CHINA SKY ONE MEDICAL, INC.
Form 10-Q
August 09, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended: June 30, 2011

or

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

For the transition period from____________________to____________________

Commission file number:
001-34080

CHINA SKY ONE MEDICAL, INC.
(Exact name of registrant as specified in its charter)

Nevada (State or other jurisdiction of incorporation or organization)	87-0430322 (I.R.S. Employer Identification No.)
No. 2158, North Xiang An Road, Song Bei District, Harbin, People's Republic of China (Address of principal executive offices)	150028 (Zip Code)

86-451-87032617 (China)
(Registrant's telephone number, including area code)

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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a small reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer x
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ¨ No x

As of July 20, 2011, the registrant had 16,940,539 shares of common stock issued and outstanding.

QUARTERLY REPORT ON FORM 10-Q
OF CHINA SKY ONE MEDICAL, INC. AND SUBSIDIARIES
FOR THE PERIOD ENDED JUNE 30, 2011

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q (“Form 10-Q”), together with other statements and information we publicly disseminate, contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We intend such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and include this statement for purposes of complying with these safe harbor provisions.

Forward-looking statements, which are based on certain assumptions and describe our future plans, strategies and expectations, are generally identifiable by use of the words “believe,” “expect,” “intend,” “anticipate,” “estimate,” “should”, “v “could”, “may”, “plan”, “possible”, “project” or similar expressions. You should not rely on forward-looking statements since they involve known and unknown risks, uncertainties and other factors that are, in some cases, beyond our control and which could materially affect actual results, performances or achievements.

Factors that may cause actual results to differ materially from current expectations include, but are not limited to the “Risk Factors” discussed in our Annual Report on Form 10-K, for the year ended December 31, 2010. Accordingly, there is no assurance that our expectations will be realized. Except as otherwise required by the federal securities laws, we disclaim any obligations or undertaking to publicly release any updates or revisions to any forward-looking statement contained herein (or elsewhere) to reflect any change our expectations with regard thereto, or any change in events, conditions or circumstances on which any such statement is based.

The terms “the Company,” “we,” “us” and “our” refer to China Sky One Medical, Inc., together with our consolidated subsidiaries.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

China Sky One Medical, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations and Comprehensive Income
(Unaudited, $ in thousands except share and per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Revenues	$37,671	$40,760	$66,036	$69,663
Cost of Goods Sold	12,753	11,216	21,817	18,491
Gross Profit	24,918	29,544	44,219	51,172
Operating Expenses				
Depreciation and amortization	1,396	827	2,730	1,668
Research and development	5,923	5,910	10,035	9,674
Selling	8,530	7,983	14,830	13,894
General and administrative	800	1,123	1,720	2,113
Total operating expenses	16,649	15,843	29,315	27,349
Income from Operations	8,269	13,701	14,904	23,823
Other Income				
Interest income	55	30	87	59
Change in fair value of derivative warrant liability	214	2,087	1,591	7,013
Total other income	269	2,117	1,678	7,072
Net Income Before Provision for Income Tax	8,538	15,818	16,582	30,895
Provision for Income Taxes	2,436	3,576	4,357	6,065
Net Income	$6,102	$12,242	$12,225	$24,830
Basic Earnings Per Share	$0.36	$0.73	$0.72	$1.48
Basic Weighted Average Shares Outstanding	16,940,539	16,790,851	16,940,539	16,783,896
Diluted Earnings Per Share	$0.36	$0.73	$0.72	$1.47
Diluted Weighted Average Shares Outstanding	16,940,539	16,812,810	16,940,539	16,894,775
Other Comprehensive Income				
Foreign currency translation adjustment	$2,275	$535	$3,690	$556
Net Income	6,102	12,242	12,225	24,830
Comprehensive Income	$8,377	$12,777	$15,915	$25,386

See accompanying summary of accounting policies and notes to the condensed consolidated financial statements.

China Sky One Medical, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
($ in thousands, except share data)

	June 30, 2011 (Unaudited)	December 31, 2010
ASSETS		
Current Assets		
Cash and cash equivalents	$ 44,295	$ 43,124
Accounts receivable, net	21,864	20,080
Inventories	6,701	2,409
Prepaid and other current assets	22	21
Total current assets	72,882	65,634
Property and equipment, net	28,890	28,960
Intangible assets, net	26,520	23,155
Construction in progress	41	19
Land use rights, net	43,042	40,844
Land and construction deposits	20,255	13,612
Total Assets	$ 191,630	$ 172,224
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Accounts payable and accrued expenses	$ 7,430	$ 3,309
Taxes payable	4,186	3,225
Derivative warrant liability	83	1,674
Total current liabilities	11,699	8,208
Commitments and Contingencies	-	-
Stockholders' Equity		
Preferred stock ($0.001 par value, 5,000,000 shares authorized, none issued and outstanding)	-	-
Common stock ($0.001 par value, 50,000,000 shares authorized, 16,940,539 issued and outstanding)	17	17
Additional paid-in capital	39,252	39,252
Retained earnings	125,967	113,742
Accumulated other comprehensive income	14,695	11,005
Total stockholders' equity	179,931	164,016
Total Liabilities and Stockholders' Equity	$ 191,630	$ 172,224

See accompanying summary of accounting policies and notes to the condensed consolidated financial statements.

China Sky One Medical, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(Unaudited, $ in thousands)

	Six Months Ended June 30, 2011	2010
Cash flows from operating activities		
Net Income	$ 12,225	$ 24,830
Adjustments to reconcile net cash provided by (used in) operating activities:		
Depreciation and amortization	3,021	1,919
Change in fair value of derivative liability	(1,591)	(7,013)
Net change in assets and liabilities:		
Accounts receivable	(1,335)	(2,719)
Inventories	(4,196)	(3,124)
Prepaid expenses and other current assets	1	50
Accounts payable and accrued expenses	4,007	3,487
Taxes payable	882	1,838
Net cash provided by operating activities	13,014	19,268
Cash flows from investing activities		
Land and construction deposits	(6,281)	(7,316)
Purchase of property and equipment	(96)	(407)
Purchase of land use rights	(1,986)	-
Purchase of intangible assets	(4,389)	-
Purchase of construction in process	(20)	-
Net cash used in investing activities	(12,772)	(7,723)
Cash flows from financing activities		
Proceeds from warrants conversion	-	94
Net cash provided by financing activities	-	94
Effect of exchange rate changes on cash and cash equivalents	929	261
Net increase in cash and cash equivalents	1,171	11,900
Cash and cash equivalents at beginning of period	43,124	52,756
Cash and cash equivalents at end of period	$ 44,295	$ 64,656
Supplemental disclosure of cash flow information		
Interest paid	$ -	$ -
Income taxes paid	$ 3,840	$ 4,942

See accompanying summary of accounting policies and notes to the condensed consolidated financial statements.

China Sky One Medical, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(Unaudited)

1. Description of Business

China Sky One Medical, Inc. (“China Sky One” or the “Company”), a Nevada corporation, was formed on February 7, 1986, and formerly known as Comet Technologies, Inc. On July 26, 2006, the Company changed the name of the reporting company from "Comet Technologies, Inc." to "China Sky One Medical, Inc."

China Sky One is a holding company whose principal operations are conducted through its wholly-owned subsidiaries. The Company has no revenues separate from its subsidiaries, and has expenses related to its status as a public reporting company and to its ownership interest in American California Pharmaceutical Group, Inc. (“ACPG”) and Harbin Tian Di Ren Medical Science and Technology Company (“TDR”).

ACPG, the Company’s non-operating United States holding company subsidiary, was incorporated on December 16, 2003, in the State of California, under the name “QQ Group, Inc.” QQ Group, Inc. changed its name to “American California Pharmaceutical Group, Inc.” in anticipation of the stock exchange transaction with China Sky One (then known as “Comet Technologies, Inc.”) and TDR, described herein. On December 8, 2005, ACPG completed a stock exchange transaction with TDR, a People’s Republic of China (“China” or “PRC”) based operating company and TDR’s subsidiaries (the “TDR Acquisition”), each of which were fully operating companies in the PRC. Under the terms of the agreement, ACPG exchanged 100% of its issued and outstanding common stock for 100% of the capital stock of TDR and its subsidiaries, described below.

Thereafter, on May 11, 2006, ACPG entered into a Stock Exchange Agreement with the shareholders of China Sky One. The stock exchange transaction was consummated and the acquisition was completed on May 30, 2006. As a result of the transaction, the Company issued a total of 10,193,377 shares of its common voting stock to the stockholders of ACPG, in exchange for 100% of the capital stock of ACPG resulting in ACPG becoming the Company’s wholly-owned subsidiary.

TDR, formerly known as “Harbin City Tian Di Ren Medical Co.,” was originally formed in 1994 and its principal executive office is located in Harbin City of Heilongjiang Province, in the PRC. TDR was reorganized and incorporated as a limited liability company on December 29, 2000, under the “Corporation Laws and Regulations” of the PRC. At the time of the TDR Acquisition, TDR had two wholly-owned subsidiaries, Harbin First Bio-Engineering Company Limited (“First”) and Kangxi Medical Care Product Factory (“Kangxi”). In July 2006, First and Kangxi were merged, with First remaining as the surviving subsidiary of TDR. The principal activities of TDR and First are the research, manufacture and sale of over-the-counter non-prescription health care products. TDR commenced its business in the sale of branded nutritional supplements and over-the-counter pharmaceutical products in the Heilongjiang Province. TDR has subsequently evolved into an integrated manufacturer, marketer, and distributor of external use natural Chinese medicine products sold primarily to and through independent agents and China’s large pharmaceutical chains.

China Sky One Medical, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(Unaudited)

As of October 16, 2006, the Company organized Harbin Tian Qing Biotech Application Company as a wholly-owned PRC subsidiary of TDR ("Tian Qing"), to conduct research and development in the areas of tissue and stem cell banks. As of June 30, 2011, Tian Qing had insignificant operations.

On April 3, 2008, TDR completed an acquisition pursuant to an Equity Transfer Agreement dated February 22, 2008, between TDR and Heilongjiang Tianlong Pharmaceutical, Inc., a corporation with a multitude of medicines approved by the PRC's State Food and Drug Administration ("SFDA") and new medicine applications, organized under the laws of the PRC ("Tianlong"), which is in the business of manufacturing external-use pharmaceuticals. TDR previously acquired the Beijing sales office of Tianlong in mid-2006. Pursuant to the Equity Transfer Agreement, TDR acquired 100% of the issued and outstanding capital stock of Tianlong from Tianlong's sole stockholder, in consideration for an aggregate purchase price of approximately $8,300,000, consisting of (i) $8,000,000 in cash, and (ii) 23,850 shares of China Sky One (at $12 per share). The acquisition received regulatory approval and closed on April 3, 2008.

The following table summarizes the approximate estimated fair values of the assets acquired in the Tianlong acquisition.

	($ in thousands)
Property and equipment	$ 6,315
Intangible assets – SFDA licenses for drug batch numbers	1,787
Other	170
Net assets acquired	$ 8,272

On April 18, 2008, China Sky One through its subsidiary TDR consummated a share acquisition pursuant to an Equity Transfer Agreement with the shareholders of Heilongjiang Haina Pharmaceutical Inc., a corporation that had been recently organized under the laws of the PRC ("Haina"), and was licensed as a wholesaler of TCDs, bio-medicines, bio-products, medicinal devices, antibiotics and chemical medicines. At the time, Haina did not have an established sales network and was acquired for its primary asset, a Good Supply Practice (GSP) license (License No. A-HLJ03-010) issued by the Heilongjiang office of the SFDA. The SFDA had recently started issuing such licenses to resellers of medicines that maintain certain quality controls. The GSP license, which was issued as of December 21, 2006 and will expire on January 29, 2012, enabled the Company to expand its sales of medicinal products without having to go through a lengthy license application process.

The following table summarizes the approximate estimated fair values of the assets acquired in the Haina acquisition:

	($ in thousands)
Cash	$ 84
Intangible assets – Goodwill	353
Net assets acquired	$ 437

China Sky One Medical, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(Unaudited)

Pursuant to the Equity Transfer Agreement, TDR acquired 100% of the issued and outstanding capital stock of Haina from its three stockholders in consideration for payment of 3,000,000 RMB (approximately $437,000). TDR has been overseeing the operations of Haina since January of 2008 as part of its due diligence prior to closing of this acquisition.

On June 9, 2008, TDR entered into a Merger and Acquisition Agreement with Peng Lai Jin Chuang Company, a corporation organized under the laws of the PRC ("Peng Lai"), which was organized to develop, manufacture and distribute pharmaceutical, medicinal and diagnostic products in the PRC. Pursuant to the acquisition agreement, TDR acquired all of the assets of Peng Lai in consideration for an aggregate of approximately (i) $2,500,000 in cash, and (ii) 381,606 shares of the Company's common stock with a fair value of approximately $4,600,000 million (at $12 per share). The acquisition of Peng Lai closed on September 5, 2008.

The following table summarizes the approximate estimated fair values of the assets acquired in the Peng Lai acquisition.

	($ in thousands)
Property and equipment	$ 4,177
Intangible assets - SFDA licenses for drug batch numbers	2,917
Net assets acquired	$ 7,094

All of the Company's significant operations and long lived assets are located in the PRC.

On December 21, 2010, TDR, entered into an agreement with Heilongjiang Tang Wang He Forest Bureau, pursuant to which the Company acquired the rights to grow and harvest herbs and other plants on approximately 74,000 acres of forest land in the Xiao Xing'an Mountain region in Heilongjiang Province, China, for a 30-year term expiring December 20, 2040. Pursuant to the agreement, the Company may utilize the herbs and other plants it grows on the forest land as raw materials in connection with the production of the Company's products, as well as for sale to third parties. The Company's total rent for the 30-year term is approximately $36 million (RMB 240 million), which was paid in full at the time of the transaction. This new arrangement is intended to provide the Company's TCM business a hedge against fluctuations in raw material prices.

2. Summary of Significant Accounting Policies

The Company has established various accounting policies that govern the application of accounting principles generally accepted in the United States of America ("U.S."), which are utilized in the preparation of the Company's financial statements. Certain accounting policies involve significant judgments and assumptions by management that have a material impact on the carrying value of certain assets and liabilities. The judgments and assumptions used by management are based on the Company's historical experience and other factors, which are believed to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made by management, actual results could differ from these judgments and estimates, which could have a material impact on the carrying values of assets and liabilities and the results of operations.

China Sky One Medical, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(Unaudited)

Principles of Consolidation – The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, ACPG, TDR, First, Tian Qing, Tianlong, Haina and Peng Lai. All significant inter-company transactions and balances were eliminated.

These financial statements are stated in U.S. Dollars and have been prepared in accordance with accounting principles generally accepted in the United States of America. This basis of accounting differs from that used under applicable accounting requirements in the PRC. No material adjustment was required.

Management acknowledges its responsibility for the preparation of the accompanying interim consolidated financial statements, which reflect all adjustments, consisting of normal recurring adjustments, considered necessary, in its opinion, for a fair statement of its consolidated financial position and the results of its operations for the interim period presented. These consolidated financial statements should be read in conjunction with the summary of significant accounting policies and notes to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

The accompanying unaudited condensed consolidated financial statements for China Sky One Medical, Inc. and Subsidiaries have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Regulation S-X. Operating results for interim periods are not necessarily indicative of results that may be expected for the fiscal year as a whole.

Use of estimates – The preparation of these financial statements in conformity with U.S. GAAP, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the dates of the financial statements, and the reported amounts of revenues and expenses during the reported periods.

Significant estimates include values and assigned lives to acquired tangible and intangible assets, uncollectible accounts receivable, impairment testing of goodwill and other long-lived assets, the valuation allowance for income taxes, and the evaluation and estimate for contingencies. Actual results may differ from these estimates.

Earnings per share - Basic earnings per common share is computed by dividing net earnings applicable to common shareholders by the weighted-average number of common shares outstanding during the period. When applicable, diluted earnings per common share is determined using the weighted-average number of common shares outstanding during the period, adjusted for the dilutive effect of common stock equivalents, consisting of shares that might be issued upon exercise of common stock options and warrants.

China Sky One Medical, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
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Potential common shares issued are calculated using the treasury stock method, which recognizes the use of proceeds that could be obtained upon the exercise of options and warrants in computing diluted earnings per share. It assumes that such proceeds would be used to purchase common stock at the average market price of the common stock during the period.

Cash and cash equivalents – The Company considers all highly liquid instruments purchased with a maturity period of three months or less to be cash equivalents. The carrying amounts reported in the accompanying consolidated balance sheets for cash and cash equivalents approximate their fair value.

A significant amount of the Company's cash and cash equivalents are held in commercial bank checking accounts in the PRC and earn interest income (annual yield of approximately 0.36% for the year ended December 31, 2010, and approximately 0.50% for the six months ended June 30, 2011). For all the bank accounts in the PRC and in the U.S., the Company earned interest income of approximately $87,000 and $59,000 for the six months ended June 30, 2011 and 2010, respectively. Management believes it is beneficial to retain sufficient cash in checking accounts so it is readily available for working capital and general corporate purposes, and to fund potential business and asset acquisitions and other opportunities which may arise.

Accounts receivable – Accounts receivable are stated at net realizable value, net of an allowance for doubtful accounts. The allowance for estimated bad debts is based upon the periodic analysis of individual customer balances including an evaluation of days of sales outstanding, payment history, recent payment trends, and perceived credit worthiness. As of June 30, 2011 and December 31, 2010, the Company's allowance for doubtful accounts was $59,000 and zero, respectively.

Inventories – Inventories include finished goods, raw materials, freight-in, packing materials, labor, and overhead costs and are valued at the lower of cost or market using the weighted-average method. Inventories are valued using the weighted-average method. Provisions are made for slow moving, obsolete and/or damaged inventory based upon the periodic analysis of individual inventory items including an evaluation of historical usage and/or movement, age, expiration date, and general conditions. The Company recorded no inventory reserve position as of June 30, 2011 and December 31, 2010.

Property and equipment – Property and equipment are stated at historical cost less accumulated depreciation. Depreciation on property and equipment is provided using the straight-line method over the estimated useful lives of the assets. The Company uses an estimated residual value of 5% of cost, or valuation for both financial and income tax reporting purposes. The estimated lengths of the useful lives of our property and equipment are as follows:

Building and Improvements	30 years
Land use rights	30 to 50 years
Furniture and Equipment	5 to 7 years
Transportation Equipment	5 to 15 years
Machinery and Equipment	7 to 14 years

China Sky One Medical, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(Unaudited)

Expenditures for renewals and betterments are capitalized while repairs and maintenance costs are charged to the consolidated statement of operations in the year in which they were incurred. In situations where it can be clearly demonstrated that the expenditure has resulted in an increase in the future economic benefits expected to be obtained from the use of the asset, the expenditure is capitalized as an additional cost of the asset. Upon sale or disposal of an asset, the historical cost and related accumulated depreciation or amortization of such asset is removed from their respective accounts, and any gain or loss is recorded in the consolidated statements of operations.

Property and equipment are evaluated for impairment in value whenever an event or change in circumstances indicates that the carrying values may not be recoverable. If such an event or change in circumstances occurs and potential impairment is indicated because the carrying value exceeds the estimated future undiscounted cash flows of the asset, the Company will measure the impairment loss as the amount by which the carrying value of the asset exceeds its fair value. The Company did not record any impairment charges of property and equipment in the six months ended June 30, 2011 and 2010.

Construction-in-progress – Properties currently under development are accounted for as construction-in-progress. Construction-in-progress includes the acquisition and land right costs, development expenditures, professional fees, and capitalized interest costs during the period of construction.

Upon completion and readiness for use of the project, the cost of construction-in-progress is transferred as part of property and equipment. In the case of construction-in-progress, management takes into consideration the estimated cost to complete the project when making the lower of cost or market calculation.

Intangible assets – Intangible assets are accounted for in accordance with ASC topic 350, "Intangibles – Goodwill and Other." Intangible assets with finite useful lives are amortized while intangible assets with indefinite useful lives are not amortized. The Company reviews its long-lived assets and finite-lived intangible assets for impairment on at least an annual basis or whenever events or changes in circumstances indicate that the carrying amount of the assets may not be fully recoverable. To determine recoverability of its long-lived assets, the Company evaluates the probability that future undiscounted net cash flows will be less than the carrying amount of the assets. Impairment costs, if any, are measured by comparing the carrying amount of the related assets to their fair value. The Company recognizes an impairment loss based on the excess of the carrying amount of the assets over their respective fair values. Fair value is determined by the use of undiscounted future cash flows, independent appraisals or other appropriate methods. The Company did not record any impairment charges for the six months ended June 30, 2011 and 2010.

China Sky One Medical, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(Unaudited)

The Company's intangible assets consist of proprietary technologies, SFDA licenses for drug batch numbers and goodwill. Proprietary technologies are technologies that we acquired either from our business acquisitions or in the normal course of business. The SFDA licenses for drug batch numbers were acquired in connection with the Company's business acquisitions of Tianlong and Peng Lai in 2008, as well as from Heilongjiang Traditional Chinese Medical University in the first quarter of 2011. We have registered "Kang Xi" as our trademark, which is used for all of the Company's Tradition Chinese Medicine ("TCM") products. The "Kang Xi" trademark was developed internally and registered by TDR before the Company became a public company. As a result, the Company's cost basis in the trademark is nominal since such costs were previously expensed in prior periods. As of June 30, 2011, the weighted average amortization period for the Company's intangible assets is approximately 7.75 years.

Derivative warrant liability– The Class A Warrants (the "Warrants") issued in connection with our January 31, 2008 private placement include a reset provision which would be triggered if we issue common shares below the exercise price of $12.50 as defined in the Warrant Agreement. Effective January 1, 2009 the reset provision of these Warrants preclude equity accounting treatment under ASC 815 (formerly EITF 07-5). Accordingly, ASC 815-40 which was effective as of January 1, 2009, has been applied resulting in a reclassification of the Warrants as a derivative liability, measured at fair value, with changes in fair value recognized as part of other income or expense for each reporting period thereafter. The Company used the Monte Carlo valuation model to estimate the fair value of the Warrants. Significant assumptions used at June 30, 2011 include a term of approximately 2.5 years; volatility of 69.0% and a risk free interest rate of 0.69%. Changes in fair value of the Warrants are recognized within the consolidated statement of operations during each reporting period.

Foreign Currency - The Company's principal country of operations is in the PRC. The financial position and results of operations of the Company are recorded in Renminbi ("RMB") as the functional currency. The results of operations denominated in foreign currency are translated at the average rate of exchange during the reporting period. Assets and liabilities denominated in foreign currencies at the balance sheet date are translated at the market rate of exchange at that date. The registered equity capital denominated in the functional currency is translated at the historical rate of exchange at the time of the capital contribution. All translation adjustments resulting from the translation of the financial statements into U.S. Dollars are recorded as accumulated other comprehensive income, a component of stockholders' equity. At June 30, 2011 the exchange rate was 6.47 RMB to one U.S. dollar compared to 6.61 RMB to one U.S. dollar at December 31, 2010. For the six months ended June 30, 2011, the average exchange rate was 6.54 RMB to one U.S. dollar compared to 6.83 RMB to one U.S. dollar for the same period of 2010.

Revenue recognition - Revenue is recognized when the following criteria are met: (1) persuasive evidence of an arrangement exists; (2) the product has been shipped and the customer takes ownership and assumes the risk of loss; (3) the selling price is fixed or determinable; and (4) collection of the resulting receivable is reasonably assured. The Company believes that all of these criteria are satisfied upon shipment from its facilities. Historically, the Company's estimated returns, allowances and claims have been deemed immaterial. The Company's sale agreements only allow a return if the product has quality related issues. In such event, the Company accepts the return for equivalent product exchange from inventory only. The Company's revenues do not include multiple deliverable arrangements.

China Sky One Medical, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(Unaudited)

The Company occasionally applies to various government agencies for research grants. Revenue from such research grants is recognized when earned. In situations where the Company receives payment in advance for the performance of research and development services, such amounts are deferred and recognized as revenue as the related services are performed.

Research and development - Research and development expenses include the costs associated with the Company's internal research and development as well as research and development conducted by third parties. These costs primarily consist of salaries, clinical trials, outside consultants, and materials. All research and development costs are expensed as incurred.

Third-party expenses reimbursed under non-refundable research and development contracts are recorded as a reduction to research and development expense in the consolidated statement of operations.

The Company recognizes in-process research and development in accordance with ASC topic 730, "Research and Development." Assets to be used in research and development activities, specifically, compounds that have yet to receive new drug approval and would have no alternative use, should approval not be given, are immediately charged to expense when acquired. Certain assets and other technologies acquired that has foreseeable future cash flows are capitalized as intangible assets. Such intangible assets are amortized starting from the year revenue is generated and amortized over the estimated stream of revenues derived from the product sale. Should under any circumstances these capitalized intangible assets have no future benefit; the Company will record an immediate write-off for the remaining net carrying value within the consolidated statement of operations.

The Company incurred research and development expenses of approximately $5,923,000 and $5,910,000, for the three months ended June 30, 2011 and 2010, respectively, and $10,035,000 and $9,674,000, for the six months ended June 30, 2011 and 2010, respectively.

Advertising – The Company signs contracts with agents who then place its advertising in the mediums of television, radio and newspaper. Advertising expense is incurred in the period the advertisements take place. Thus, costs of advertising are expensed as incurred. Advertising costs were approximately $4,502,000 and $3,710,000 for the three months ended June 30, 2011 and 2010, respectively, and $7,496,000 and $6,396,000 for the six months ended June 30, 2011 and 2010, respectively. An immaterial amount of the Company's advertisement expenses were related to advertising production costs. Advertising costs are reported as part of selling expenses in the consolidated statements of operations.

Taxation – The Company uses the asset and liability method of accounting for deferred income taxes. The Company's provision for income taxes includes income taxes currently payable and those deferred because of temporary differences between the financial statement and tax bases of assets and liabilities. The Company records liabilities for income tax contingencies based on the Company's best estimate of the underlying exposures.

The Company periodically estimates its tax obligations using historical experience in tax jurisdictions and informed judgments. There are inherent uncertainties related to the interpretation of tax regulations in the jurisdictions in which the Company transacts business. The judgments and estimates may change based on the outcome of tax audits, as well as changes to, or further interpretations of, regulations. The Company adjusts income tax expense in the period in which these events occur.

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Provision for the PRC enterprise income tax is calculated at the prevailing rate based on the estimated assessable profits less available tax relief for losses brought forward. The Company does not accrue taxes on unremitted earnings from foreign operations as it is the Company's intention to invest these earnings in the foreign operations indefinitely.

Enterprise income tax

According to "Enterprise Income Tax and Certain Preferential Policies Notice" published by the Ministry of Finance and the National Tax Affairs Bureau, if the enterprise is authorized by the State Council as a special entity, the enterprise income tax rate is reduced to 15%. The following table sets forth the Company's income tax rate for TDR and its subsidiaries for the six months ended June 30, 2011 and 2010:

Income Tax Rate for Subsidiaries	As of June 30, 2011		2010	
TDR	15	%	15	%
First	15	%	15	%
Tianlong	15	%	15	%
Haina	25	%	25	%
Peng Lai	2% of Revenue	*	2% of Revenue	*

* Reflects a 25% tax rate on 8% of Peng Lai's revenue, regardless of its taxable income. As authorized by Peng Lai Municipal Tax Bureau, Peng Lai was not required to pay tax on the remaining 92% of revenue.

The Company's management is confident these favorable tax rates will be renewed. If the Company failed to obtain these favorable tax rates, the impact to the Company's financial results for the three or six months ended June 30, 2011 would be immaterial.

Value added tax

The Provisional Regulations of PRC Concerning Value Added Tax promulgated by the State Council came into effect on January 1, 1994. Under these regulations and the Implementing Rules of the Provisional Regulations of the PRC Concerning Value Added Tax, value added tax is imposed on goods sold in, or imported into, the PRC and on processing, repair and replacement services provided within the PRC.

Value added tax payable in the PRC is charged on an aggregated basis at a rate of 13% or 17% (depending on the type of goods involved) on the full price collected for the goods sold or, in the case of taxable services provided, at a rate of 17% on the charges for the taxable services provided, but excluding, in respect of both goods and services, any amount paid in respect of value added tax included in the price or charges, and less any deductible value added tax already paid by the taxpayer on purchases of goods and services in the same financial year.

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According to "Agriculture Product Value Added Tax Rate Adjustment and Certain Items' Value Added Tax Waiver" published by the Ministry of Finance and the National Tax Affairs Bureau, the value added tax for agriculture related products is to be taxed at 13%. Furthermore, traditional Chinese medicine and medicinal plant are by definition agriculture related products.

The Company may from time-to-time be assessed interest or penalties by major tax jurisdictions, although such assessments historically have been minimal and immaterial to the Company's financial results. The Company's policy is to recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense.

The Company files corporate income tax returns in the U.S. for China Sky One and ACPG. ACPG wholly owns 100% of TDR and subsidiaries in the PRC. China Sky One and ACPG are holding companies and do not generate business revenues and management's intent is not to distribute dividend income from TDR and subsidiaries to either China Sky One or ACPG. As such, management has established a full valuation allowance for the net operating losses incurred by China Sky One and ACPG. The Company files income tax returns in the PRC for TDR and its subsidiaries.

Comprehensive income – Comprehensive income consists of net income and other gains and losses affecting stockholders' equity that, under generally accepted accounting principles are excluded from net income. For the Company, such items consist entirely of foreign currency translation gains and losses.

Retirement benefit costs – According to the PRC regulations on pension plans, the Company contributes to a defined contribution retirement plan organized by municipal government in the province in which the Company is registered and all qualified employees as defined by statutory regulations are eligible to participate in the plan.

The Company's contributions to the pension or retirement plan are calculated at 22% of the employees' salaries above a fixed threshold amount. The employees contribute 8% to the pension plan. The Company has no other material obligations for the payment of retirement benefits beyond the annual contributions under this plan. The Company incurred costs of $58,000 and $72,000 for each of the three months ended June 30, 2011 and 2010, respectively, and $117,000 and $116,000 for the six months ended June 30, 2011 and 2010, respectively.

Fair value of financial instruments – The carrying amounts of certain financial instruments, including cash and cash equivalents, accounts receivable, other receivables, accounts payable and accrued expenses, and other payables approximate their fair values at June 30, 2011 and December 31, 2010 because of the relatively short-term maturity of these instruments. The fair value of derivative instruments is provided by an independent third party valuation expert. Certain derivatives with limited market activity are valued using externally developed models that consider unobservable market parameters.

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Recent accounting pronouncements

In June 2011, the FASB issued ASU No. 2011-05 “Presentation of Comprehensive Income.” The updated guidance requires companies to disclose the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The updated guidance does not affect how earnings per share is calculated or presented. The updated guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company is currently evaluating the impact of adoption of this accounting guidance on its financial statements.

In May 2011, the FASB issued ASU No. 2011-04 “Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.” ASU No. 2011-04 amends FASB ASC Topic 820, Fair Value Measurements and Disclosures, to establish common requirements for measuring fair value and for disclosing information about fair value measurements in accordance with GAAP and IFRSs. ASU No. 2011-04 is effective for fiscal years beginning after December 15, 2011 and for interim periods within those fiscal years. The Company is currently evaluating the impact of adoption of this accounting guidance on its financial statements.

The Financial Accounting Standards Board (“FASB”) has codified a single source of authoritative nongovernmental U.S. GAAP, the “Accounting Standards Codification” (the “Codification” or “ASC”). While the Codification does not change U.S. GAAP, it introduces a new structure that is organized in an easily accessible, user-friendly on-line research system. The Codification supersedes all existing accounting standards documents. All other accounting literature not included in the Codification will be considered non-authoritative.

In December 2010, the FASB issued new accounting guidance related to the goodwill impairment test for reporting units with zero or negative carrying values. The amendments in ASU 2010-28 modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts by requiring an entity to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more than likely than not that goodwill impairment exists, an entity should consider whether any adverse qualitative factors indicate that impairment may exist. The qualitative factors are consistent with existing guidance and examples in paragraph 350-20-35-30 which requires that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below carrying value. The new accounting guidance is to be applied prospectively for fiscal years, and interim periods within those years beginning after December 15, 2010 for public entities. The new accounting guidance did not have a material impact on the Company’s consolidated financial statements.

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In December 2010, the FASB issued new accounting guidance on business combinations (Topic 805). The amendments in ASU 2010-29 specify that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. ASU 2010-29 also expands supplemental pro forma disclosures under Topic 805 to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in reported pro forma revenue and earnings. The new accounting guidance is to be applied prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010; however, as the provision of the guidance will be applied prospectively to business combinations with an acquisition date on or after the guidance becomes effective, the impact to the Company cannot be determined until a transaction occurs. Early adoption is permitted.

We believe there is no additional new accounting guidance adopted, but not yet effective, that is relevant to the readers of our financial statements. However, there are numerous new proposals under development which, if and when enacted, may have a significant impact on our financial reporting.

3. Revenue by Product Category and Geographic Region

For the six months ended June 30, 2011 and 2010, overseas sales were approximately $2,306,000, or 3.5%, and $3,726,000, or 5.3% respectively. For the three months ended June 30, 2011 and 2010, overseas sales were approximately $1,267,000 and $2,910,000, respectively.

Our total revenues for the six month periods ended June 30, 2011 and 2010 were approximately $66,036,000 and $69,663,000, respectively. The following table sets forth our principal product categories based on application type and the approximate amount and percentage of revenue from each of such product categories, during the six months ended June 30, 2011 and 2010:

For the Six Months Ended June 30,
($ in thousands) (Unaudited)

	2011		2010		Variance
Product Category	Sales	% of Sales	Sales	% of Sales	
Ointments	$14,921	22.6 %	$19,419	27.9 %	$(4,498)
Patches	11,161	16.9 %	17,927	25.7 %	(6,766)
Wash Fluids	6,959	10.5 %	2,704	3.9 %	4,255
Sprays	6,506	9.9 %	8,124	11.7 %	(1,618)
Drops	4,189	6.3 %	4,700	6.7 %	(511)
Diagnostic Kits	5,097	7.7 %	3,778	5.4 %	1,319
Suppositories	4,496	6.8 %	3,479	5.0 %	1,017
Other	12,707	19.3 %	9,532	13.7 %	3,175
Total	$66,036	100 %	$69,663	100 %	$(3,627)

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Please refer to “Part I, Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations” for an analysis on changes in revenue by product category.

4. Concentrations of Business and Credit Risk

Substantially all of the Company's long-lived assets and business operations are located in the PRC.

The Company maintains certain bank accounts in the PRC which are not protected by FDIC insurance or other insurance. As of June 30, 2011, the Company held approximately $710,000 of cash and cash equivalent account balances within the U.S., $234,000 of which were not covered by the FDIC insurance limits. As of June 30, 2011, the Company had approximately $43,574,000 in China bank deposits, which is not insured.

A significant amount of the Company’s sales are concentrated in China. Accordingly, the Company is susceptible to fluctuations in its business caused by adverse economic conditions in China. Difficult economic conditions in other geographic areas into which the Company may expand may also adversely affect its business, operations and finances.

The Company provides credit in the normal course of business. The Company performs ongoing credit evaluations of its customers and maintains allowances for doubtful accounts based on factors surrounding the credit risk of specific customers, historical trends, and other information.

The Company does not require collateral for financial instruments subject to credit risk.

The Company is self-insured for all risks and carries no liability or property insurance coverage of any kind. The Company does not set aside any reserves for product liability risks or other potential claims. The Company’s policy is to record losses associated with its lack of insurance coverage at such time as a realized loss is incurred. Historically, the Company has not had any material losses in connection with its lack of insurance coverage and was not party to any material pending legal proceedings as of June 30, 2011. Management’s intention is to use the Company’s working capital to fund any such losses incurred due to the Company’s exposure to inadequate insurance coverage.

Payments of dividends may be subject to some restrictions due to the Company’s operating subsidiaries all being located in the PRC.

Major Customers

For the six months ended June 30, 2011, no customer accounted for 10% or more of our total revenues or accounts receivable. For the six months ended June 30, 2010, no customer accounted for 10% or more of our total revenues. At June 30, 2010, Harbin Shiji Baolong Medicine Company accounted for approximately 10% of all accounts receivable. No other customers accounted for 10% or more of our accounts receivable at June 30, 2011 and 2010.