

CHINA SKY ONE MEDICAL, INC.
Form 10-Q
May 17, 2010

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

FORM 10-Q

(Mark One)

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

For the three months ended: March 31, 2010

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)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark 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 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

Non-accelerated filer

Smaller reporting company

(Do not check if a 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

As of May 17, 2010, the registrant had 16,790,851 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 MARCH 31, 2010

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on 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”, “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 Form 10-K, as amended, for the year ended December 31, 2009. 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.

EXPLANATORY PARAGRAPH

As previously announced in a Current Report on Form 8-K (the “Form 8-K”) the Company filed with the Securities and Exchange Commission (“SEC”) on May 11, 2010, the Company’s management has determined that the Company’s previously filed financial statements for the fiscal year ended December 31, 2009, included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2009, filed with the SEC on March 16, 2010, as previously amended by the filing of a Form 10-K/A on March 17, 2010 (the “Form 10-K”), should no longer be relied upon due to an error in such financial statements with respect to the accounting for certain common stock purchase warrants the Company issued in 2008. As further disclosed in the Form 8-K, the Company’s management has determined to file an amended Form 10-K to reflect the corrections made in response to these accounting errors. The Company has not yet filed an amendment to the Form 10-K reflecting the proposed restatement with the SEC.

The December 31, 2009 financial information presented in this Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2010 (the “Form 10-Q”) gives effect to the proposed restatement and the March 2009 and 2010 financial statements have been prepared consistent with the restatement the Company intends to file with the SEC. There can be no assurance that the SEC will accept the Company’s proposed accounting treatment, or that the SEC will not have further comments on the Company’s proposed restatement, either of which could result in a restatement of the financial information set forth in this Form 10-Q.

For more information regarding the Company’s restatement of financial statements included in the Form 10-K, see the Form 8-K and Note 2 to the Company’s condensed consolidated financial statements included in Part I, Item 1 of this Form 10-Q.

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 March 31,	
	2010	2009
Revenues	\$ 28,903	\$ 24,834
Cost of Goods Sold	7,275	6,041
Gross Profit	21,628	18,793
Operating Expenses		
Depreciation and amortization	841	451
Research and development	3,764	2,413
Selling	5,911	5,967
General and administrative	990	911
Total operating expenses	11,506	9,742
Income from Operations	10,122	9,051
Other Income (Expense)		
Interest income	29	12
Change in fair value of derivative warrant liability	4,927	-
Total other income (expense)	4,956	12
Net Income Before Provision for Income Tax	15,078	9,063
Provision for Income Taxes	2,489	1,820
Net Income	\$ 12,589	\$ 7,243
Basic Earnings Per Share	\$ 0.75	\$ 0.44
Basic Weighted Average Shares Outstanding	16,776,864	16,413,920
Diluted Earnings Per Share	\$ 0.74	\$ 0.43

Diluted Weighted Average Shares Outstanding	16,955,535	16,665,221
Comprehensive Income		
Net Income	\$ 12,589	\$ 7,243
Foreign currency translation adjustment	21	117
Comprehensive Income	\$ 12,610	\$ 7,360

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)

	March 31, 2010 (Unaudited)	December 31, 2009 (Restated)
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 65,399	\$ 52,756
Accounts receivable, net	18,583	21,146
Inventories	2,223	2,413
Prepaid and other current assets	98	74
Total current assets	86,303	76,389
Property and equipment, net	15,319	15,491
Intangible assets, net	24,438	25,114
Construction in progress	12,932	12,932
Land use rights, net	4,577	4,586
Construction deposit	5,851	5,851
Total Assets	\$ 149,420	\$ 140,363
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Accounts payable and accrued expenses	\$ 5,329	\$ 4,186
Taxes payable	4,011	3,873
Derivative warrant liability	5,636	11,435
Total current liabilities	14,976	19,494
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, 16,790,851 and 16,714,267 issued and outstanding, respectively)	17	17
Additional paid-in capital	38,154	37,188
Accumulated other comprehensive income	5,900	5,879
Retained earnings	90,374	77,785
Total stockholders' equity	134,445	120,869
Total Liability and Shareholders' Equity	\$ 149,420	\$ 140,363

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)

	Three Months Ended March 31,	
	2010	2009
Cash flows from operating activities		
Net Income	\$ 12,589	\$ 7,243
Adjustments to reconcile net cash provided by operating activities		
Depreciation and amortization	944	588
Change in fair value of derivative liability	(4,927)	-
Net change in assets and liabilities		
Accounts receivable	2,563	912
Inventories	190	(857)
Prepaid expenses and other current assets	(24)	36
Accounts payable and accrued expenses	1,143	736
Taxes payable	138	(165)
Net cash provided by operating activities	12,616	8,493
Cash flows from investing activities		
Purchase of fixed assets	(77)	(66)
Purchase of intangible assets	-	(4)
Net cash used in investing activities	(77)	(70)
Cash flows from financing activities		
Proceeds from warrants conversion	94	29
Net cash provided by financing activities	94	29
Effect of exchange rate changes on cash and cash equivalents	10	48
Net increase in cash and cash equivalents	12,643	8,500
Cash and cash equivalents at beginning of period	52,756	40,288
Cash and cash equivalents at end of period	\$ 65,399	\$ 48,788
Supplemental disclosure of cash flow information		
Taxes paid	\$ 2,452	\$ 2,107

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

China Sky One Medical, Inc. and Subsidiaries
Notes to Consolidated Financial Statements

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. (“Comet”). 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 through its wholly-owned subsidiaries; it 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 City Tian Di Ren Medical Co. (“TDR”).

ACPG, our 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 Agreement 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 (the “Exchange Agreement”) with the shareholders of China Sky One. The terms of the Exchange Agreement were 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 our wholly-owned subsidiary. The transaction is treated as a reverse merger for accounting purposes.

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 by ACPG in December of 2005, TDR had two wholly-owned subsidiaries, Harbin First Bio-Engineering Company Limited (“First”) and Kangxi Medical Care Product Factory, until July, 2006, when the two were merged, with First 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 China’s various domestic pharmaceutical chain stores.

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 December 31, 2010, Tian Qing had insignificant operation.

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. Our TDR subsidiary

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.

China Sky One Medical, Inc. and Subsidiaries
Notes to Consolidated Financial Statements

1. Description of Business (Continued)

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

	(\$ in thousands)
Fixed assets	\$ 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 recently formed corporation organized under the laws of the PRC (“Haina”) licensed as a wholesaler of TCD, bio-medicines, bio-products, medicinal devices, antibiotics and chemical medicines. Haina does 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 State Food and Drug Administration (“SFDA”). The SFDA recently started issuing such licenses to resellers of medicines that maintain certain quality controls. The GSP license was issued as of December 21, 2006 and will expire on January 29, 2012 and will enable 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

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 (the “Acquisition Agreement”) with Peng Lai Jin Chuang Company, a corporation organized under the laws of the People’s Republic of China (“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) U.S.\$2.5 million in cash, and (ii) 381,606 shares of the Company’s common stock with a fair value of approximately \$4.6 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)
Fixed assets	\$ 4,177
Intangible assets - SFDA licenses for drug batch numbers	2,917

Net assets acquired	\$	7,094
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All of our significant operations and long lived assets are located in the PRC.

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China Sky One Medical, Inc. and Subsidiaries
Notes to Consolidated Financial Statements

2. Restatement

On May 7, 2010, the Company's management determined that the Company's previously filed financial statements for the fiscal year ended December 31, 2009, included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009, filed with the SEC on March 16, 2010, as previously amended by the filing of a Form 10-K/A on March 17, 2010 (the "Form 10-K"), should no longer be relied upon due to an error in such financial statements with respect to the accounting for certain derivative instruments (warrants it issued in 2008 discussed below), which were previously recorded as equity instruments in accordance with generally accepted accounting principles in effect through December 31, 2008. Management concluded that the historical financial statements in the Original Form 10-K require restatement to properly record 750,000 common stock purchase warrants, issued in connection with its January 31, 2008 private placement (the "Class A Warrants"), as a derivative liability.

The Company has performed a complete assessment of the Class A Warrants and has concluded that the Class A Warrants are within the scope of Accounting Standards Codification 815-40, "Derivatives and Hedging – Contracts in Entity's Own Equity" ("ASC 815-40"), formerly Emerging Issues Task Force Issue No. 07-05, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock" ("EITF 07-05"), due to the inclusion in the Class A Warrants of a provision requiring a weighted average adjustment to the exercise price of the Class A Warrants in the event the Company issues common stock, or securities convertible into or exercisable for common stock, at a price per share lower than such exercise price. Accordingly, ASC 815-40, formerly EITF 07-05, which was effective as of January 1, 2009, should have been applied resulting in a reclassification of the warrants as a liability, measured at fair value, with changes in fair value recognized as part of other income or expense in the Company's Consolidated Statements of Operations for each reporting period thereafter.

The Company previously recorded a derivative liability of approximately \$1.3 million in connection with registration rights obligations with respect to the securities under the Company's January 31, 2008 private placement. Also, on May 7, 2010, the Company determined that, because the obligations do not require a cash settlement and the Class A Warrants can be settled in unregistered shares, paragraphs 14-18 of EITF 00-19 do not apply to the registration rights obligation. As a result, no liability is required to be recorded with respect to this obligation and the Company is recharacterizing the \$1.3 million liability previously recorded as of December 31, 2009.

After discussions with the Audit Committee of its Board of Directors and the Company's independent registered public accounting firm, management has determined to file an amended Form 10-K to reflect the corrections made in response to these accounting errors. The correction of the errors impacts the Company's Consolidated Statements of Operations, Consolidated Balance Sheets and Consolidated Statements of Stockholders' Equity but has no impact on the Company's income from operations or Consolidated Statement of Cash Flows. Additionally, the Company determined that the application of ASC 815-40 did not have a material impact on its financial statements for the quarterly periods ended March 31, 2009, June 30, 2009 and September 30, 2009.

The Company has not yet filed an amendment to the Form 10-K reflecting the proposed restatement with the SEC.

3. Summary of Significant Accounting Policies

We have 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 our 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 our 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.

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.

China Sky One Medical, Inc. and Subsidiaries
Notes to Consolidated Financial Statements

3. Summary of Significant Accounting Policies (Continued)

Certain items in our 2009 restated financial statements (see Note 2) have been reclassified to conform with the 2010 financial statements presentation.

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 Form 10-K annual report for the year ended December 31, 2009.

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.

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 our 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, 2009). For all the bank accounts in the PRC and in the U.S., the Company earned interest income of approximately \$29,000 and \$12,000 for the three months ended March 31, 2010 and 2009, respectively.

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 March 31, 2010 and December 31, 2009, the Company’s allowance for doubtful accounts was \$56,000.

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 first-in, first-out method. Inventory units 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 March 31, 2010 and December 31, 2009.

China Sky One Medical, Inc. and Subsidiaries
Notes to Consolidated Financial Statements

3. Summary of Significant Accounting Policies (Continued)

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	50 years
Furniture & Equipment	5 to 7 years
Transportation Equipment	5 to 15 years
Machinery and Equipment	7 to 14 years

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 three months ended March 31, 2010 and 2009.

Construction-in-progress – Properties currently under development are accounted for as construction-in-progress. Construction-in-progress includes the acquisition and land right cost, 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 approximate methods. The Company did not record any impairment charges for the three months ended March 31, 2010 and 2009.

Our intangible assets consist of proprietary technologies, SFDA licenses for drug batch numbers, and goodwill. Proprietary technologies are technologies that we own. The SFDA licenses for drug batch numbers and goodwill were acquired in the business acquisitions of Tianlong, Peng Lai and Haina. 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. The Company’s cost basis in the trademark is nominal. Therefore, the Company did not have its “Kang Xi” trademark appraised, or recorded an intangible asset for it. Additionally, none of the costs associated with the trademark have been capitalized. As of March 31, 2010, the weighted average amortization period for our intangible assets is approximately 8 years.

China Sky One Medical, Inc. and Subsidiaries
Notes to Consolidated Financial Statements

3. Summary of Significant Accounting Policies (Continued)

Derivative Instruments – The Class A Warrants (“the Warrants”) issued under our January 31, 2008 private placement memorandum include a reset provision triggered if the Company issues common shares below the exercise price of \$12.50 as defined under the Warrant Agreement. Effective January 1, 2009 the reset provision of these warrants preclude equity accounting treatment under ASC 815 (formerly EITF 07-05). Accordingly, effective January 1, 2009, the Company is required to reclassify the Warrants at their fair value to liabilities each reporting period under ASC 815-40. At March 31, 2010, the fair value of the Company’s derivative warrants liability was \$5,636,000. The Company used the Monte Carlo valuation model to estimate the fair value of the Warrants. Significant assumptions used at March 31, 2010 include a term of approximately 3.7 years; volatility of 74.0% and a risk free interest rate of 1.94%. Changes in fair value of these warrants are recognized in earnings 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.

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.

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 \$3,764,000 and \$2,413,000, for the three months ended March 31, 2010 and 2009, respectively.

China Sky One Medical, Inc. and Subsidiaries
Notes to Consolidated Financial Statements

3. Summary of Significant Accounting Policies (Continued)

Advertising – The Company signs contracts with agents who then place its advertising in the mediums of television, radio and internet. Advertising expense is incurred in the period the advertisements take place. Thus, costs of advertising are expensed as incurred. Advertising costs for the three months ended March 31, 2010 and 2009 were approximately \$2,686,000 and \$2,776,000, 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 our 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.

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 three months ended March 31, 2010 and 2009:

Income Tax Rate for Subsidiaries	As of March 31,	
	2010	2009
TDR	15%	15%
First	15%	15%
Tianlong	15%	15%
Haina	25%	25%
Peng Lai	2% of Revenue	