness of the hedging relationships related to residential mortgage loans held for sale. The ineffectiveness on these forward contracts is reported within noninterest income in the Condensed Consolidated Statements of Income. Those forward contracts that do not meet the criteria for fair value hedge accounting are accounted for as free-standing derivatives.

The following table reflects the market value of all fair value hedges included in the Condensed Consolidated Balance Sheets:

(\$ in millions)	September 30, 2007		December 31, 2006		September 30, 2006	
	Notional Amount	Fair Value	Notional Amount	Fair Value	Notional Amount	Fair Value
Included in other assets:						
Interest rate swaps related to debt	\$ 500	\$ 9			300	11
Forward contracts related to mortgage loans held for sale	489	2	653	4		
Total included in other assets		\$ 11		4		11
Included in other liabilities:						
Interest rate swaps related to debt	\$ 2,575	\$ 77	2,575	95	2,075	91
Forward contracts related to mortgage loans held for sale	896	8	419	2	726	6
Total included in other liabilities		\$ 85		97		97

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During 2006, the Bancorp terminated interest rate swaps designated as fair value hedges and, in accordance with SFAS No. 133, an amount equal to the cumulative fair value adjustment to the hedged items at the date of termination is amortized as an adjustment to interest expense over the remaining term of the long-term debt. For the three months ended September 30, 2007 and 2006, \$2 million and \$5 million in net deferred losses, net of tax, on the terminated fair value hedges were amortized into interest expense, respectively.

CASH FLOW HEDGES - The Bancorp may enter into interest rate swaps to convert floating-rate assets and liabilities to fixed rates or to hedge certain forecasted transactions. The assets and liabilities are typically grouped and share the same risk exposure for which they are being hedged. The Bancorp may also enter into interest rate caps and floors to limit cash flow variability of floating rate assets and liabilities. As of September 30, 2007, all hedges designated as cash flow hedges are assessed for effectiveness using regression analysis. Ineffectiveness is generally measured as the amount by which the cumulative change in the fair value of the hedging instrument exceeds the present value of the cumulative change in the hedged item's expected cash flows. Ineffectiveness is

Fifth Third Bancorp and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

reported within other noninterest income in the Condensed Consolidated Statements of Income. For the three months ended September 30, 2007, the Bancorp recognized a net loss of less than \$1 million attributable to cash flow hedge ineffectiveness.

As of September 30, 2007, \$6 million of deferred gains on cash flow hedges are recorded in accumulated other comprehensive income. Gains and losses on derivative contracts are reclassified from accumulated other comprehensive income to current period earnings when the forecasted transaction affects earnings and are included in the line item in which the hedged item's effect in earnings is recorded. As of September 30, 2007, less than \$1 million in net deferred losses, net of tax, recorded in accumulated other comprehensive income are expected to be reclassified into earnings during the next twelve months.

(\$ in millions)	September 30, 2007		December 31, 2006		September 30, 2006	
	Notional Amount	Fair Value	Notional Amount	Fair Value	Notional Amount	Fair Value
Included in other assets:						
Interest rate floors related to commercial loans	\$ 1,500	\$ 67				
Interest rate caps related to debt	1,750	20				
Total included in other assets		\$ 87				
Included in other liabilities:						
Interest rate swaps related to consumer loans	\$ 1,000	\$ 8				
Total included in other liabilities		\$ 8				

In prior periods, the Bancorp terminated certain derivatives qualifying as cash flow hedges. The deferred gains or losses of those terminated instruments, net of tax, were included in accumulated other comprehensive income and amortized over the designated hedging periods. As of December 31, 2006 and September 30, 2006, less than \$1 million and \$5 million, respectively, of deferred losses, net of tax, related to terminated cash flow hedges were recorded in accumulated other comprehensive income.

FREE-STANDING DERIVATIVE INSTRUMENTS - The majority of the free-standing derivative instruments the Bancorp enters into are for the benefit of commercial customers. These derivative contracts are not designated against specific assets or liabilities on the Condensed Consolidated Balance Sheets or to forecasted transactions and, therefore, do not qualify for hedge accounting. These instruments include foreign exchange derivative contracts entered into for the benefit of commercial customers involved in international trade to hedge their exposure to foreign currency fluctuations, commodity contracts to hedge such items as natural gas and various other derivative contracts. The Bancorp may economically hedge significant exposures related to these derivative contracts entered into for the benefit of customers by entering into offsetting contracts with approved, reputable, independent counterparties with substantially matching terms. The Bancorp hedges its interest rate exposure on commercial customer transactions by executing offsetting swap agreements with primary dealers. Revaluation gains and losses on foreign exchange, commodity and other commercial customer derivative contracts are recorded as a component of corporate banking revenue.

Starting in the first quarter of 2007, the Bancorp offered its customers an equity-linked certificate of deposit that has a return linked to equity indices. Under SFAS No. 133, a certificate of deposit that pays interest based on changes on an equity index is a hybrid instrument that requires separation into a host contract (the certificate of deposit) and an embedded derivative contract (written equity call option). The Bancorp enters into an offsetting derivative contract to economically hedge the exposure taken through the issuance of equity-linked certificates of deposit. Both the embedded derivative and derivative contract entered into by the Bancorp are recorded as a free-standing derivatives and recorded at fair value with offsetting gains and losses recognized in the Condensed Consolidated Statements of Income.

The Bancorp enters into foreign exchange derivative contracts to economically hedge certain foreign denominated loans. Derivative instruments that the Bancorp may use to economically hedge these foreign denominated loans include foreign exchange swaps and forward contracts. The Bancorp does not designate these instruments against the foreign denominated loans, and therefore, does not obtain hedge accounting treatment. Revaluation gains and losses on such foreign currency derivative contracts are recorded within other noninterest income in the Condensed

Consolidated Statements of Income as are revaluation gains and losses on foreign denominated loans.

As part of its overall risk management strategy relative to its mortgage banking activity, the Bancorp may enter into various free-standing derivatives (principal-only swaps, swaptions, floors, options and interest rate swaps) to economically hedge changes in fair value of its largely fixed-rate MSR portfolio. Principal-only swaps hedge the mortgage-LIBOR spread because these swaps appreciate in value as a result of tightening spreads. Principal-only swaps also provide prepayment protection by increasing in value when prepayment speeds increase, as opposed to MSRs that lose value in a faster prepayment environment. Receive fixed/pay floating interest rate swaps and swaptions increase in value when interest rates do not increase as quickly as expected. The Bancorp enters into forward contracts to economically hedge the change in fair value of certain residential mortgage loans held for sale due to changes in interest rates. The Bancorp enters into forward swaps to economically hedge the change in fair value of certain commercial mortgage loans held for sale due to changes in interest rates. Interest rate lock commitments issued on commercial and residential mortgage loan commitments that will be held for resale are also considered free-standing derivative

Fifth Third Bancorp and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

instruments and the interest rate exposure on these commitments is economically hedged primarily with forward contracts. Revaluation gains and losses from free-standing derivatives related to mortgage banking activity are recorded as a component of mortgage banking net revenue in the Condensed Consolidated Statements of Income.

Additionally, the Bancorp occasionally may enter into free-standing derivative instruments (options, swaptions and interest rate swaps) in order to minimize significant fluctuations in earnings and cash flows caused by interest rate volatility. Revaluation gains and losses on interest rate risk derivative contracts are recorded within other noninterest income in the Condensed Consolidated Statements of Income.

The net gains (losses) recorded in the Condensed Consolidated Statements of Income relating to free-standing derivative instruments are summarized below:

(\$ in millions)	For the three months		For the nine months ended September 30,	
	ended September 30,		ended September 30,	
	2007	2006	2007	2006
Foreign exchange contracts for customers	\$ 15	13	\$ 43	39
Commodity contracts for customers	1		1	
Interest rate lock commitments	4	4	4	4
Derivative instruments related to held-for-sale mortgages	(20)	(8)	(11)	(4)
Derivative instruments related to MSR portfolio	13	5	1	(1)
Derivative instruments related to foreign currency risk	(10)		(19)	
Derivative instruments related to interest rate risk			(1)	(3)

The following table reflects the market value of all free-standing derivatives included in the Condensed Consolidated Balance Sheets:

(\$ in millions)	September 30, 2007		December 31, 2006		September 30, 2006	
	Notional Amount	Fair Value	Notional Amount	Fair Value	Notional Amount	Fair Value
Included in other assets:						
Foreign exchange contracts for customers	\$ 5,486	\$ 287	5,064	164	5,077	125
Interest rate contracts for customers	11,169	170	8,174	110	7,633	66
Commodity contracts for customers	200	14	68	4	7	1
Derivative instruments related to equity-linked CD	38	4				
Interest rate lock commitments	601	4	389	2	626	5
Derivative instruments related to held-for-sale mortgages	35		243	1	20	
Derivative instruments related to MSR portfolio	3,160	32	2,335	14	1,370	9
Derivative instruments related to foreign currency risk				1		
Derivative instruments related to interest rate risk	4		213	9	113	2
Total included in other assets		\$ 511		305		208

Included in other liabilities:

Foreign exchange contracts for customers	\$ 5,292	\$ 270	4,783	149	4,753	113
Interest rate contracts for customers	11,378	170	8,398	110	7,818	66
Commodity contracts for customers	199	13	62	4	7	1
Derivative instruments related to equity-linked CD	38	4				
Interest rate lock commitments	217	1	750	3	79	
Derivative instruments related to held-for-sale mortgages	218	2	103	1	306	2
Derivative instruments related to MSR portfolio	2,382	8	583	5	549	8

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Derivative instruments related to foreign currency risk	147	8	68	
Derivative instruments related to interest rate risk	4		7	5
Other derivative instruments	30			
Total included in other liabilities		\$ 477	272	190

Fifth Third Bancorp and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

The following table summarizes the Bancorp's derivative instrument positions (excluding \$34.8 billion in notional amount from the customer accommodation program) at September 30, 2007:

(\$ in millions)	Notional Balance	Weighted-Average Remaining Maturity (in months)	Average Receive Rate	Average Pay Rate
Interest rate swaps related to debt:				
Receive floating/pay fixed	\$ 3,075	170	5.36%	5.66%
Mortgage lending commitments:				
Forward contracts on residential mortgage loans held for sale	1,552	1		
Forward swaps on commercial mortgage loans held for sale	86	100		
Mortgage servicing rights portfolio:				
Interest rate swaps - Receive fixed/pay floating	1,112	86	5.42	5.47
Interest rate swaps - Receive floating/pay fixed	1,780	19	5.58	5.00
Interest rate swaptions Pay fixed	725	1		4.56
Purchased swaptions Pay fixed	1,750	3		5.36
Purchased swaptions Receive fixed	175	8	5.00	
Aggregate balance sheet risk:				
Interest rate floors	1,500	67		
Interest rate caps	1,750	45		
Forward swaps related to consumer loans	1,000	25		
Interest rate futures/forwards	8	74		
Other derivative instruments:				
Written option	30	150		
Total	\$ 14,543			

6. Guarantees

The Bancorp has performance obligations upon the occurrence of certain events under financial guarantees provided in certain contractual arrangements. These various arrangements are summarized below.

As of September 30, 2007 and 2006, the Bancorp had issued \$8.3 billion and \$8.0 billion, respectively, of financial and performance standby letters of credit to guarantee the performance of various customers to third parties. The maximum amount of credit risk in the event of nonperformance by these parties is equivalent to the contract amount and totals \$8.3 billion and \$8.0 billion, respectively. Upon issuance, the Bancorp recognizes a liability equivalent to the amount of fees received from the customer for these standby letter of credit commitments. At September 30, 2007 and 2006, the reserve related to these standby letters of credit was approximately \$1 million. Approximately 72% and 70% of the total standby letters of credit were secured at September 30, 2007 and 2006, respectively. In the event of nonperformance by the customers, the Bancorp has rights to the underlying collateral, which can include commercial real estate, physical plant and property, inventory, receivables, cash and marketable securities.

Through September 30, 2007 and 2006, the Bancorp had transferred, subject to credit recourse, certain primarily floating-rate, short-term, investment grade commercial loans to an unconsolidated QSPE that is wholly owned by an independent third party. The outstanding balance of such loans at September 30, 2007 and 2006 was \$3.0 billion and \$3.4 billion, respectively. These loans may be transferred back to the Bancorp upon the occurrence of certain specified events. These events include borrower default on the loans transferred, bankruptcy preferences initiated against underlying borrowers and ineligible loans transferred by the Bancorp to the QSPE. The maximum amount of credit risk in the event of nonperformance by the underlying borrowers is approximately equivalent to the total outstanding balance. In addition, the Bancorp's agreement to provide liquidity support to the QSPE was \$4.0 billion and \$3.8 billion as of September 30, 2007 and 2006, respectively. During the nine

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months ended September 30, 2007 and 2006, no amounts were drawn on the liquidity agreement. At September 30, 2007 and 2006, the Bancorp's loss reserve related to the liquidity support and credit enhancement provided to the QSPE was \$13 million and \$14 million, respectively, recorded in other liabilities on the Condensed Consolidated Balance Sheets.

At the end of the third quarter of 2007, the Bancorp purchased asset-backed commercial paper from the QSPE due to widening credit spreads in the commercial paper market. As of September 30, 2007, the amount of commercial paper held was \$547 million. In October 2007, the credit spreads narrowed and the Bancorp reduced its holdings to \$20 million as of October 31, 2007.

As of September 30, 2007 and 2006, the Bancorp had provided credit recourse on approximately \$1.6 billion and \$1.3 billion, respectively, of residential mortgage loans sold to unrelated third parties. In the event of any customer default, pursuant to the credit recourse provided, the Bancorp is required to reimburse the third party. The maximum amount of credit risk in the event of nonperformance by the underlying borrowers is equivalent to the total outstanding balance. In the event of nonperformance, the Bancorp has rights to the underlying collateral value securing the loan. The Bancorp maintained an estimated credit loss reserve of approximately \$18 million relating to these residential mortgage loans sold at September 30, 2007 and 2006, which is recorded in

Fifth Third Bancorp and Subsidiaries**Notes to Condensed Consolidated Financial Statements (continued)**

other liabilities on the Condensed Consolidated Balance Sheets. To determine the credit loss reserve, the Bancorp used an approach that is consistent with its overall approach in estimating credit losses for various categories of residential mortgage loans held in its loan portfolio.

As of September 30, 2007 and 2006, the Bancorp had fully and unconditionally guaranteed \$1.4 billion and \$376 million, respectively, of certain long-term borrowing obligations issued by four wholly-owned issuing trust entities. During the first quarter of 2007, the amount guaranteed increased due to the issuance of \$750 million of trust preferred securities which was partially offset by the redemption of two previous trust preferred securities issuances that totaled approximately \$300 million. During the third quarter of 2007, the amount guaranteed increased due to the issuance of \$575 million of trust preferred securities. In October 2007, the Bancorp issued \$863 million of Tier I-qualifying trust preferred securities to third party investors through a wholly-owned issuing trust entity and invested the proceeds in junior subordinated notes issued by the Bancorp. See Note 19 for further discussion on this issuance.

The Bancorp, through its electronic payment processing division, processes VISA[®] and MasterCard[®] merchant card transactions. Pursuant to VISA[®] and MasterCard[®] rules, the Bancorp assumes certain contingent liabilities relating to these transactions which typically arise from billing disputes between the merchant and cardholder that are ultimately resolved in the cardholder's favor. In such cases, these transactions are charged back to the merchant and disputed amounts are refunded to the cardholder. If the Bancorp is unable to collect these amounts from the merchant, it will bear the loss for refunded amounts. The likelihood of incurring a contingent liability arising from chargebacks is relatively low, as most products or services are delivered when purchased and credits are issued on returned items. For the nine months ended September 30, 2007 and 2006, the Bancorp processed approximately \$102 million and \$90 million, respectively, of chargebacks presented by issuing banks, resulting in no material losses to the Bancorp. The Bancorp accrues for probable losses based on historical experience and did not carry a credit loss reserve related to such chargebacks at September 30, 2007 and 2006.

Fifth Third Securities, Inc. (FTS), a subsidiary of the Bancorp, guarantees the collection of all margin account balances held by its brokerage clearing agent for the benefit of FTS customers. FTS is responsible for payment to its brokerage clearing agent for any loss, liability, damage, cost or expense incurred as a result of customers failing to comply with margin or margin maintenance calls on all margin accounts. The margin account balance held by the brokerage clearing agent as of September 30, 2007 was \$48 million compared to \$54 million as of September 30, 2006. In the event of any customer default, FTS has rights to the underlying collateral provided. Given the existence of the underlying collateral provided and negligible historical credit losses, the Bancorp does not maintain a loss reserve related to the margin accounts.

7. Income Taxes

As of January 1, 2007, the Bancorp adopted FIN No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109. Upon adoption of this Interpretation on January 1, 2007, the Bancorp recognized an after-tax adjustment to beginning retained earnings of \$2 million representing the cumulative effect of applying the provisions of this Interpretation. Upon adoption, the Bancorp had unrecognized tax benefits of \$446 million, which included \$99 million of tax positions that, if recognized, would impact the effective tax rate and \$7 million in tax positions that would impact goodwill. The remaining \$340 million is related to tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of those deductions. A significant portion of these tax positions relate to the leveraged lease litigation discussed below and in Note 10. The balance of the uncertain tax positions did not materially change during the quarter ended September 30, 2007.

Any interest and penalties incurred in connection with income taxes are recorded as a component of tax expense. At January 1, 2007, the Bancorp had accrued interest, net of the related tax benefit, of \$65 million. No liabilities were recorded for penalties.

It is reasonably possible that the amount of the unrecognized benefit with respect to certain of the Bancorp's uncertain tax positions will significantly increase or decrease during the next 12 months. The Bancorp has filed suit in the United States District Court for the Southern District of Ohio in a dispute with the Internal Revenue Service concerning the timing of deductions associated with certain leveraged lease transactions in its 1997 tax return. Subsequent to September 30, 2007, the trial was rescheduled for March 2008. The Internal Revenue Service has also proposed adjustments to the tax effects of certain leveraged lease transactions in subsequent tax return years. The proposed adjustments relate to the Bancorp's portfolio of lease-in lease-out transactions, service contract leases and qualified technology equipment leases with both domestic and foreign municipalities. The Bancorp is challenging the Internal Revenue Service's proposed treatment of all of these leasing transactions. While it is possible that a settlement of some portion of these issues may be reached in connection with the trial, the Bancorp believes a settlement is unlikely. At this time, an estimate of the range of the reasonably possible changes cannot be made.

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The statute of limitations for federal income tax returns remains open for tax years 2004 through 2006. In addition, limited statute extensions have been agreed to for tax years 1997 through 2003 primarily for leasing uncertainties. With the exception of the state impact of the federal items discussed above as well as a few states with insignificant uncertain liabilities, the statutes of limitations for state income tax returns remain open for tax years 2003 through 2006.

Fifth Third Bancorp and Subsidiaries**Notes to Condensed Consolidated Financial Statements (continued)****8. Junior Subordinated Debentures**

In March 2007, Fifth Third Capital Trust IV (Trust IV), a wholly-owned non-consolidated subsidiary of the Bancorp, issued \$750 million of trust preferred securities to third party investors and invested these proceeds in junior subordinated notes (JSN IV) issued by the Bancorp. The Bancorp's obligations under the transaction documents, taken together, have the effect of providing a full and unconditional guarantee by the Bancorp, on a subordinated basis, of the payment obligations of the Trust IV. No other subsidiaries of the Bancorp are guarantors of the JSN IV. The scheduled maturity of the JSN IV is April 2037 but may be extended at the Bancorp's option to April 2047, subject to certain conditions. The principal amount of the JSN IV is due on the scheduled maturity date provided the Bancorp, using commercially reasonable efforts, has received proceeds from the sale of certain capital qualifying securities to permit repayment of the JSN IV. All outstanding principal and interest must be repaid by April 1, 2067. The JSN IV held by the Trust IV bear a fixed rate of interest of 6.50% until April 2017. After April 2017, the JSN IV bear interest at a variable rate of three-month LIBOR plus 1.3675%. After April 2047, the JSN IV bear interest at a variable rate of one-month LIBOR plus 2.3675%. During the term of the JSN IV, the Bancorp has the right to defer interest for one or more periods not to exceed 5 years without being subject to the alternative payment mechanism, and for one or more periods not to exceed 10 years, without giving rise to an event of default.

The JSN IV may be redeemed at the option of the Bancorp on April 15, 2017, April 15, 2027, any time on or after April 15, 2037, or in certain other limited circumstances at a redemption price of 100% of the principal amount plus accrued but unpaid interest. The JSN IV may be redeemed by the Bancorp at any other time at a make-whole redemption price. All redemptions are subject to certain conditions and require the approval by the Federal Reserve Board.

In August 2007, Fifth Third Capital Trust V (Trust V), a wholly-owned non-consolidated subsidiary of the Bancorp, issued \$575 million of Tier 1-qualifying trust preferred securities to third party investors and invested these proceeds in junior subordinated notes (JSN V) issued by the Bancorp. The Bancorp's obligations under the transaction documents, taken together, have the effect of providing a full and unconditional guarantee by the Bancorp, on a subordinated basis, of the payment obligations of the Trust V. No other subsidiaries of the Bancorp are guarantors of the JSN V. The JSN V will mature on August 15, 2067. The JSN V held by the Trust V bear a fixed rate of interest of 7.25% until August 15, 2057. After August 15, 2057, the JSN V bear interest at a variable rate of three-month LIBOR plus 2.57%. During the term of the JSN V, the Bancorp has the right to defer interest for one or more periods not to exceed 5 years without being subject to the alternative payment mechanism, and for one or more periods not to exceed 10 years, without giving rise to an event of default.

The JSN V may be redeemed at the option of the Bancorp on August 15, 2012, or in certain other limited circumstances at a redemption price of 100% of the principal amount plus accrued but unpaid interest. All redemptions are subject to certain conditions and require approval by the Federal Reserve Board.

In October 2007, Fifth Third Capital Trust VI, a wholly-owned non-consolidated subsidiary of the Bancorp, issued \$863 million of trust preferred securities to third party investors and invested the proceeds in junior subordinated notes issued by the Bancorp. See Note 19 for further discussion.

9. Related Party Transactions

At September 30, 2007 and 2006, certain directors, executive officers, principal holders of the Bancorp's common stock, associates of such persons, and affiliated companies of such persons were indebted, including undrawn commitments to lend, to the Bancorp's banking subsidiaries in the aggregate amount, net of participations, of \$329 million and \$266 million, respectively. As of September 30, 2007 and 2006, the outstanding balance on loans to related parties, net of participations and undrawn commitments, was \$123 million and \$73 million, respectively.

Commitments to lend to related parties as of September 30, 2007 and 2006, net of participations, were comprised of \$321 million and \$255 million, respectively, to directors and \$8 million and \$11 million, respectively, to executive officers. The commitments are in the form of loans and guarantees for various business and personal interests. This indebtedness was incurred in the ordinary course of business on substantially the same terms, including interest rates and collateral, as those prevailing at the time of comparable transactions with unrelated parties. This indebtedness does not involve more than the normal risk of repayment or present other unfavorable features. None of the Bancorp's affiliates, officers, directors or employees has an interest in or receives any remuneration from any special purpose entities or QSPE with which the Bancorp transacts business.

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The Bancorp maintains written policy and procedures covering related party transactions. These procedures cover transactions such as employee-stock purchase loans, personal lines of credit, residential secured loans, overdrafts, letters of credit and increases in indebtedness. Such transactions are subject to the Bancorp's normal underwriting and approval procedures. Prior to the loan closing, Compliance Risk Management must approve and determine whether the transaction requires approval from or a post notification be sent to the Bancorp's Board of Directors.

Fifth Third Bancorp and Subsidiaries**Notes to Condensed Consolidated Financial Statements (continued)****10. Legal and Regulatory Proceedings**

During May 2005, the Bancorp filed suit in the United States District Court for the Southern District of Ohio related to a dispute with the Internal Revenue Service concerning the timing of deductions associated with certain leveraged lease transactions in its 1997 tax return. The Internal Revenue Service has also proposed adjustments to the tax effects of certain leveraged lease transactions in subsequent tax return years. The proposed adjustments, including penalties, relate to the Bancorp's portfolio of lease-in lease-out transactions, service contract leases and qualified technology equipment leases with both domestic and foreign municipalities. The Bancorp is challenging the Internal Revenue Service's proposed treatment of all of these leasing transactions. The Bancorp's original net investment in these leases totaled approximately \$900 million. Management continues to believe that its treatment of these leveraged leases was appropriate and in compliance with applicable tax law and regulations. While management cannot predict with certainty the result of the suit, given the tax treatment of these transactions has been challenged by the Internal Revenue Service, they believe a resolution may involve a projected change in the timing of the leveraged lease cash flows. FSP FAS 13-2, which was effective as of January 1, 2007, mandates that a change or projected change in the timing of lessor cash flows related to income taxes generated by leveraged lease transactions, excluding interest and penalty assessments, will require a lessor to recalculate the rate of return and allocation of income to positive investment years from inception of the lease. Upon adoption of FSP FAS 13-2 on January 1, 2007, the Bancorp recorded a \$96 million after-tax charge to retained earnings related to its portfolio of leveraged leases. The amount of this reduction will be recognized as income over the remaining term of the affected leases. During the first quarter of 2007, the Bancorp made deposits of \$386 million with the IRS to mitigate the risk associated with tax years currently under audit. These deposits enable the Bancorp to stop the accrual of interest on any tax deficiency, to the extent of the deposit, if the Bancorp is not ultimately successful.

During April 2006, the Bancorp was added as a defendant in a consolidated antitrust class action lawsuit originally filed against Visa®, MasterCard® and several other major financial institutions in the United States District Court for the Eastern District of New York. The plaintiffs, merchants operating commercial businesses throughout the U.S. and trade associations, claim that the interchange fees charged by card-issuing banks are unreasonable and seek injunctive relief and unspecified damages. As this litigation is still in its early stages, it is not possible for management to assess the probability of a material adverse outcome or the range of possible damages to the Bancorp, if any.

Several putative class action complaints have been filed against the Bancorp in various federal and state courts. The federal cases have been consolidated by the Judicial Panel on Multidistrict Litigation and are now known as *In Re TJX Security Breach Litigation*. The state court actions have been removed to federal court and have now been consolidated into that same case. The complaints relate to the alleged intrusion of The TJX Companies, Inc.'s (TJX) computer system and the potential theft of their customers' non-public information and alleged violations of the Gramm-Leach-Bliley Act. Some of the complaints were filed by consumers and seek unquantified damages on behalf of putative classes of persons who transacted business at any one of TJX's stores during the period of the alleged intrusion. Another was filed by financial institutions and seeks unquantified damages on behalf of other similarly situated entities that suffered losses in relation to the alleged intrusion. The U.S. District Court (Court) has granted the Bancorp's motion to dismiss certain of the claims, but additional claims remain pending. A proposed class action settlement funded by TJX in the consumer litigation is being reviewed by the Court. Additionally, the named plaintiffs in the financial institution litigation pending only against the Bancorp have filed a motion for class certification. That motion has been fully briefed and argued and has been taken under submission by the Court. Discovery in the financial institution matter is ongoing and is to be completed by November 30, 2007. Management believes there are substantial defenses to these claims and intends to defend them vigorously. The impact of the final disposition of these lawsuits cannot be assessed at this time.

In June 2007, Ronald A. Katz Technology Licensing, L.P. (Katz) filed a suit in the United States District Court for the Southern District of Ohio against the Bancorp and its Ohio banking subsidiary. In the suit, Katz alleges that the Bancorp and its Ohio bank are infringing on Katz's patents for interactive call processing technology by offering certain automated telephone banking and other services. This lawsuit is one of many related patent infringement suits brought by Katz in various courts against numerous other defendants. Katz is seeking unspecified monetary damages and penalties as well as injunctive relief in the suit. Management believes there are substantial defenses to these claims and intends to defend them vigorously. The impact of the final disposition of this lawsuit cannot be assessed at this time.

The Bancorp and its subsidiaries are not parties to any other material litigation. However, there are other litigation matters that arise in the normal course of business. While it is impossible to ascertain the ultimate resolution or range of financial liability with respect to these contingent matters, management believes any resulting liability from these other actions would not have a material effect upon the Bancorp's consolidated financial position or results of operations or cash flows.

Fifth Third Bancorp and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

11. Retirement and Benefit Plans

The following table summarizes the components of net periodic pension cost:

(\$ in thousands)	For the three months ended September 30,		For the nine months ended September 30,	
	2007	2006	2007	2006
Service cost	\$ 54	120	162	352
Interest cost	3,463	3,325	10,388	10,653
Expected return on assets	(4,930)	(4,890)	(14,803)	(14,410)
Amortization of actuarial loss	1,984	2,394	5,951	6,733
Amortization of unrecognized prior service cost	130	130	389	389
Settlement	5,590	8,001	5,590	8,001
Net periodic pension cost	\$ 6,291	9,080	7,677	11,718

Net periodic pension cost is recorded as a component of employee benefits in the Condensed Consolidated Statements of Income. The plan assumptions are evaluated annually and are updated as necessary. The discount rate assumption reflects the yield on a portfolio of high quality fixed-income instruments that have a similar duration to the plan's liabilities. The expected long-term rate of return assumption reflects the average return expected on the assets invested to provide for the plan's liabilities. In determining the expected long-term rate of return, the Bancorp evaluated actuarial and economic inputs, including long-term inflation rate assumptions and broad equity and bond indices long-term return projections, as well as actual long-term historical plan performance.

Based on the current year actuarial assumptions, the Bancorp did not make any cash contributions to its pension plans during the nine months ended September 30, 2007, and does not expect to contribute to the plans during the remainder of 2007. The Bancorp offers certain officers (Vice President level and above) a nonqualified deferred compensation plan. This plan allows for the deferral of base salary and/or bonus. The plan also provides for the Bancorp to make a contribution for loss of qualified plan 401(k) match and/or discretionary contributions due to deferral of pay into this plan or due to wage and/or contribution limitations under the qualified 401(k) plan. These contributions have historically been invested 100% in the Bancorp's common stock; however, beginning January 1, 2007, participants may diversify their investments into the existing 401(k) plan investment alternatives. The impact of the diversification of the nonqualified deferred compensation plan was recorded in the Bancorp's Condensed Consolidated Statements of Changes in Shareholders' Equity during the first quarter of 2007.

On December 31, 2006, the Bancorp adopted SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R). See Note 2 for further information.

12. Stock-Based Compensation

Effective January 1, 2006, the Bancorp adopted SFAS No. 123(R), Share-Based Payment. This Statement requires measurement of the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award with the cost to be recognized over the vesting period.

Stock-based compensation awards are eligible to key employees, officers and directors of the Bancorp and its subsidiaries for issuance under the Incentive Compensation Plan approved by shareholders on March 23, 2004. The Incentive Compensation Plan provides for nonqualified and incentive stock options, stock appreciation rights (SARs), restricted stock and restricted stock units, performance shares and stock awards. Stock options and SARs are issued at fair market value based on the closing price on the date of grant, have up to ten-year terms and vest and become fully exercisable either at the end of four years or ratably over four years of continued employment. Currently, all SARs outstanding are to be settled with stock. Restricted stock grants vest either after four years or ratably after three, four and five years of continued employment and include dividend and voting rights. Performance shares and stock awards have three-year cliff vesting terms with performance and market conditions as defined by the plan.

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Approximately 6.6 million SARs and 1.6 million restricted stock awards were granted during the nine months ended September 30, 2007. For the nine months ended September 30, 2006, approximately 6.9 million SARs and 1.2 million restricted stock awards were granted. The weighted-average grant-date fair values of SARs granted were \$6.24 and \$7.35 for the nine months ended September 30, 2007 and 2006, respectively. The Bancorp used the following assumptions, which are evaluated and revised as necessary, in estimating the grant-date fair value of each SAR grant for the nine months ended September 30:

	2007	2006
Expected option life (in years)	6	6
Expected volatility	22%	23%
Expected dividend yield	4.44%	4.06%
Risk-free interest rate	4.56%	4.88%

Fifth Third Bancorp and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

The expected option life is derived from historical exercise patterns and represents the amount of time that options granted are expected to be outstanding. The expected volatility is based on a combination of historical and implied volatilities of the Bancorp's stock. The expected dividend yield is based on annual dividends divided by the Bancorp's stock price. The interest rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

Stock-based compensation expense was \$12 million and \$17 million for the three months ended September 30, 2007 and 2006, respectively, and \$47 million and \$60 million for the nine months ended September 30, 2007 and 2006, respectively, and is included in salaries, wages and incentives expense in the Condensed Consolidated Statements of Income.

13. Accumulated Other Comprehensive Income

The Bancorp has elected to present the disclosures required by SFAS No. 130, Reporting Comprehensive Income, in the Condensed Consolidated Statements of Changes in Shareholders' Equity and in the table below. On December 31, 2006, the Bancorp adopted SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R). This statement requires companies to recognize the unamortized actuarial net gains or losses and unamortized prior service costs as components of accumulated other comprehensive income. Disclosure of the reclassification adjustments, related tax effects allocated to other comprehensive income and accumulated other comprehensive income for the nine months ended September 30 were as follows:

(\$ in millions)	Pre-Tax Activity	Tax Effect	Net Activity	Beginning Balance	Net Activity	Ending Balance
2007						
Losses on available-for-sale securities	\$ (33)	12	(21)			
Reclassification adjustment for net gains recognized in net income	(14)	5	(9)			
Unrecognized losses on available-for-sale securities	(47)	17	(30)	\$ (119)	(30)	(149)
Gains on cash flow hedge derivatives	12	(4)	8			
Reclassification adjustment for net gains on cash flow hedge derivatives recognized in net income	(1)		(1)			
Unrecognized gains (losses) on cash flow hedge derivatives	11	(4)	7	(1)	7	6
Defined benefit plans:						
Net prior service cost						
Net actuarial loss	6	(2)	4			
Total defined benefit plans	6	(2)	4	(59)	4	(55)
Total other comprehensive income	\$ (30)	11	(19)			
Total accumulated other comprehensive income				\$ (179)	(19)	(198)
2006						
Gains on available-for-sale securities	\$ 54	(19)	35			
Reclassification adjustment for net gains recognized in net income	(34)	12	(22)			
Unrecognized gains (losses) on available-for-sale securities	20	(7)	13	\$ (395)	13	(382)
	13	(5)	8			

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Reclassification adjustment for net losses on cash flow hedge
derivatives recognized in net income

Unrecognized gains (losses) on cash flow hedge derivatives		(13)	8	(5)
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Change in minimum pension liability		(5)		(5)
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Total other comprehensive income	\$ 33	(12)	21	
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Total accumulated other comprehensive income		\$ (413)	21	(392)
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Fifth Third Bancorp and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

14. Earnings Per Share

The calculation of earnings per share and the reconciliation of earnings per share and earnings per diluted share were as follows:

For the three months ended September 30:	2007			2006			
	(in millions except per share data)	Income	Average Shares	Per Share Amount	Income	Average Shares	Per Share Amount
Earnings per share:							
Net income	\$ 325				\$ 377		
Net income available to common shareholders (a)	\$ 325	530	\$ 0.61	\$ 377	556	\$ 0.68	
Earnings per diluted share:							
Net income available to common shareholders	\$ 325	530	\$ 0.61	\$ 377	556	\$ 0.68	
Effect of dilutive securities:							
Stock based awards		2			2		
Convertible preferred stock (b)							
Net income available to common shareholders plus assumed conversions	\$ 325	532	\$ 0.61	\$ 377	558	\$ 0.68	

(a) Dividends on preferred stock are \$.185 million for the three months ended September 30, 2007 and 2006.

(b) The additive effect to income from dividends on convertible preferred stock is \$.145 million and the average share dilutive effect from convertible preferred stock is .308 million shares for the three months ended September 30, 2007 and 2006.

For the nine months ended September 30:	2007			2006			
	(in millions except per share data)	Income	Average Shares	Per Share Amount	Income	Average Shares	Per Share Amount
Earnings per share:							
Net income before cumulative effect	\$ 1,059				\$ 1,119		
Net income available to common shareholders before cumulative effect (a)	1,059	540	\$ 1.96	1,118	555	\$ 2.02	
Cumulative effect of change in accounting principle, net of tax				4			
Net income available to common shareholders (a)	\$ 1,059	540	\$ 1.96	\$ 1,122	555	\$ 2.02	
Earnings per diluted share:							
Net income available to common shareholders before cumulative effect	\$ 1,059	540	\$ 1.96	\$ 1,118	555	\$ 2.02	
Effect of dilutive securities:							
Stock based awards		3	(0.01)		2	(0.01)	
Convertible preferred stock (b)							
Income plus assumed conversions before cumulative effect	1,059	543	\$ 1.95	1,118	557	\$ 2.01	

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Cumulative effect of change in accounting principle, net of tax

4

Net income available to common shareholders plus assumed conversions	\$ 1,059	543	\$ 1.95	\$ 1,122	557	\$ 2.01
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(a) Dividends on preferred stock are \$.555 million for the nine months ended September 30, 2007 and 2006.

(b) The additive effect to income from dividends on convertible preferred stock is \$.435 million and the average share dilutive effect from convertible preferred stock is ..308 million shares for the nine months ended September 30, 2007 and 2006.

Options to purchase 37.6 million and 34.5 million shares outstanding during the three months ended September 30, 2007 and 2006, respectively, and 34.4 million and 33.3 million shares outstanding, respectively, during the nine months ended September 30, 2007 and 2006 were not included in the computation of net income per diluted share because the exercise prices of these options were greater than the average market price of the common shares and, therefore, the effect would be antidilutive.

Fifth Third Bancorp and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

15. Business Segments

The Bancorp's principal activities include Commercial Banking, Branch Banking, Consumer Lending, Investment Advisors and Processing Solutions. Commercial Banking offers banking, cash management and financial services to large and middle-market businesses, government and professional customers. Branch Banking provides a full range of deposit and loan and lease products to individuals and small businesses through retail locations. Consumer Lending includes the Bancorp's mortgage, home equity, auto and other indirect lending activities. Investment Advisors provides a full range of investment alternatives for individuals, companies and not-for-profit organizations. Processing Solutions provides electronic funds transfer, debit, credit and merchant transaction processing, operates the Jeanie[®] ATM network and provides other data processing services to affiliated and unaffiliated customers. The General Corporate and Other column includes the unallocated portion of the investment portfolio, certain non-deposit funding, unassigned equity and certain support activities and other items not attributed to the business segments.

Results of the Bancorp's business segments are presented based on its management structure and management accounting practices. The structure and accounting practices are specific to the Bancorp; therefore, the financial results of the Bancorp's business segments are not necessarily comparable with similar information for other financial institutions. The Bancorp refines its methodologies from time to time as management accounting practices are improved and businesses change. Revisions to the Bancorp's methodologies are applied on a retroactive basis. During the fourth quarter of 2006, the Bancorp changed the application of the provision for loan and lease losses to the segments to include only actual net charge-offs.

The Bancorp manages interest rate risk centrally at the corporate level by employing a funds transfer pricing (FTP) methodology. This methodology insulates the business segments from interest rate volatility, enabling them to focus on serving customers through loan originations and deposit taking. The FTP system assigns charge rates and credit rates to classes of assets and liabilities, respectively, based on expected duration and the Treasury swap curve. Matching duration, or the expected term until an instrument can be repriced, allocates interest income and interest expense to each segment so its resulting net interest income is insulated from interest rate risk. The net impact of the FTP methodology is captured in General Corporate and Other. During 2006, the Bancorp made certain changes to the average duration of indeterminate-lived deposits and corresponding changes to the FTP crediting rates assigned to those deposits. This change more closely aligns the crediting rates to the expected economic benefit while continuing to insulate the segments from interest rate volatility.

The financial results of the business segments include allocations for shared services and headquarters expenses. Even with these allocations, the financial results are not necessarily indicative of the business segments' financial condition and results of operations as if they were to exist as independent entities. Additionally, the business segments form synergies by taking advantage of cross-sell opportunities and when funding operations by accessing the capital markets as a collective unit. The financial information for each segment is reported on the basis used internally by the Bancorp's management to evaluate performance and allocate resources. The allocation has been consistently applied for all periods presented. Revenues from affiliated transactions are typically charged at rates available to and transacted with unaffiliated customers. Results of operations and selected financial information by segment for the three and nine months ended September 30, 2007 and 2006 are as follows:

Fifth Third Bancorp and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

(\$ in millions)	Commercial	Branch	Consumer	Investment	Processing Solutions	General Corporate	Eliminations	Total
	Banking	Banking	Lending	Advisors				
Three months ended September 30, 2007:								
Net interest income (a)	\$ 292	374	85	37	1	(29)		760
Provision for loan and lease losses	21	44	40	4	4	26		139
Net interest income after provision for loan and lease losses (a)	271	330	45	33	(3)	(55)		621
Noninterest income:								
Electronic payment processing	4	57			207		(15)(b)	253
Service charges on deposits	35	113		2	2	(1)		151
Investment advisory revenue	1	23		96		(2)	(23)(c)	95
Corporate banking revenue	82	3		3	1	2		91
Mortgage banking net revenue		1	24			1		26
Other noninterest income	16	25	22	1		29		93
Securities gains (losses), net						13		13
Total noninterest income	138	222	46	102	210	42	(38)	722
Noninterest expense:								
Salaries, wages and incentives	54	96	13	35	16	96		310
Employee benefits	9	23	6	6	3	20		67
Payment processing expense		2			104	(1)		105
Net occupancy expense	4	34	2	2	1	23		66
Technology and communications	1	3	1	1	7	28		41
Equipment expense	1	9			1	19		30
Other noninterest expense	122	125	38	53	101	(126)	(38)	275
Total noninterest expense	191	292	60	97	233	59	(38)	894
Income before income taxes (a)	218	260	31	38	(26)	(72)		449
Applicable income taxes (a)	57	92	11	13	(9)	(40)		124
Net income	\$ 161	168	20	25	(17)	(32)		325
Average assets	\$ 38,639	44,545	23,729	5,897	1,362	(12,041)		102,131
Three months ended September 30, 2006:								
Net interest income (a)	\$ 300	331	90	30	6	(38)		719
Provision for loan and lease losses	23	27	24	1	2	10		87
Net interest income after provision for loan and lease losses (a)	277	304	66	29	4	(48)		632
Noninterest income:								
Electronic payment processing	3	51			176	(1)	(11)(b)	218
Service charges on deposits	34	97		2	1			134
Investment advisory revenue	1	20		89		(1)	(20)(c)	89
Corporate banking revenue	73	4		1		1		79
Mortgage banking net revenue		1	35					36
Other noninterest income	10	31	15	2	5	24		87
Securities gains (losses), net					53	(34)		19

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Total noninterest income	121	204	50	94	235	(11)	(31)	662
Noninterest expense:								
Salaries, wages and incentives	49	89	16	35	14	85		288
Employee benefits	9	23	7	6	3	26		74
Payment processing expense		5			81	(2)		84
Net occupancy expense	3	30	2	2	1	25		63
Technology and communications	1	3	1	1	7	23		36
Equipment expense		8			1	23		32
Other noninterest expense	114	106	42	48	26	(115)	(31)	190
Total noninterest expense	176	264	68	92	133	65	(31)	767
Income before income taxes (a)	222	244	48	31	106	(124)		527
Applicable income taxes (a)	60	86	17	11	37	(61)		150
Net income	\$ 162	158	31	20	69	(63)		377
Average assets	\$ 35,470	43,813	22,242	5,731	1,171	(2,559)		105,868

- (a) Includes taxable-equivalent adjustments of \$6 million for the three months ended September 30, 2007 and 2006.
- (b) Electronic payment processing service revenues provided to the banking segments are eliminated in the Condensed Consolidated Statements of Income.
- (c) Revenue sharing agreements between Investment Advisors and Branch Banking are eliminated in the Condensed Consolidated Statements of Income.

Fifth Third Bancorp and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

(\$ in millions)	Commercial	Branch	Consumer	Investment	Processing Solutions	General Corporate	Eliminations	Total
	Banking	Banking	Lending	Advisors				
Nine months ended September 30, 2007:								
Net interest income (a)	\$ 876	1,103	264	111	9	(116)		2,247
Provision for loan and lease losses	63	105	93	10	16	57		344
Net interest income after provision for loan and lease losses (a)	813	998	171	101	(7)	(173)		1,903
Noninterest income:								
Electronic payment processing	10	164		1	589		(43)(b)	721
Service charges on deposits	105	304		5	5			419
Investment advisory revenue	2	69		291		(4)	(70)(c)	288
Corporate banking revenue	238	9		8	2	4		261
Mortgage banking net revenue		4	99	1		3		107
Other noninterest income	49	82	56	2	14	64		267
Securities gains (losses), net						14		14
Total noninterest income	404	632	155	308	610	81	(113)	2,077
Noninterest expense:								
Salaries, wages and incentives	160	281	42	104	46	279		912
Employee benefits	34	76	21	21	10	60		222
Payment processing expense		4			290			294
Net occupancy expense	11	101	6	7	3	71		199
Technology and communications	4	11	2	2	22	81		122
Equipment expense	2	27	1	1	3	56		90
Other noninterest expense	362	365	117	163	151	(395)	(113)	650
Total noninterest expense	573	865	189	298	525	152	(113)	2,489
Income before income taxes (a)	644	765	137	111	78	(244)		1,491
Applicable income taxes (a)	163	270	48	39	29	(117)		432
Net income	\$ 481	495	89	72	49	(127)		1,059
Average assets	\$ 37,726	44,846	23,401	5,962	1,557	(12,785)		100,707
Nine months ended September 30, 2006:								
Net interest income (a)	\$ 879	978	275	93	19	(90)		2,154
Provision for loan and lease losses	64	79	64	3	6	20		236
Net interest income after provision for loan and lease losses (a)	815	899	211	90	13	(110)		1,918
Noninterest income:								
Electronic payment processing	9	144		1	505	1	(34)(b)	626
Service charges on deposits	106	279		5	4	1		395
Investment advisory revenue	2	66		277		(3)	(66)(c)	276
Corporate banking revenue	216	12		5	1	2		236
Mortgage banking net revenue		4	120	1				125
Other noninterest income	23	78	62	2	7	70		242
Securities gains (losses), net					78	(44)		34

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Total noninterest income	356	583	182	291	595	27	(100)	1,934
Noninterest expense:								
Salaries, wages and incentives	146	266	52	106	42	263		875
Employee benefits	34	75	25	23	10	63		230
Payment processing expense		15			222	(1)		236
Net occupancy expense	10	90	6	7	2	65		180
Technology and communications	3	10	1	2	21	65		102
Equipment expense	1	24	1	1	2	57		86
Other noninterest expense	338	314	123	148	78	(353)	(100)	548
Total noninterest expense	532	794	208	287	377	159	(100)	2,257
Income before income taxes and cumulative effect (a)	639	688	185	94	231	(242)		1,595
Applicable income taxes (a)	177	243	65	33	82	(124)		476
Income before cumulative effect	462	445	120	61	149	(118)		1,119
Cumulative effect of change in accounting principle, net of tax						4		4
Net income	\$ 462	445	120	61	149	(114)		1,123
Average assets	\$ 34,659	43,151	21,973	5,437	1,284	(1,052)		105,452

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- (a) Includes taxable-equivalent adjustments of \$18 million and \$20 million for the nine months ended September 30, 2007 and 2006, respectively.
- (b) Electronic payment processing service revenues provided to the banking segments are eliminated in the Condensed Consolidated Statements of Income.
- (c) Revenue sharing agreements between Investment Advisors and Branch Banking are eliminated in the Condensed Consolidated Statements of Income.

Fifth Third Bancorp and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

16. Restatement of 2006 Consolidated Financial Statements

On May 11, 2007, the Bancorp filed an amended 2006 Form 10-K to restate the Consolidated Statements of Cash Flows for the years ended December 31, 2006, 2005 and 2004. The restatement did not affect the Bancorp's Consolidated Statements of Income, Consolidated Balance Sheets or Consolidated Statements of Changes in Shareholders' Equity for any of the affected periods. Accordingly, the Bancorp's historic revenues, net income, earnings per share, total assets and regulatory capital remained unchanged.

The restatement resulted from the misclassification of cash flows from the sale of residential mortgage loans originally held for investment, which had been inappropriately classified as operating activities, and cash flows from commercial loans originated to be sold, which had been inappropriately classified as investing activities. In accordance with Statement of Financial Accounting Standards No. 102, Statement of Cash Flows Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale, cash flows from the sale of residential mortgage loans originally held for investment should have been classified as investing activities, rather than operating activities, and cash flows from commercial loans originated to be sold should have been classified as operating activities, rather than investing activities. Accordingly, the restatement affects the classification of these activities and the subtotals of cash flows from operating and investing activities presented in the affected Consolidated Statements of Cash Flows, but it has no impact on the Net Increase (Decrease) in Total Cash and Due from Banks set forth in the Consolidated Statements of Cash Flows for any of the previously reported periods.

The accompanying Condensed Consolidated Statement of Cash Flows for the nine-month period ended September 30, 2006, which was originally reported in the Bancorp's September 30, 2006 Form 10-Q, has also been restated. The effects of the restatement are reflected in the following table:

	September 30, 2006
For the nine months ended (\$ in millions)	
Originally Reported:	
Loans originated for sale, net of repayments	\$ (5,063)
Proceeds from sales of loans held for sale	6,951
Net Cash Provided by Operating Activities	3,055
Net increase in loans and leases	(5,133)
Proceeds from sale of loans	
Net Cash Provided by (Used in) Investing Activities	(2,934)
As Restated:	
Loans originated for sale, net of repayments	\$ (6,255)
Proceeds from sales of loans held for sale	6,646
Net Cash Provided by Operating Activities	1,558
Net increase in loans and leases	(3,941)
Proceeds from sale of loans	305
Net Cash Provided by (Used in) Investing Activities	(1,437)
Difference:	
Loans originated for sale, net of repayments	\$ (1,192)
Proceeds from sales of loans held for sale	(305)
Net Cash Provided by Operating Activities	(1,497)
Net increase in loans and leases	1,192

Proceeds from sale of loans

305

Net Cash Provided by (Used in) Investing Activities

1,497

17. Bank-Owned Life Insurance

At September 30, 2007, the Bancorp's carrying value of bank-owned life insurance was \$2.0 billion. During the third quarter of 2007, the value of the separate account investments underlying a bank owned life insurance policy with a carrying value of \$682 million at September 30, 2007 declined significantly due to the disruptions in the credit markets. This policy has a stable value agreement in place that provides limited cash surrender value protection from declines in the separate account's underlying investments. The stable value agreement was amended in the third quarter to provide additional cash surrender value protection. The carrying value of the policy was reduced by \$2 million during the third quarter of 2007 to reflect a higher fee structure that would be in place during the process required to affect a surrender. As of September 30, 2007, substantially all of the cash surrender value protection afforded by the stable value agreement has been utilized and, as a result of the contractual terms on the separate account insurance policy, the crediting rate on the policy has been reduced to zero.

Fifth Third Bancorp and Subsidiaries**Notes to Condensed Consolidated Financial Statements (continued)****18. Pending Acquisitions**

In May 2007, Fifth Third Financial Corporation (Fifth Third Financial), a wholly-owned subsidiary of Fifth Third Bancorp, and R&G Financial Corporation (R&G Financial) announced that they entered into a Stock Purchase Agreement (the Agreement) pursuant to which Fifth Third Financial will acquire 100% of the outstanding stock in R&G Crown Bank, FSB (Crown) from R&G Financial. Under the Agreement, Fifth Third Financial paid \$259 million to R&G Financial and assumed \$50 million of trust preferred securities. Additionally, Fifth Third Financial paid approximately \$16 million to R-G Crown Real Estate, LLC to acquire land currently leased by Crown for certain branches. The transaction closed on November 2, 2007.

In August 2007, Fifth Third Financial and First Charter Corporation (First Charter), a full service financial institution which operates 57 branches in North Carolina and two in suburban Atlanta, announced that they entered into a definitive agreement under which Fifth Third Financial will acquire 100% of the outstanding stock in First Charter. Under the definitive agreement, Fifth Third Financial will pay \$31.00 per First Charter share, or approximately \$1.09 billion. Consideration will be paid in the form of 70% Fifth Third common stock and 30% cash. The acquisition is subject to legal and regulatory approvals and is expected to close in the first quarter of 2008.

19. Subsequent Events

In October 2007, Fifth Third Capital Trust VI (Trust VI), a wholly-owned non-consolidated subsidiary of the Bancorp, issued \$863 million of Tier 1-qualifying trust preferred securities to third party investors and invested these proceeds in junior subordinated notes (JSN VI) issued by the Bancorp. The Bancorp's obligations under the transaction documents, taken together, have the effect of providing a full and unconditional guarantee by the Bancorp, on a subordinated basis, of the payment obligations of the Trust VI. No other subsidiaries of the Bancorp are guarantors of the JSN VI. The JSN VI will mature on November 15, 2067. The JSN VI held by the Trust VI bear a fixed rate of interest of 7.25% until November 15, 2057. After November 15, 2057, the JSN VI bear interest at a variable rate of three-month LIBOR plus 3.03%. During the term of the JSN VI, the Bancorp has the right to defer interest for one or more periods not to exceed 5 years without being subject to the alternative payment mechanism, and for one or more periods not to exceed 10 years, without giving rise to an event of default.

The JSN VI may be redeemed at the option of the Bancorp on or after November 15, 2012, or in certain other limited circumstances, at a redemption price of 100% of the principal amount plus accrued but unpaid interest. All redemptions are subject to certain conditions and require approval by the Federal Reserve Board.

On October 3, 2007, Visa Inc. (Visa) announced that it had completed restructuring transactions in preparation for its initial public offering (IPO) expected to occur in the first quarter of 2008. As part of this restructuring, the Bancorp received approximately 17.5 million Class USA shares of Visa Inc. common stock. It is anticipated that a portion of these shares will be redeemed as part of the IPO with the remaining shares eventually converted to Class A shares three years after the IPO or upon settlement of certain litigation, whichever is later. Additionally, Visa is expected to apply a portion of the proceeds from the IPO to fund an escrow account to cover certain litigation judgments and settlements.

On November 7, 2007, Visa announced that a settlement had been reached with American Express (AmEx) related to AmEx's claim that Visa and its member banks had illegally blocked AmEx from the bank-issued card business in the United States. The Bancorp was not a named defendant in this lawsuit and therefore will not be directly liable for any amount of the settlement; however, in accordance with Visa's bylaws, the Bancorp and other Visa USA member banks may be required to share in certain losses incurred by Visa. The settlement is subject to certain approvals, including approval by at least two-thirds of Visa USA, Inc. voting members. Based on the announced settlement amount and the Bancorp's membership interest in Visa USA, Inc. the Bancorp recorded a liability of \$78 million as of September 30, 2007. Although the Visa by-laws could require the Bancorp to fund this amount to Visa, it is anticipated that the escrow account to be created by Visa and funded from a portion of the proceeds of the IPO will be used to settle such litigation judgments and settlements. In the event this IPO occurs, the Bancorp expects that the current liability would no longer be required and that its proceeds from the anticipated share redemption will more than offset this amount.

PART II. OTHER INFORMATION**Legal Proceedings (Item 1)**

During May 2005, the Bancorp filed suit in the United States District Court for the Southern District of Ohio related to a dispute with the Internal Revenue Service concerning the timing of deductions associated with certain leveraged lease transactions in its 1997 tax return. The Internal Revenue Service has also proposed adjustments to the tax effects of certain leveraged lease transactions in subsequent tax return years. The proposed adjustments, including penalties, relate to the Bancorp's portfolio of lease-in lease-out transactions, service contract leases and qualified technology equipment leases with both domestic and foreign municipalities. The Bancorp is challenging the Internal Revenue Service's proposed treatment of all of these leasing transactions. The Bancorp's original net investment in these leases totaled approximately \$900 million. Management continues to believe that its treatment of these leveraged leases was appropriate and in compliance with applicable tax law and regulations. While management cannot predict with certainty the result of the suit, given the tax treatment of these transactions has been challenged by the Internal Revenue Service, they believe a resolution may involve a projected change in the timing of the leveraged lease cash flows. FSP FAS 13-2, which was effective as of January 1, 2007, mandates that a change or projected change in the timing of lessor cash flows related to income taxes generated by leveraged lease transactions, excluding interest and penalty assessments, will require a lessor to recalculate the rate of return and allocation of income to positive investment years from inception of the lease. Upon adoption of FSP FAS 13-2 on January 1, 2007, the Bancorp recorded a \$96 million after-tax charge to retained earnings related to its portfolio of leveraged leases. The amount of this reduction will be recognized as income over the remaining term of the affected leases. During the first quarter of 2007, the Bancorp made deposits of \$386 million with the IRS to mitigate the risk associated with tax years currently under audit. These deposits enable the Bancorp to stop the accrual of interest on any tax deficiency, to the extent of the deposit, if the Bancorp is not ultimately successful.

During April 2006, the Bancorp was added as a defendant in a consolidated antitrust class action lawsuit originally filed against Visa®, MasterCard® and several other major financial institutions in the United States District Court for the Eastern District of New York. The plaintiffs, merchants operating commercial businesses throughout the U.S. and trade associations, claim that the interchange fees charged by card-issuing banks are unreasonable and seek injunctive relief and unspecified damages. As this litigation is still in its early stages, it is not possible for management to assess the probability of a material adverse outcome or the range of possible damages to the Bancorp, if any.

Several putative class action complaints have been filed against the Bancorp in various federal and state courts. The federal cases have been consolidated by the Judicial Panel on Multidistrict Litigation and are now known as *In Re TJX Security Breach Litigation*. The state court actions have been removed to federal court and have now been consolidated into that same case. The complaints relate to the alleged intrusion of The TJX Companies, Inc.'s (TJX) computer system and the potential theft of their customers' non-public information and alleged violations of the Gramm-Leach-Bliley Act. Some of the complaints were filed by consumers and seek unquantified damages on behalf of putative classes of persons who transacted business at any one of TJX's stores during the period of the alleged intrusion. Another was filed by financial institutions and seeks unquantified damages on behalf of other similarly situated entities that suffered losses in relation to the alleged intrusion. The U.S. District Court (Court) has granted the Bancorp's motion to dismiss certain of the claims, but additional claims remain pending. A proposed class action settlement funded by TJX in the consumer litigation is being reviewed by the Court. Additionally, the named plaintiffs in the financial institution litigation pending only against the Bancorp have filed a motion for class certification. That motion has been fully briefed and argued and has been taken under submission by the Court. Discovery in the financial institution matter is ongoing and is to be completed by November 30, 2007. Management believes there are substantial defenses to these claims and intends to defend them vigorously. The impact of the final disposition of these lawsuits cannot be assessed at this time.

In June 2007, Ronald A. Katz Technology Licensing, L.P. (Katz) filed a suit in the United States District Court for the Southern District of Ohio against the Bancorp and its Ohio banking subsidiary. In the suit, Katz alleges that the Bancorp and its Ohio bank are infringing on Katz's patents for interactive call processing technology by offering certain automated telephone banking and other services. This lawsuit is one of many related patent infringement suits brought by Katz in various courts against numerous other defendants. Katz is seeking unspecified monetary damages and penalties as well as injunctive relief in the suit. Management believes there are substantial defenses to these claims and intends to defend them vigorously. The impact of the final disposition of this lawsuit cannot be assessed at this time.

The Bancorp and its subsidiaries are not parties to any other material litigation. However, there are other litigation matters that arise in the normal course of business. While it is impossible to ascertain the ultimate resolution or range of financial liability with respect to these contingent matters, management believes any resulting liability from these other actions would not have a material effect upon the Bancorp's consolidated financial position or results of operations or cash flows.

Risk Factors (Item 1A)

There have been no material changes made during the third quarter of 2007 to the risk factors as previously disclosed in the Registrant's 2006 Form 10-K.

Unregistered Sales of Equity Securities and Use of Proceeds (Item 2)**Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

Period	Total Number of Shares Purchased (a)	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (b)
July 1, 2007 - July 31, 2007	400,818	\$ 38.67	395,900	21,711,518
August 1, 2007 - August 31, 2007	2,510,007	\$ 37.78	2,510,000	19,201,518
September 1, 2007 - September 30, 2007	1,455			19,201,518
Total	2,912,280	\$ 37.92	2,905,900	19,201,518

- (a) The Bancorp repurchased 4,918, 7 and 1,455 shares during July, August and September of 2007, respectively, in connection with various employee compensation plans. These purchases are not included in the calculation for average price paid per share and do not count against the maximum number of shares that may yet be purchased under the Board of Directors' authorization.
- (b) On May 21, 2007, the Bancorp announced that its Board of Directors had authorized management to purchase up to 30 million shares of the Bancorp's common stock through the open market or any private transaction. The timing of the purchases and the exact number of shares to be purchased depends upon market conditions. The authorization does not include specific price targets or an expiration date.

Exhibits (Item 6)

(a) List of Exhibits

- 1.1 Underwriting Agreement dated October 23, 2007 among Fifth Third Bancorp, Fifth Third Capital Trust VI and Citigroup Global Markets Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, and UBS Securities LLC, as Representatives of the Underwriters named in the Underwriting Agreement. Incorporated by reference to Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on October 29, 2007.
- 3(i) Second Amended Articles of Incorporation, as amended (Incorporated by reference to the Bancorp's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001).
- 3(ii) Code of Regulations, as amended (Incorporated by reference to the Bancorp's Quarterly Report on Form 10-Q for the quarter ended March 31, 2007).
- 4.1 Third Supplemental Indenture dated as of October 30, 2007 between Fifth Third Bancorp and Wilmington Trust Company, as trustee, to the Junior Subordinated Indenture dated as of May 20, 1997 between Fifth Third and the trustee. Incorporated by reference to Registrant's Registration Statement on Form 8-A filed with the Securities and Exchange Commission on October 31, 2007.
- 4.2 Certificate Representing \$862,510,000 of 7.25% Junior Subordinated Notes of Fifth Third Bancorp. Incorporated by reference to Registrant's Registration Statement on Form 8-A filed with the Securities and Exchange Commission on October 31, 2007.
- 4.3 Amended and Restated Declaration of Trust dated as of October 30, 2007 of Fifth Third Capital Trust VI among Fifth Third Bancorp, as Sponsor, Wilmington Trust Company, as Property Trustee and Delaware Trustee, and the Administrative Trustees named therein. Incorporated by reference to Registrant's Registration Statement on Form 8-A filed with the Securities and Exchange Commission on October 31, 2007.
- 4.4 Certificate Representing 20,000,000 7.25% Trust Preferred Securities of Fifth Third Capital Trust VI (liquidation amount \$25 per Trust Preferred Security). Incorporated by reference to Registrant's Registration Statement on Form 8-A filed with the Securities and Exchange Commission on October 31, 2007.¹
- 4.5 Certificate Representing 400 7.25% Common Securities of Fifth Third Capital Trust VI (liquidation amount \$25 per Trust Preferred Security).
- 4.6 Guarantee Agreement, dated as of October 30, 2007 between Fifth Third Bancorp, as Guarantor, and Wilmington Trust Company, as Guarantee Trustee. Incorporated by reference to Registrant's Registration Statement on Form 8-A filed with the Securities and Exchange Commission on October 31, 2007.
- 4.7 Agreement as to Expense and Liabilities, dated as of October 30, 2007 between Fifth Third Bancorp and Fifth Third Capital Trust VI.
- 12.1 Computations of Consolidated Ratios of Earnings to Fixed Charges.
- 12.2 Computations of Consolidated Ratios of Earnings to Combined Fixed Charges and Preferred Stock Dividend Requirements.
- 31(i) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by Chief Executive Officer.
- 31(ii) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by Chief Financial Officer.
- 32(i) Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 by Chief Executive Officer.
- 32(ii) Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 by Chief Financial Officer.
- 99.1 Replacement Capital Covenant of Fifth Third Bancorp dated as of October 30, 2007. Incorporated by reference to Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on October 31, 2007.

¹ Issuer also entered into an identical certificate on October 30, 2007 representing \$362,500,000 in aggregate liquidation amount of 7.25% Trust Preferred Securities of Fifth Third Capital Trust VI.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Fifth Third Bancorp
Registrant

Date: November 9, 2007

/s/ Christopher G. Marshall
Christopher G. Marshall
Executive Vice President and Chief Financial Officer